Anderson Kill & Olick, P.C.

BANKRUPTCY & RESTRUCTURING ADVISOR

www.andersonkill.com Spring 2004

The Solvent Debtor's Obligation to Pay Post-Petition Interest

By Mark Silverschotz and John Scott

As most creditors know all too well, ordinarily, unsecured creditors cannot recover interest on their claims accruing after a debtor files a bankruptcy petition because claims for post-petition interest generally are "disallowed." However, post-petition interest *will* be awarded when the debtor is solvent.

This concept is self evident as an equitable proposition, but its application has caused courts, creditors and practitioners to stumble when considering the *rate* at which such interest is to be paid. Several distinct analytical approaches—unsurprisingly—have produced different results. This article will address the different schools of thought.

The "Best Interests Test"

One statutory basis commonly asserted for imposing post-petition interest on both solvent chapter 7 and chapter 11 debtors is section 726(a)(5) which mandates that before funds are returned to the debtor, unsecured creditors are to receive "payment of interest at *the legal rate* from the date of the filing of the petition . . .". 11 U.S.C. § 726(a)(5). Courts have found an award of post-petition interest to a chapter 11 debtor's unsecured creditors appropriate pursuant to section 1129's "best interest of creditors" test, which requires that "each holder of a claim or interest . . . receive or retain . . . property of a value . . . that is not less than the amount such holder would so receive under chapter 7 . . .". 11 U.S.C. § 1129(a)(7)(A)(ii); *Kitrosser v. CIT Group/Factoring, Inc.*, 177 B.R. 458, 469 (S.D.N.Y 1995). Thus, if a chapter 11 estate has sufficient assets to pay all debts plus pay post-petition interest,

"The Solvent Debtor's Obligation..." continued p2

Howard D. Ressler

A Note from the Editor

As editor of the newsletter, my goal is to provide information on topics that will be useful to our readers in cases or situations they may be required to confront. Our articles provide insights that AKO attorneys have developed from their own experience in complex transactions. I hope you will find them both interesting and helpful. As always, my colleagues and I in AKO's Bankruptcy and Reorganization Group would be pleased to respond to any comments you might have about either article.

Buying Trouble or Insuring Against It?

What Does It Mean to Buy a Debtor's Assets "Free and Clear"?

By Larry D. Henin and Andrea Pincus

Anderson Kill regularly represents debtors or purchasers in asset sales pursuant to Section 363 of the Bankruptcy Code and recently completed more than a dozen such sales on behalf of the debtors in the Standard Automotive bankruptcy case in the Southern District of New York.

Section 363 of the Bankruptcy Code permits debtors to sell their property outside of a plan of reorganization and often on an expedited basis, "free and clear" of any "interest" in such property. This article deals with one of the issues most regularly confronted in connection with such sales—the interpretation of the phrase "free and clear" in section 363 of the Code as it relates to successor liability claims.

Buyers of assets under Section 363 are usually motivated by the belief that they are obtaining the assets "free and clear" of all liens, encumbrances, interests, and claims, including successor liability claims. While certain Courts have adopted a narrow definition of "free and clear" that may well subject unwary purchasers to successor liability claims, a recent decision from the Third Circuit Court of Appeals, United States v. Knox-Schillinger (In re Trans World Airlines Inc.) ("TWA"), 322 F.3d 283 (3d Cir. 2003), may have changed that landscape. In TWA, the Court held that a debtor can sell its assets free and clear of successor liability claims when selling assets of an ongoing business under Section 363.

The claims at issue in TWA, arising out of the sale of substantially all of the assets of TWA to American Airlines, involved violations of several federal employment discrimination statutes by TWA. The claimants contended that the bankruptcy court

"Buying Trouble..." continued p2

"Buying Trouble..." continued from p1

had no ability to preclude them from asserting their federally mandated successor liability claims against the purchaser. The Third Circuit disagreed on two separate and independent grounds.

The Court first determined that the phrase "interest in such property" should be construed broadly to include interests that could otherwise travel with the property being sold, even if the asserted interest is a general unsecured claim. The Court concluded that claims arising out of violations of federal employment discrimination statutes were "interests in such property" because the assets of the debtor gave rise to the claims. In other words, had the debtor not invested in airline assets which required the employment of individuals, the successor liability claims would not have arisen. Therefore, the transfer of the assets to the purchaser was free and clear of such interests. In reaching this conclusion, the Court drew on the broad interpretation by numerous bankruptcy courts of the term "interest in such property" to include a wide variety of interests, including successor liability claims, and rejected the holding of other Circuit Courts that "interests" should be limited to direct tangible property interests such as liens and encumbrances.

Secondly, the Third Circuit ruled that even if the successor liability claims were not construed to be an "interest in such property", the priority scheme of the Bankruptcy Code supported transferring the assets to the purchaser free and clear of such claims. The Third Circuit adopted the same logic used by many bankruptcy courts, opining that elevating successor liability claims above those of other creditors would be patently inconsistent with the distribution and priority scheme of the Bankruptcy Code. As the Court explained, as holders of successor liability claims merely hold general unsecured claims against the debtor, it would be inconsistent with the Bankruptcy Code's distribution and priority scheme to allow them to assert their claims against the purchaser while, at the same time, precluding other creditors from doing so.

Prior to the TWA decision, a number of bankruptcy courts shared the view that the threat of successor liability claims and their likely negative impact on the value and purchase price of a debtor's

"Buying Trouble..." continued p3

"The Solvent Debtor's Obligation..." continued from p1

section 1129 of the Bankruptcy Code requires that, under a plan, creditors receive "not less than" the post-petition interest those creditors would receive under section 726(a)(5).

Courts have developed several theories for determining what "the legal rate" means. However, our view is that the case law fails to adequately address the issue of whether this statute's legislative history clearly manifests an intention to do away with (or "abrogate," in legal parlance) the prior "common law" practice which generally awarded *contract-rate* post-petition interest.

The Federal Judgment Rate Approach

Some courts have held the "legal rate" to mean the "federal judgment rate" established by 28 U.S.C. § 1961(a), providing interest "at a rate equal to the weekly average 1-year constant maturity Treasury yield . . .".

Courts applying the "federal judgement rate" approach rationalize its application using several factors, including the practicality and effectiveness that supposedly results from the use of a "single" federal judgment rate. As the Ninth Circuit found in *In re Beguelin*, 220 B.R. 94 (9th Cir. B.A.P. 1998), "[u]se of the federal judgment rate for all creditors in a case provides bankruptcy trustees with an efficient and inexpensive means of calculating the amount of interest to be paid to each creditor . . . ". *Id*. at 101.

Courts have also found that a single interest rate promotes fairness and predictability in the distribution of post-petition interest, and utilizes federal law to decide what they assert is a federal issue. *In re Ogle*, 261 B.R. 22, 30-31 (Bankr. D. Idaho 2001) ("To promote equitable treatment of all unsecured claims, as well as predictability and practicality . . . the federal post-judgment interest rate should apply . . .".).

Moreover, some courts have concluded that the drafters' choice of the definite article "the" rather than an indefinite article such as "a" or "an" suggests that Congress intended that a single interest rate be used, as opposed to multiple rates of interest, "which would necessarily result if a contractual rate of interest were applied. *In re Country Manor of Kenton, Inc.*, 254 B.R. 179, 183 (Bankr. N.D. Ohio 2000) (applying the federal judgment rate approach).

We also note that the only federal court of appeals to address the issue has adopted the "federal judgment rate" approach. *In re Cardelucci*, 285 F.3d 1231 (9th Cir. 2002).

The State Law Approach

The application of the federal judgment rate, however, by no means has been universal. Many courts have rejected the approach of exalting mere uniformity as the touchstone of fairness. Under the state law approach, "the legal rate" is interpreted as "the applicable lawful rate," with post-petition interest awarded at the contract rate if a contract exists between the debtor and creditor. *In re Schoenenberg*, 156 B.R. 963, 972 (Bankr. W.D. Tex. 1993); *In re Carter*, 220 B.R. 411, 415 (Bankr. D.N.M. 1998). Courts taking this approach have noted the potential windfall for the debtor if the federal judgment rate is applied, and have validated the creditor's right to receive the benefit of its bargain with the debtor.

Federal Common Law

Courts have recognized that a prior judicial practice applying a particular legal standard may manifest "federal common law," and Congress' intent to "abrogate" the federal common law must be clearly expressed. In the interest rate context, the question arises whether the meaning of "the legal rate" as contained in section 726(a)(5) is sufficiently explicated by the legislative history so as to indicate Congressional intent to reverse the prior practice of paying interest at the

"The Solvent Debtor's Obligation..." continued p4

Mark D. Silverschotz is a shareholder in the New York office of Anderson Kill & Olick, P.C., and a senior member of the Bankruptcy & Restructuring Group. He has extensive bankruptcy and reorganization experience. Mark can be reached at (212) 278-1870 or msilverschotz@andersonkill.com.

John Scott is an attorney in the New York office of Anderson Kill & Olick, P.C., and a member of the Bankruptcy & Restructuring Group. His practice includes representing both debtors and creditors in all aspects of Chapter 11 bankruptcy cases. John can be reached at (212) 278-1473 or jscott@andersonkill.com.

Larry D. Henin is a shareholder in the New York office of Anderson Kill & Olick, P.C., and a senior member of the Bankruptcy and Restructuring Practice Group. He has more than 20 years of bankruptcy experience. Larry can be reached at (212) 278-1569 or lhenin@andersonkill.com.

Andrea J. Pincus is a shareholder in the New York office of Anderson Kill & Olick, P.C., and a senior member and Deputy Chair of the Bankruptcy and Restructuring Group. Her experience includes all aspects of Chapter 11 cases as well as workouts involving private and publicly held companies. Andrea can be reached at (212) 278-1793 or apincus@andersonkill.com.

"Buying Trouble..." continued from p2

assets is antithetical to the goals of the Bankruptcy Code, namely, to maximize the value of troubled assets for the benefit of all creditors. As a general rule, buyers of corporate assets -- outside the bankruptcy arena -- only incur such liabilities as they contractually assume. Nevertheless, buyers of assets outside of bankruptcy often are saddled with successor liability arising out of employment and product liability claims by virtue of common law and various federal statutes. The possibility of successor liability claims against the purchaser of assets undoubtedly results in a lower purchase price since the purchaser will have to account for the potential costs of such liabilities. To avoid this result, many bankruptcy courts routinely entered sale orders declaring the debtor's assets to be sold "free and clear" of claims, including successor liability claims.

In addition, many bankruptcy courts have typically supported such comprehensive sale orders by relying on Section 105 of the Bankruptcy Code, which authorizes the bankruptcy court to issue any order "that is necessary or appropriate to carry out the provisions of the Bankruptcy Code". These courts argue that a sale order under Section 363 would be meaningless (in essence, unable to provide the estate and its creditors with the requisite value from the sale) unless the order provided that the sale was free and clear of all claims, including successor liability claims.

Until TWA, only a handful of appellate courts had addressed this issue. The Fourth Circuit has adopted the reasoning of the bankruptcy courts previously discussed. The Fifth, Sixth and Seventh Circuit Courts of Appeals adopted a more narrow and literal definition of "interest" and declined to include successor liability claims within such definition. Other Circuit Courts, including the Second Circuit, have yet to rule on this issue.

As a result of the split of authority, the location of the courthouse may very well dictate the scope and breadth of the "free and clear" language of Section 363 as it relates to successor liability claims. Nevertheless, the TWA decision is likely to give greater comfort to debtors and purchasers of assets utilizing section 363 that such assets are free and clear of claims for successor liability. ■

"The Solvent Debtor's Obligation..." continued from p3

contract rate. Even the *Cardelucci* court noted "a paucity of legislative history regarding this statutory provision." 285 F. 3d. at 1234.

The Supreme Court has held that "[w]hen Congress amends the bankruptcy laws, it does not write 'on a clean slate' . . . Furthermore, this Court has been reluctant to accept arguments that would interpret the Code, however vague the particular language under consideration might be, to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history." *Dewsnup v. Timm*, 502 U.S. 410 (1992).

Accordingly, given the "paucity" of legislative history discussing section 726(a)(5), the Supreme Court's reluctance to "effect a major" change that is not the subject of at least some discussion in the legislative history, and the presence of substantial case law under the prior Bankruptcy Act requiring solvent debtors to pay contract rate interest, one may argue that "the legal rate" means the contract rate. Such an approach is supported by such cases as *In re Realty Assocs. Sec. Corp.*, 163 F. 2d 387 (2d Cir. 1947), which held that a solvent debtor was required to pay interest to unsecured bondholders at the rate set forth in the controlling indenture.

Some Perspective

Recently, Anderson Kill & Olick litigated this issue on behalf of the Official Committee of Unsecured Creditors of Kasper A.S.L., Ltd., against the debtor's equity holders. The spread between the two interest rates derived under the two approaches was approximately 12 percentage points. Not surprisingly, with so much at stake, the parties ultimately reached a mutually satisfactory settlement. Accordingly, it remains to be seen how a New York court will decide this issue under the Bankruptcy Code. ■

Upcoming Events

June 20-23, 2004

Michael J. Venditto

Michael J. Venditto will be speaking at the 28th Annual Conference of the Institute for Professionals in Tax to be held at The Westin Bayshore Resort in Vancouver June 20-23, 2004. Mr. Venditto's topic will be: "Bankruptcies in emerging markets, true value indicators or anomalies to be discounted?"

To register for conferences, or for more information, please visit us at www.andersonkill.com.

We hope you have found this issue of the Bankrupcy & Restructuring Advisor informative. We invite you to contact the department Chair or the Editors, listed below, with your questions and/or concerns.

J. Andrew Rahl, Jr., Chair
Bankruptcy & Restructuring Practice
arahl@andersonkill.com
(212) 278-1469

Howard Ressler, Editor
Bankrutpcy & Restructuring Newsletter
hressler@andersonkill.com
(212) 278-1343

Michael Venditto, Co-Editor
Bankruptcy & Restructuring Newsletter
mvenditto@andersonkill.com
(212) 278-1462

The AKO **Bankruptcy & Restructuring Advisor** is published quarterly by Anderson Kill & Olick, P.C. to inform clients, friends, and fellow professionals of developments in bankruptcy and restructuring laws. The newsletter is available free of charge to interested parties. The articles appearing in the AKO **Bankruptcy & Restructuring Advisor** do not constitute legal advice or opinions. Legal advice and opinions are provided by the Firm only upon engagement with respect to specific factual situations.