DOES "BEST INTERESTS" TEST PROTECT THE TARDY?

By Lori Sinanyan and Bennett L. Spiegel

While chapter 11 is generally known as the reorganization chapter of the Bankruptcy Code, more recently, chapter 11 has been used as a vehicle to manage the orderly liquidation of business entities through plans of liquidation. Whether such liquidations follow sales of a debtor's assets under § 363 or monetization of assets of a debtor over time, the liquidating plan often provides for payments to the creditor body that generally follow the priority of distribution set forth in § 726.

The "best interests of creditors test," which must be met in order to confirm any chapter 11 plan, states: "[w]ith respect to each impaired class of claims or interests … (A) each holder of a claim or interest of such class … (i) has accepted the plan; or (ii) will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date." 11 U.S.C. § 1129(a)(7)(A).

Notably, in a chapter 7 case, under § 726(a), late filed priority claims receive payment before any unsecured nonpriority claims are paid, and late filed unsecured nonpriority claims will be paid before timely filed claims on account of fines, penalties, punitive damages, or interest on unsecured claims, and before the holders of equity interests receive any distribution. What happens if a claim is disallowed under § 502(b)(9) because it is tardily filed, but that same claimant would receive a distribution in a hypothetical chapter 7 liquidation of the debtor? Does that claimant have standing to assert her rights under the best interests test at plan confirmation, and if so, must the chapter 11 plan make provision for distributions on account of late filed claims? Or, is it clear that once a late filed claim is disallowed in chapter 11, the holder of that claim is not entitled to the protections of the best interests test? There is a seeming inconsistency in the case law on this issue, an inconsistency that is only highlighted when reviewing the case law under § 1129(a)(7) on payment of post-petition interest to creditors in a solvent chapter 11 case whose claims for unmatured interest would otherwise be disallowed by § 502(b)(2). Until the courts or Congress resolve this inconsistency, holders of late filed claims in chapter 11 cases may argue that they are intended beneficiaries of the protections of § 1129(a)(7) and that the chapter 11 plan must provide for them to receive distributions on account of their late filed claims at least equal to what they would receive in a liquidation under chapter 7.

In order to determine the hypothetical distribution in a liquidation for purposes of satisfying § 1129(a)(7), the question arises as to whether the Bankruptcy Court must consider the provisions of § 726(a) as they would be applied to late filed claims in a chapter 7 case or only as they would apply to the universe of claims that are then allowed in the chapter 11 case.

In that regard, § 1129(a)(7) conspicuously does not use the word "allowed" for purposes of a hypothetical liquidation analysis whereas the analogous chapters 12 and 13 provisions do. Specifically, while §§1225(a)(4) and 1325(a)(4) explicitly state that the hypothetical liquidation tests in chapters 12 and 13 are designed to protect the holder of an "allowed unsecured claim" from receiving less than she would in a liquidation, the word "allowed" does not appear in § 1129(a)(7). It is a well-settled rule of statutory construction that where Congress has used a

specific term or phrase in a code section, failure to include the same specific term or phrase elsewhere in the same statute is presumed intentional. *See*, *e.g.*, *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 537, 114 S. Ct. 1757 (1994). It might be argued, therefore, that since § 1129(a)(7) does not use the word "allowed" (unlike §§ 1225(a)(4) and 1325(a)(4)), a tardily filed claim that could otherwise be, or has been, disallowed under § 502(b)(9) should be considered when applying the best interests test in chapter 11.

Although a deadline by which to file proofs of claim in a chapter 11 case was clearly contemplated by the Bankruptcy Code as evidenced by the use of the words "timely file a proof of such creditor's claim" in § 501(c), the Bankruptcy Code did not address the "allowance" or "disallowance" of a tardily filed claim until the 1994 amendments which added § 502(b)(9). *See* BANKRUPTCY REFORM ACT OF 1994, 1994 Enacted H.R. 5116, 103 Enacted H.R. 5116, 108 Stat. 4106, § 213. Section 502(b)(9) provides, in relevant part and subject to certain exceptions, that the Bankruptcy Court shall allow a claim except to the extent that proof of such claim is not timely filed.

Notwithstanding the introduction of § 502(b)(9) in 1994, some claimants still argue that their late claims should not be disallowed. For example, in *Tribune*, the Cook County Department of Revenue argued that § 502(b)(9) makes reference to §726(a)(1) and by such reference, the Bankruptcy Code provides that tardy priority claims in chapter 11 cases should be allowed and paid before any distribution is made to general unsecured creditors. *In re Tribune*, Case No. 08-13141, Bankr. D. Del. D.I. 8061. Judge Carey disallowed the claim stating that "a limited reference to § 726 in a chapter 5 section cannot operate to broaden the reach of § 726 to other chapters." *See In re Tribune*, 506 B.R. 613, 617 (Bankr. D. Del. 2013). Additionally, in dictum, Judge Carey stated that while he opined that "the best interests of creditors test is applied in chapter 11 when considering a plan treatment of *allowed* claims," he concluded that the best interests analysis did not apply to whether a claim should be allowed under § 502(b)(9). *Id.* at 618 (emphasis added).

Similarly, in a Texas case, a claimant who filed a tardy claim which was disallowed under § 502(b)(9) filed a confirmation objection for failure to provide for the payment of a class of late claims in the plan's waterfall structure. *See In re Provident Royalties*, 2010 Bankr. LEXIS 1947, *20 (Bankr. N.D. Tex June 10, 2010). The court found that § 726(a) does not apply in chapter 11 cases and that therefore, the claimant had no claim in the bankruptcy case and thus no standing to file an objection to the plan. *Id.* at 21-22.

In contrast, Judge Walrath held in *Washington Mutual* that a plan of liquidation could not be confirmed because, among other things, it did not meet the best interests test without establishing a class of subordinated claims for late filing creditors who would receive distributions prior to unsecured creditors receiving post-petition interest in a chapter 7 liquidation. *See In re Wash. Mut., Inc.*, 442 B.R. 314, 357 (Bankr. D. Del. 2011).

In a case regarding a general unsecured claim filed after confirmation of a chapter 11 plan of a solvent debtor, Judge Cristol ordered the plan be amended and modified to allow the late filed claim. *See In re Banco Latino Int'l*, 2003 Bankr. LEXIS 2139, *29 (Bankr. S.D. Fla. Jan. 23, 2003). In this case, former directors of the debtor sought to file a late claim for indemnification against a solvent chapter 11 debtor who already had confirmed its plan. *Id.* at

*20. The directors argued that their claims should be allowed and paid as late-filed claims pursuant to § 726(a)(3). The court found that "since late-filed claims would be allowed and paid under § 726(a)(3) if this were a Chapter 7 case, the best interests test requires that they be allowed and paid in this liquidating Chapter 11 case." *Id.* at 26.

Judge Bucki analyzed the question of the allowance of a tardily filed priority claim in a chapter 11 case and the related consequences under § 1129(a)(7). *See In re Sheehan Mem'l Hosp.*, 507 B.R. 802 (Bankr. W.D.N.Y. 2014). The Court first determined that § 1129(a)(7) requires a liquidation analysis that takes into account distributions to parties as specified in § 726(a), which distribution scheme includes late filed claims. *Id.* at 803. Thus the Court reasoned, the late filed claim in the case could not be expunged but rather allowed, but only as a tardily filed claim. *Id*.

In the context of a post-confirmation claim objection, Judge Bernstein recognized that an objection to a claim's timeliness in the case of a solvent debtor would arguably circumvent the best interests test. *See In re Best Payphone, Inc.*, 523 B.R. 54, 75 (Bankr. S.D.N.Y. 2015). Judge Bernstein concluded that the best interests test would "require the solvent chapter 11 plan proponent to satisfy late claims, as the trustee would have to do in a chapter 7 case, before equity can receive or retain property." *Id.* at 75-76.

Courts considering the question of payment of post-petition interest, which is otherwise disallowed under § 502(b)(2), appear consistently to hold that interest should be paid in the plan of a solvent debtor pursuant to § 726(a)(5) as incorporated into § 1129(a)(7). *See*, *e.g.*, *In re Nortel Networks, Inc.*, 522 B.R. 491, 506 (Bankr. D. Del 2014) (in the context of approving a 9019 motion, stating that § 1129(a)(7) makes § 726(a)(5) applicable in a chapter 11 case to entitle an unsecured creditor of a solvent debtor to post-petition interest to the same extent it would in a chapter 7 context even though the general rule is disallowance of interest under § 502(b)(2)); *In re Crossroads Ford, Inc.*, 2011 Bankr. LEXIS 2186 (Bankr. Neb. June 3, 2011) (denying confirmation because the chapter 11 plan did not provide for § 726(a)(5) distribution requirement as incorporated into chapter 11 cases by the best interests test); *In re Coram Healthcare Corp*., 315 B.R. 321, 344 (Bankr. D. Del 2004) (in the context of plan confirmation, denying equity committee's objection that noteholders are not entitled to interest because unsecured creditors of a solvent chapter 11 debtor would be paid interest under § 726).

Indeed, Judge Carey, in another opinion in *In re Tribune*, citing to § 726(a)(5), stated that "[i]n a chapter 7 liquidation, where the debtor is solvent, a creditor must receive post-petition interest on its claim before shareholders receive any distribution. Therefore, to meet the best interests of creditors test in § 1129(a)(7), the non-consenting impaired creditors must get interest on their claims before shareholders receive any recovery." *See In re Tribune*, 464 B.R. 126, 211 at n. 92 (Bankr. D. Del. 2011) (internal citations omitted).

Thus, we are left with the following questions – In the context of a liquidating chapter 11 plan where there is a waterfall of recovery that otherwise generally follows the priorities of § 726, or for that matter, in any chapter 11 plan, does § 1129(a)(7) require that the plan provide for the payment of late-filed claims at least to the extent that they would be paid in a chapter 7 liquidation? If the answer is "no" then, is § 1129(a)(7) truly assuring that parties in interest will receive under the plan at least as much as they would receive in a chapter 7 liquidation of the

debtor? If the answer is "yes", then how is that reconciled with the disallowance of late filed claims under § 502(b)(9)? At the moment, the case law on this issue is both sparse and inconsistent. Until this inconsistency is resolved, perhaps by following the line of cases interpreting §§ 502(b)(2) and 726(a)(5) in an analogous context, the holders of late filed claims in chapter 11 cases may find receptivity to the argument that they are intended beneficiaries of the best interests test and thus are entitled to receive under the chapter 11 plan at least as much as they would receive in a chapter 7 liquidation, notwithstanding that their claims may have been disallowed as late-filed under § 502(b)(9).

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