TREATMENT OF BANKRUPTCY CLAIMS WITH GUARANTEES AND THE UNUSUAL (BUT QUITE INTERESTING) ISSUE CONCERNING ALLOCATION OF POSTPETITION INTEREST

*By James H. Millar**

Introduction

Bankruptcy practitioners often say they know the rule on how to treat a claim in bankruptcy when the claimant has already recovered something from a third party on account of a guarantee. The rule, they say, is that the claimant may assert its entire claim against the bankruptcy estate until it is paid in full, but it can't recover more than the full amount owed. Some will even ascribe a moniker to it: the "*Ivanhoe* rule."

In this article, we will explore the genesis of the *Ivanhoe* rule, which not surprisingly comes from a Supreme Court case from way back when,[1] and the vitality of the rule today. Given that the *Ivanhoe* rule stands as a rule of federal law, we will also discuss the permutations surrounding issues of state law. In particular, does state law always follow the *Ivanhoe* rule? What happens in a bankruptcy case if there is a conflict between state law and the Ivanhoe rule?

Finally, we'll address a specific issue concerning postpetition interest. We will consider, in situations where a guarantor pays some (but not all) of the debt owed to the creditor, whether the creditor could allocate the amount received from the guarantor to the payment of postpetition interest. If the creditor were allowed to do that allocation, it could then assert the remainder of its prepetition claim against the estate without having that claim disallowed as postpetition interest

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[1]See *Ivanhoe Building & Loan Ass'n of Newark, N.J. v. Orr*, 295 U.S. 243, 55 S. Ct. 685, 79 L. Ed. 1419 (1935).

under Section 502(b)(2) of the Bankruptcy Code.[2] As we'll see, the Fourth Circuit has addressed this issue,[3]and we'll raise some issues with its analysis and holding.

The Origins of the *Ivanhoe* Rule

In the 1935 decision *Ivanhoe Building & Loan Ass'n of Newark, N.J. v. Orr*, the United States Supreme Court addressed an issue under the old Bankruptcy Act—the predecessor to the Bankruptcy Code that controls bankruptcy proceedings today—concerning treatment of claims in bankruptcy when the claimant has an additional source of recovery outside of the bankruptcy case. In that case, the creditor held a claim against the debtor for money due on a bond, and also held a mortgage over certain real property that was owned by a non-debtor.[4] During the bankruptcy case, the creditor foreclosed on the non-debtor-owned real property and purchased it through a credit bid at the foreclosure sale.[5] The creditor then presented a claim against the debtor's estate in the amount of $10,739.94, which was the amount due on the bond after deducting $100 bid for the property at the sale.[6] The parties agreed, however, that the property was "worth" $9,000.[7]The bankruptcy referee reduced the creditor's claim by the value of the property received, thus allowing a claim for $1,739.94, and the district court and circuit court affirmed.[8]

In reversing the lower courts, the Supreme Court resolved the issue by looking to the text of the statute—again, the old

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[2]See 11 U.S.C.A. § 101 et seq. (the "Bankruptcy Code").

[3]See *In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007).

[4]*Ivanhoe Building & Loan Ass'n of Newark, N.J. v. Orr*, 295 U.S. 243, 244–45, 55 S. Ct. 685, 79 L. Ed. 1419 (1935).

[5]*Ivanhoe Building & Loan Ass'n of Newark, N.J. v. Orr*, 295 U.S. 243, 244–45, 55 S. Ct. 685, 79 L. Ed. 1419 (1935).

[6]*Ivanhoe Building & Loan Ass'n of Newark, N.J. v. Orr*, 295 U.S. 243, 245, 55 S. Ct. 685, 79 L. Ed. 1419 (1935).

[7]*Ivanhoe Building & Loan Ass'n of Newark, N.J. v. Orr*, 295 U.S. 243, 245, 55 S. Ct. 685, 79 L. Ed. 1419 (1935).

[8]*Ivanhoe Building & Loan Ass'n of Newark, N.J. v. Orr*, 295 U.S. 243, 245, 55 S. Ct. 685, 79 L. Ed. 1419 (1935).

Bankruptcy Act.[9] It concluded that the definition of a "secured creditor" encompassed only those creditors that have a security interest in the debtor's property, as opposed to another entity's property.[10] Given that the creditor in *Ivanhoe* did not have a security interest in the debtor's property, it was not a secured creditor within the definition.[11]

Next, the Court held that the provision of the Bankruptcy Act that covered allowance of secured claims required only a "secured creditor" to reduce its unsecured claim by the amount of its collateral.[12] Since the creditor in *Ivanhoe* was not a "secured creditor," the Supreme Court concluded that the creditor did not need to reduce its claim by the value of the collateral.[13] Thus, the Supreme Court held that the creditor may assert its entire unsecured claim against the debtor, but "may not collect and retain dividends which with the sum realized from the foreclosure will more than make up that amount."[14] In other words, even though a creditor may assert its full claim against the debtor, the creditor may not recover more than 100% of the amount owed.

The Court also noted how the lower court had gotten off track by resorting to a statutory section that addressed set-off.[15] That section provided that set-off was required where the debtor and the creditor held mutual debts and credits.[16] But here, the creditor did not owe the debtor anything because "[a] creditor holding security, who realizes upon it,

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[9] *Ivanhoe Building & Loan Ass'n of Newark, N.J. v. Orr*, 295 U.S. 243, 245–46, 55 S. Ct. 685, 79 L. Ed. 1419 (1935).

[10] *Ivanhoe Building & Loan Ass'n of Newark, N.J. v. Orr*, 295 U.S. 243, 245, 55 S. Ct. 685, 79 L. Ed. 1419 (1935).

[11] *Ivanhoe Building & Loan Ass'n of Newark, N.J. v. Orr*, 295 U.S. 243, 245, 55 S. Ct. 685, 79 L. Ed. 1419 (1935).

[12] *Ivanhoe Building & Loan Ass'n of Newark, N.J. v. Orr*, 295 U.S. 243, 245, 55 S. Ct. 685, 79 L. Ed. 1419 (1935).

[13] *Ivanhoe Building & Loan Ass'n of Newark, N.J. v. Orr*, 295 U.S. 243, 245–46, 55 S. Ct. 685, 79 L. Ed. 1419 (1935).

[14] *Ivanhoe Building & Loan Ass'n of Newark, N.J. v. Orr*, 295 U.S. 243, 246, 55 S. Ct. 685, 79 L. Ed. 1419 (1935).

[15] *Ivanhoe Building & Loan Ass'n of Newark, N.J. v. Orr*, 295 U.S. 243, 246, 55 S. Ct. 685, 79 L. Ed. 1419 (1935).

[16] *Ivanhoe Building & Loan Ass'n of Newark, N.J. v. Orr*, 295 U.S. 243, 246, 55 S. Ct. 685, 79 L. Ed. 1419 (1935).

does not 'owe' his debtor the amount realized."[17] Thus, set-off was not appropriate.

Let's make two related observations about the Supreme Court's *Ivanhoe* decision. First, the Court grounded its result in statutory interpretation of the old Bankruptcy Act. Second, it did not consider any underlying state law when it determined the amount of the claim that the creditor may assert. In other words, the Court did not question whether, under state law, a creditor may assert the entire amount of its claim against an obligor even after the creditor has recovered part of that claim by foreclosing on collateral. As we'll see, the Supreme Court's omission of any discussion of the underlying state law sets up an issue for later courts to consider.

A few years after *Ivanhoe*, in a railroad reorganization under section 77 of the Bankruptcy Act, the Supreme Court stated the "rule" from *Ivanhoe* as black letter law: "The rule is settled in bankruptcy proceedings that a creditor secured by the property of others need not deduct the value of that collateral or its proceeds in proving his debt."[18] Without any further discussion, the Supreme Court concluded that the *Ivanhoe* rule should apply in railroad reorganizations as well.[19]

Rolling the clock forward, the *Ivanhoe* rule was found to continue to apply in bankruptcy cases filed after the 1978 enactment of the Bankruptcy Code, even though some of the underlying statutory provisions changed.[20] In addition, courts have applied the *Ivanhoe* rule to situations other than where the creditor is secured by non-debtor property, such as a claim

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[17] *Ivanhoe Building & Loan Ass'n of Newark, N.J. v. Orr*, 295 U.S. 243, 247, 55 S. Ct. 685, 79 L. Ed. 1419 (1935).

[18] *Reconstruction Finance Corporation v. Denver & R.G.W.R. Co.*, 328 U.S. 495, 526, 329 U.S. 679, 66 S. Ct. 1384, 90 L. Ed. 1400 (1946) (emphasis added) (citing *Ivanhoe Building & Loan Ass'n of Newark, N.J. v. Orr*, 295 U.S. 243, 55 S. Ct. 685, 79 L. Ed. 1419 (1935).)

[19] *Reconstruction Finance Corporation v. Denver & R.G.W.R. Co.*, 328 U.S. 495, 526, 329 U.S. 679, 66 S. Ct. 1384, 90 L. Ed. 1400 (1946).

[20] *Matter of Campbell*, 8 B.R. 335, 337 (Bankr. S.D. Ohio 1980) ("Even though [section 506 of the Bankruptcy Code], unlike former law, distinguishes between secured and unsecured claims, rather than secured and unsecured creditors, the fundamental principles enunciated by the decision of the Supreme Court in Ivanhoe control . . .") (citation omitted). See also *In re F.W.D.C., Inc.*, 158 B.R. 523, 528 (Bankr. S.D. Fla. 1993) (concluding that the comparable portions of the Bankruptcy Act and the Bankruptcy Code "have the same effect."); *In re Johnson*, 477 B.R. 879, 882 (Bankr.

on a guarantee,[21] draws made by a creditor on a letter of credit,[22]and funds received from a litigation settlement with a third party.[23] Also, courts found that it was irrelevant whether the creditor received the funds before or after the petition date,[24]irrespective of Section 502(b) of the Bankruptcy Code, which requires that a claim be valued on the petition date.[25] In sum, the *Ivanhoe* rule remains established precedent in bankruptcy cases.

Does State Law Play a Role in the Analysis?

As noted above, the *Ivanhoe* rule results from the Supreme Court's interpretation of provisions of the old Bankruptcy Act—without regard to state law. But one might sensibly ask the questions: what does state law say about the issue of whether a claim should be reduced by money received from a third party? And, if state law is inconsistent with the *Ivanhoe* rule in a given situation, does the *Ivanhoe* rule take precedence? These are important questions because, generally speaking, state law unquestionably plays a role in claims analysis. As the Supreme Court recognized in *Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Company*, under Section 502(b)(1) of the Bankruptcy Code,

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M.D. Fla. 2012), as amended, (Feb. 17, 2012) (same, citing In re F.W.D.C., Inc.).

[21]See *In re LightSquared Inc.*, 2014 WL 5488413, at *5 (Bankr. S.D. N.Y. 2014) (applying Ivanhoe rule to guarantee situation).

[22]See *In re Stone & Webster, Incorporated*, 547 B.R. 588, 607, 75 Collier Bankr. Cas. 2d (MB) 304 (Bankr. D. Del. 2016) (holding that letter of credit proceeds are not property of the estate and, thus, unless the creditor "receives payment in full of the amount owed, the proceeds from the letters of credit will not reduce its claim.").

[23]See *In re Biovance Technologies, Inc.*, 2014 WL 2861003 (Bankr. D. Neb. 2014) (holding that creditor did not need to reduce its claim by the amount of settlement proceeds received).

[24]See *In re Stone & Webster, Incorporated*, 547 B.R. 588, 607, 75 Collier Bankr. Cas. 2d (MB) 304 (Bankr. D. Del. 2016) (holding that even though the creditor received letter of credit proceeds prepetition, the proceeds will not reduce the creditors' claim); *In re Johnson*, 477 B.R. 879, 880, (Bankr. M.D. Fla. 2012), as amended, (Feb. 17, 2012) (stating that foreclosure sale occurred prepetition but holding that creditors' claim need not be reduced by value of property received in foreclosure sale).

[25]11 U.S.C.A. § 502(b) ("[T]he court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition . . .).

"with limited exceptions, any defense to a claim that is available outside of the bankruptcy contest is also available in bankruptcy."[26] This is consistent "with the settled principle that '[c]reditors' entitlements in bankruptcy arise in the first instance from the underlying substantive law creating the debtor's obligation, subject to any qualifying or contrary provisions of the Bankruptcy Code.' "[27] Let's break down the analysis into bite-size chunks.

State laws do in fact address situations where a creditor has received money from a third party but nevertheless seeks to pursue its full claim against the obligor. As one might suppose, those laws vary state to state. As an example, New York law, which often is the state law of choice for debt obligations, guarantees and related financial instruments, provides:

> The amount or value of any consideration received by the obligee from one or more of several obligors, or from one or more of joint, or of joint and several obligors, in whole or in partial satisfaction of their obligations, **shall be credited** to the extent of the amount received on the obligations of all co-obligors to whom **the obligor or obligors giving the consideration did not stand in the relation of a surety**.[28]

In other words, under New York law, the creditor must deduct the amount received from the third party from its claim against the primary obligor unless the creditor received the funds from a "surety." Under New York common law, a surety—that is, one that has suretyship status—is "a secondary obligor [that] is bound to pay for the debt or answer for the default of the principal obligor to the obligee."[29] Thus, a guarantee gives rise to suretyship status, even where the

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[26] *Travelers Cas. and Sur. Co. of America v. Pacific Gas and Elec. Co.*, 549 U.S. 443, 450, 127 S. Ct. 1199, 167 L. Ed. 2d 178, 47 Bankr. Ct. Dec. (CRR) 265, 57 Collier Bankr. Cas. 2d (MB) 314, Bankr. L. Rep. (CCH) P 80880 (2007).

[27] *Travelers Cas. and Sur. Co. of America v. Pacific Gas and Elec. Co.*, 549 U.S. 443, 450, 127 S. Ct. 1199, 167 L. Ed. 2d 178, 47 Bankr. Ct. Dec. (CRR) 265, 57 Collier Bankr. Cas. 2d (MB) 314, Bankr. L. Rep. (CCH) P 80880 (2007) (quoting *Raleigh v. Illinois Dept. of Revenue*, 2000-2 C.B. 109, 530 U.S. 15, 20, 120 S. Ct. 1951, 147 L. Ed. 2d 13, 36 Bankr. Ct. Dec. (CRR) 39, 43 Collier Bankr. Cas. 2d (MB) 869, Bankr. L. Rep. (CCH) P 78182, 2000-1 U.S. Tax Cas. (CCH) P 50498 (2000)).

[28] N.Y. Gen. Oblig. Law § 15-103 (McKinney 2021) (emphasis added).

[29] *Chemical Bank v. Meltzer*, 93 N.Y.2d 296, 690 N.Y.S.2d 489, 712 N.E.2d 656, 660 (1999).

language of the guarantee purports to make the guarantor liable "as a primary obligor and not merely as a surety."[30] So, while New York law has a broad definition of a surety, the statute certainly contemplates situations where a creditor receives money from someone other than a surety, and in that situation the creditor must credit the amount received against its claim.

What happens, then, when state law would compel the creditor to credit the amount received against its claim, but the obligor is in bankruptcy where the *Ivanhoe* rule seemingly applies? One court has addressed that precise issue. In *In re Del Biaggio, III*, the creditor received money from a settlement with a third party, but it nevertheless asserted the full amount of its claim against the debtor.[31] Yet, under governing state law (California), the payment received by the creditor would reduce the amount of the claim that the creditor could assert against the obligor/debtor.[32] The official committee of unsecured creditors objected to the creditor's claim on the grounds that state law, rather than the *Ivanhoe* rule, should control.[33]

Judge Thomas Carlson of the United States Bankruptcy Court for the Northern District of California disagreed with the committee and held that the *Ivanhoe* rule trumped applicable state law in situations where a conflict arose.[34] He provided four reasons for his ruling:

First, "*Ivanhoe* [] chooses to value equality of treatment by the debtor's estate above equality of overall outcomes among creditors having different rights against third parties. This choice is at heart a question of federal bankruptcy law."[35] In this regard, the court thus necessarily recognized that the *Ivanhoe* rule is an exception to the general rule of *Travelers*

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[30] *Chemical Bank v. Meltzer*, 93 N.Y.2d 296, 690 N.Y.S.2d 489, 712 N.E.2d 656, 658 (1999).

[31] *In re Del Biaggio*, 496 B.R. 600, 601 (Bankr. N.D. Cal. 2012).

[32] *In re Del Biaggio*, 496 B.R. 600, 603 (Bankr. N.D. Cal. 2012) ("It is also true that California law provides that payment by a co-obligor reduces the amount of the claim the creditor can assert").

[33] *In re Del Biaggio*, 496 B.R. 600, 601 (Bankr. N.D. Cal. 2012).

[34] *In re Del Biaggio*, 496 B.R. 600, 601 (Bankr. N.D. Cal. 2012).

[35] *In re Del Biaggio*, 496 B.R. 600, 603 (Bankr. N.D. Cal. 2012).

Casualty & Surety Co. of America that state law governs the substance of claims.

Second, the court reasoned that the choice between the *Ivanhoe* rule and conflicting state law only matters "when the defendant co-obligor is in bankruptcy."[36] Where the defendant/co-obligor is solvent, both approaches yield payment in full.[37] This point is somewhat less compelling because it does not take into account situations where an insolvent company winds-up outside of bankruptcy and creditors share the available assets *pro rata* based on the size of their claim.[38]

Third, the court noted that the "California authorities" do not explain why the California approach "is to be preferred when the defendant co-obligor is insolvent and in bankruptcy."[39] Further, according to the court, the California authorities "do not even mention insolvency, and seem tacitly to assume that the defendant co-obligor will pay the full amount of any judgment entered . . ."[40] One might consider this point as further to the *Second* point in that it supports the notion that state law did not focus on situations where the defendant/co-obligor was insolvent.

Fourth, the choice between the California approach and the *Ivanhoe* rule is not based on contractual or non-contractual liability, or property rights—i.e. the areas of law that are

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[36] *In re Del Biaggio*, 496 B.R. 600, 604 (Bankr. N.D. Cal. 2012).

[37] *In re Del Biaggio*, 496 B.R. 600, 604 (Bankr. N.D. Cal. 2012).

[38] The court sought to address this point in a footnote by stating that, even where the insolvent defendant/co-obligor did not enter bankruptcy, the creditor under the California rule would likely obtain the same result as the Ivanhoe rule because it has access "to all of the defendant's non-exempt, unencumbered property until the debt was satisfied." *In re Del Biaggio*, 496 B.R. 600, 605 n.6 (Bankr. N.D. Cal. 2012) (italics in original). "If the debt was not paid in full, it would be because the defendant's assets were insufficient, not because the claim had been reduced by payments from [another party]." *In re Del Biaggio*, 496 B.R. 600, 605 n.6 (Bankr. N.D. Cal. 2012). That seems true only where the defendant/co-obligor has one significant creditor. If there are more than one significant creditor, they may well share pro rata in the defendant/co-obligors assets in proportion to their claim. In that situation, the creditor would do better if it did not have its claim reduced by the amount of payments from another party.

[39] *In re Del Biaggio*, 496 B.R. 600, 604 (Bankr. N.D. Cal. 2012).

[40] *In re Del Biaggio*, 496 B.R. 600, 604 (Bankr. N.D. Cal. 2012).

normally reserved for state law.[41] Rather, the underlying issue is resolved by reference to insolvency and bankruptcy law.[42] Thus, Congress may well have determined to retain the *Ivanhoe* rule for calculating claim amounts and dividends when it enacted the Bankruptcy Code.[43] So long as the creditor does not recovery more than 100% of its claim—which is true under the *Ivanhoe* rule—the bankruptcy court concluded that California's interest in this issue is satisfied.[44]

The Fourth Circuit is the only other court to allude to the issue, although it offered a somewhat curious approach.[45] In *Nat'l Energy & Gas Transmission, Inc.*, the creditor recovered $140 million postpetition under a guarantee provided by a non-debtor.[46](The amount received, $140 million, was the maximum amount recoverable under the guarantee by its express terms.)[47] The creditor then asserted its full claim against the debtor ($157 million), but affirmatively recognized that it could not recover more than an additional $17 million that it claimed remained outstanding.[48] The debtor objected to this claim by arguing in the first instance that the creditor's claim must be reduced by $140 million, and thus its claim should only be $17 million.[49]

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[41] *In re Del Biaggio*, 496 B.R. 600, 605 (Bankr. N.D. Cal. 2012).

[42] *In re Del Biaggio*, 496 B.R. 600, 605 (Bankr. N.D. Cal. 2012).

[43] *In re Del Biaggio*, 496 B.R. 600, 605 (Bankr. N.D. Cal. 2012).

[44] *In re Del Biaggio*, 496 B.R. 600, 605 (Bankr. N.D. Cal. 2012).

[45] See Nat'l Energy & Gas Transmission, Inc. (f/k/a PG&E Nat'l *In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007).

[46] *In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 300, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007).

[47] *In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 299, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007).

[48] *In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 300, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007).

[49] *In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 300, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007).

The Fourth Circuit ruled against the debtor on this point by relying upon both the *Ivanhoe* rule and state law.[50]

> The debtors' argument is foreclosed by the combination of *Ivanhoe* [] and New York law, which governs pursuant to the Agreement. In *Ivanhoe*, the Supreme Court held that a creditor need not deduct from his claim in bankruptcy an amount received from a non-debtor third party in partial satisfaction of an obligation. Thus, as a matter of bankruptcy law, [the debtor's] debt to [the creditor] is not reduced by the amount which [the creditor] received from [the guarantor]. However, this merely leads to the question of what the value of [the debtor's] debt is, and New York law provides the answer to this question.[51]

The Fourth Circuit went on to rule that the guarantor was a "surety" under New York law.[52] Accordingly, the creditor did not need to set off the amount of its claim by the amount received on account of the guarantee.[53] In other words, the *Ivanhoe* rule and New York law reached the same result in this situation—i.e. the creditor could submit the full amount of its claim against the debtor notwithstanding the amounts received on account of the guarantee.

The curious aspect to this decision is the Fourth Circuit's view that both federal and state law proved relevant. If state law had come out the other way—that is, if state law required the creditor to reduce its claim by the funds received on the guarantee—would the *Ivanhoe* rule have trumped the conflicting state law result? If, as some might argue, the Fourth Circuit meant to give precedence to state law, then what exactly is the purpose, in its view, of the *Ivanhoe* rule? Is the *Ivanhoe* rule simply a stopgap approach for situations when state law doesn't answer the question?

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[50] *In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 300, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007).

[51] *In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 301, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007).

[52] *In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 301, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007).

[53] *In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 301, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007).

In any event, the court did not have to grapple with these questions, as it found that both federal and state law yielded the same result. In that regard, the decision does not provide express guidance on how to address situations where a conflict might exist. Indeed, in ruling that federal law trumped conflicting state law, Judge Carlson in *In re Del Biaggio* noted that the Fourth Circuit's decision "does not suggest that state law can overcome *Ivanhoe's* determination that in bankruptcy the policy of equality of distribution from the debtor is to prevail over concern for equalizing creditor's recovery from all sources. The [Fourth Circuit] had previously held that *Ivanhoe* governed, and its discussion of state law is at most an alternative holding."[54]

So, this is where the law is at present. The *Ivanhoe* rule provides that the creditor may assert its entire unsecured claim against the debtor without deducting amounts received from third parties but may not recover more than 100% of the amount owed. That rule is consistent with the result under New York law in situations where the third party is a "surety," which includes a guarantor. This provision of New York law is quite relevant, given that New York law regularly governs funded debt and the attendant underlying documents. Finally, where a conflict between the *Ivanhoe* rule and state law might exist, the courts may very well follow *In re Del Biaggio* and conclude that the *Ivanhoe* rule takes precedence. Thus, one would need several stars to align to reach a result contrary to the *Ivanhoe* rule.[55]

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[54] *In re Del Biaggio*, 496 B.R. 600, 605 n.7 (Bankr. N.D. Cal. 2012).

[55] Two other cases bear mention, but in the author's view don't impact the analysis. In In re Mason, the court noted that the Ivanhoe rule did not apply because the creditor "expressly limited its claim under applicable non-bankruptcy law" in a settlement stipulation. *In re Mason*, 573 B.R. 75, 81 n.4 (Bankr. S.D. N.Y. 2017). In In re Doctors Hosp. of Hyde Park, Inc., the court determined that damages recovered from a third party must be set off against the creditor's claim. *In re Doctors Hosp. of Hyde Park, Inc.*, 494 B.R. 344, 358–68 (Bankr. N.D. Ill. 2013). That case, however, was essentially about whether the creditor could get a double recovery—that is, recover more than the principal and interest due on its debt when the amounts recovered from the third party on account of arguably different contractual claims are included in the calculation. See *In re Doctors Hosp. of Hyde Park, Inc.*, 494 B.R. 344, 358–68 (Bankr. N.D. Ill. 2013). In ruling against the creditor, the court focused on what constitutes an impermissible double recovery under state law (Illinois) and in fact never mentioned

Allocation of Postpetition Interest to Non-Debtors

Another issue that orbits in this universe is whether a creditor may allocate monies received from a non-debtor source to the payment of postpetition interest, thereby making it possible to look to the debtor for recovery of a greater amount of prepetition debt. The Fourth Circuit's *In re National Energy & Gas Transmission, Inc.* addressed this issue, and we'll thus use the facts of that case to set it up. Then, we'll consider whether the court failed to consider some relevant Bankruptcy Code provisions that perhaps would have led it to a different result.

In *National Energy*, the debtor and a non-debtor/guarantor jointly and severally owed the creditor a prepetition amount of $140 million.[56] Postpetition, the creditor recovered $140 million from the guarantor, the maximum amount available under the guarantee.[57] However, before receiving this payment, $17 million of postpetition interest accrued on the debt.[58] The creditor allocated the first $17 million received from the guarantor to postpetition interest, and the remainder to principal.[59] It then sought to collect the remaining $17 million in principal from the debtor.[60] (As discussed above, the Fourth Circuit ruled that the creditor's claim against the debtor was not offset by the money received from the guaran-

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Ivanhoe. See *In re Doctors Hosp. of Hyde Park, Inc.*, 494 B.R. 344, 358–68 (Bankr. N.D. Ill. 2013).

[56] *In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 299, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007).

[57] *In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 299–300, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007).

[58] *In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 300, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007).

[59] *In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 300, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007).

[60] *In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 300, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007).

tor, and thus the creditor asserted its entire claim against the debtor.[61])

The allocation issue was important in this instance because of the operation of Section 502(b)(2) of the Bankruptcy Code, which disallows postpetition interest.[62] If, on the one hand, the creditor were able to allocate the amount received from the guarantor to the payment of the $17 million of postpetition interest, it would still receive another $17 million of principal from the debtor.[63] If, on the other hand, the creditor's allocation were not permitted and all amounts received from the guarantor were viewed as principal, then the $17 million sought from the debtor would be disallowed under Section 502(b)(2) as postpetition interest.[64]

The Fourth Circuit announced that Section 502(b) "prevents [the creditor] from collecting the additional $17 million it seeks despite [the creditor's] classification of that amount as principal."[65] As support for this conclusion, the Fourth Circuit noted that it must " 'sift the circumstances surrounding' the claim to determine the reality of the transaction for purposes of the bankruptcy proceeding."[66] In its view, that "sifting" led to the following proposition: because the debt increased by

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[61] *In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 301, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007).

[62] See *In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 302, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007) ("Section 502(b)(2) of the Code provides that a claim shall not be allowed 'to the extent . . . [it] is for unmatured interest[.]' ") (modifications in original) (citing 11 U.S.C.A. § 502).

[63] See *In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 302, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007).

[64] See *In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 302, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007).

[65] *In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 302, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007).

[66] *In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 302, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007) (citing *Smith v. Robinson*, 343 F.2d 793, 801 (4th Cir. 1965)).

$17 million due to the accrual of postpetition accrual, then the $17 million sought by the creditor necessarily must be postpetition interest.[67] This, according to the Fourth Circuit, remained true even though the underlying documents evidently permitted the creditor to allocate the amount received on account of the guarantee to principal or interest as the creditor saw fit.[68]

The court sought to support its rather cursory legal analysis with a policy point.[69] It viewed one of the underlying policies of Section 502(b)(2)—the section that disallows postpetition interest—as seeking "to ensure the fair allocation of assets between creditors."[70] It thus concluded that allowing the creditor to collect $17 million from the estate would diminish the amount available for distribution to other creditors.[71]

It is worth noting that Judge Duncan filed a dissent in *In re National Energy & Gas Transmission, Inc.* where he asserted that the majority's decision violates Section 524(e) of the Bankruptcy Code—which states that the "discharge of a debt of the debtor does not affect the liability of any other entity"—because the court's ruling had the effect of limiting the liability of the guarantor.[72] The majority's response was that the amounts recoverable on the guarantee are unaffected by

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[67] *In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 303, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007).

[68] See *In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 303, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007).

[69] See *In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 303, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007).

[70] *In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 303, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007) (quoting *In re Kielisch*, 258 F.3d 315, 325, 38 Bankr. Ct. Dec. (CRR) 54, Bankr. L. Rep. (CCH) P 78484 (4th Cir. 2001)).

[71] *In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 303, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007).

[72] *In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 305, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007).

their ruling,[73] which seems correct and thus a facially cogent point. The author believes Judge Duncan's dissent was directionally correct but didn't actually hit the critical points noted below.

In an unpublished opinion, the Ninth Circuit in a concurrence cited the majority's approach without any analysis or discussion whatsoever.[74] As is too often the case, a holding from one circuit court—whether correctly reasoned or not—becomes the "rule" in other circuits without any further thought. Here, there are some further considerations that suggest a different result may be more appropriate.

Let's consider issues of indemnity and subrogation, starting first with indemnity, and again we'll look at New York law:

> Under New York law . . . a guarantor is equitably entitled to full indemnity against the consequences of a principal obligor's default. Once a guarantee agreement is enforced and the guarantor has satisfied the debtor's obligations to the creditor, the guarantor may proceed against the debtor to recover the full amount paid. The source of this rule is a common-law implied-contract theory of liability; so long as the debtor is aware of the guarantee agreement, there is no requirement that the guarantor and the debtor have a separate indemnification agreement.[75]

Thus, in situations such as *In re Nat'l Energy & Gas Transmission, Inc.* where the guarantor pays money to the creditor, the guarantor would have an indemnity claim back against the primary obligor/debtor. That indemnity claim would be

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[73] See *In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 303 n.7, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007).

[74] *In re Washington Group Intern., Inc.*, 530 Fed. Appx. 650, 651 (9th Cir. 2013) (concurrence) ("If [the creditor] recovers less than that amount, it may not allocate any portion of the [third party's] payment to post-petition interest first in an effort to maximize recovery from the bankruptcy estate, because doing so would be an attempt to circumvent § 502(b)(2)'s bar on collection of post-petition interest from the estate.") (citing *In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 302–03, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007)).

[75] *Steinhardt v. Shadow*, 2018 WL 4278334, at *2 (S.D. N.Y. 2018) (internal citations and quotations omitted).

subject to Section 502(e)(1)(A) of the Bankruptcy Code,[76] which provides:

> (e)(1) Notwithstanding subsections (a), (b), and (c) of this section and paragraph (2) of this subsection, the court shall disallow any claim for reimbursement or contribution of an entity that is liable with the debtor on or has secured the claim of a creditor, to the extent that—
>
> (A) **such creditor's claim against the estate is disallowed**;[77]

Of critical importance, this section provides that the indemnity claim of the guarantor is disallowed to the same extent as the underlying claim of the creditor. As we know, the creditor's claim for postposition interest is disallowed under Section 502(b)(2) of the Bankruptcy Code. Thus, if a guarantor pays amounts to the creditor that are allocated to postpetition interest, the guarantor's indemnity claim back against the primary obligor/debtor for the amounts attributable to postpetition interest would be disallowed.[78]

The same application holds true under concepts of subrogation.[79] When a guarantor or other surety pays the creditor, it may stand in the shoes of the creditor to assert the

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[76]Indemnity claims fall within the universe of "claims for reimbursement or contribution" as that phrase is used in Section 502(e)(1)(B). E.g., Sorenson v The Drexel Burnham Lambert Group, Inc. (In re The Drexel Burnham Lambert Group, Inc.), 146 B.R. 92, 96 (S.D.N.Y. 1992).

[77]11 U.S.C.A. § 502(e)(1)(A) (emphasis added).

[78]See, e.g. *Matter of Baldwin-United Corp.*, 55 B.R. 885, 893–94, 13 Bankr. Ct. Dec. (CRR) 1083, 13 Collier Bankr. Cas. 2d (MB) 1369, Fed. Sec. L. Rep. (CCH) P 92419 (Bankr. S.D. Ohio 1985) (disallowing contribution claim because direct claim of creditor would be disallowed under Section 502(b)(2) as postpetition interest).

[79]Under New York law, a surety, such as a guarantor, is entitled to the right of subrogation. *Chemical Bank v. Meltzer*, 93 N.Y.2d 296, 690 N.Y.S.2d 489, 712 N.E.2d 656, 661 (1999). The Bankruptcy Code also provides a statutory right of subrogation. See 11 U.S.C.A. § 509(a) ("Except as provided in subsection (b) or (c) of this section, an entity that is liable with the debtor on, or that has secured, a claim of a creditor against the debtor, and that pays such claim, is subrogated to the rights of such creditor to the extent of such payment.).

creditor's claim as against the primary obligor/debtor.[80] If the guarantor pays amounts allocable to postpetition interest, it would then likewise be subrogated to the creditor's claim against the primary obligor/debtor for postpetition interest. This claim for postpetition interest, now held by the guarantor standing in the shows of the creditor, would be disallowed under Section 502(b)(2).[81]

The bottom line is that someone—whether the original creditor or the guarantor—is going to hold a claim against the debtor's estate for the full amount of the debt. If the guarantor is deemed to pay only prepetition amounts to the creditor—as in the Fourth Circuit's *In re Nat'l Energy & Gas Transmission, Inc.* decision—then the guarantor should have an allowed claim for this amount back against the debtor. The creditor's remaining claim for postpetition interest would then be disallowed, as it was in that case.

Let's consider the opposite of the result compelled by the Fourth Circuit. If the guarantor is deemed to have paid some amount of postpetition interest to the creditor along with some prepetition amount, then the creditor's remaining claim against the debtor is attributable only to the remaining prepetition amount. That claim would be allowed. The guarantor, by contrast, will hold the claim against the debtor for postpetition interest (in addition to a claim for whatever amount it paid on behalf of prepetition debt), given that it paid amounts allocated to postpetition interest to the creditor. The guarantor's claim for postpetition interest should be disallowed as against the estate under the concepts discussed above.

At the end of the day, someone—be it the creditor or the guarantor[82]—is going to have an allowed claim for principal against the debtor's estate. Likewise, one of those two entities

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[80]See *Millennium Holdings LLC v. Glidden Co.*, 27 N.Y.3d 406, 33 N.Y.S.3d 846, 53 N.E.3d 723, 728 (2016) (surety may stand in the shoes of insured under concepts of contractual and equitable subrogation).

[81]See *In re Denby Stores, Inc.*, 86 B.R. 768, 781 (Bankr. S.D. N.Y. 1988) (holding that guarantor's claim by way of subrogation to landlord's claim is subject to the limitation under Section 502(b)(6) that would be applicable had landlord asserted the claim).

[82]This assumes, for the avoidance of doubt, that the guarantor has paid the amounts due to the creditor and thus issues under Section 502(e)(1)(B) don't arise.

will have a claim for postpetition interest that should be disallowed. Thus, the Fourth Circuit's policy point that its ruling somehow preserves estate assets doesn't really hold water. Someone is going to get an allowed claim for the prepetition amount owed, and no one is getting an allowed claim for postpetition interest.

The more interesting point is that the Fourth Circuit's rule favors the guarantor over the original creditor. Under the Fourth Circuit's rule, the creditor—not the guarantor—would be stuck holding the bag with the disallowed claim for postpetition interest. If the creditor contracted for the guarantor to bear that risk—indeed, credit support is the fundamental purpose for a guarantee—is doesn't make sense to shift that risk back to the creditor on policy grounds, especially if the results are neutral to the estate.[83] The Fourth Circuit seemed oblivious to these issues, and perhaps if and when this issue arises again, another court should take a closer look.

Conclusion

The *Ivanhoe* rule continues to rule the roost. It likely will apply in the vast majority of bankruptcy cases because bankruptcy courts respect it as settled and binding precedent. Moreover, the same result may be reached by application of state law—including in many situations the law of New York, which often governs financial instruments—independently of the *Ivanhoe* rule. A confluence of factors would have to align for a bankruptcy court to reach a contrary result.

As to the issue of allocation of postpetition interest, we have a holding from the Fourth Circuit that stands for the proposition that the creditor may not allocate the amount received

[83]This paper concerns the issue of allocation of postpetition interest and the attendant effects on the claims as against the estate. There are other issues that may arise concerning the statutory subordination of the guarantor's indemnity or subrogation claim to the creditor's claim until the creditor's claim is paid in full. See 11 U.S.C.A. § 509(c). That doesn't change the fact that the creditor and the guarantor taken together will have an allowed claim for the prepetition amount and any claim for postpetition interest will be disallowed.

from the guarantor to the payment of postpetition interest.[84] That holding does not seem to fully consider all the underlying considerations—and indeed appears as a policy judgment that rests on fairly weak moorings. The next court to address this issue should take a closer look at the whole picture, including the treatment of the various claims by the creditor and guarantor, and revisit whether the Fourth Circuit's holding should continue to be followed.

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[84] See *In re National Energy & Gas Transmission, Inc.*, 492 F.3d 297, 301–03, 48 Bankr. Ct. Dec. (CRR) 123, 58 Collier Bankr. Cas. 2d (MB) 452, Bankr. L. Rep. (CCH) P 80976 (4th Cir. 2007).