Too Much Insolvency: “Unmatured Interest” and “Debt” Under the Code

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Abstract

An unacknowledged fact about the Bankruptcy Code’s definition of “insolvent” is that it requires unmatured interest to be counted as debt. Ignored in practice, this statutory requirement makes no economic sense, but remains a trap awaiting a litigant in front of a court compelled to apply the statute’s plain meaning. I lay out the clear statutory argument and explain why it makes no economic sense. While ignoring unmatured interest in the solvency calculation avoids some absurd results, it may also create perverse incentives to choose higher-yield debt over lower-yield debt.

Key words: Insolvency, Solvency Test, Bankruptcy Code

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I. Introduction

Hiding in plain sight is a curious reality about insolvency under the United States Bankruptcy Code. The Code defines "insolvent" as a "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation," not including exempt or fraudulently transferred assets.[1] A "debt" is defined as "liability on a claim."[2] A "claim" is a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured[.]"[3]

It is well recognized that the face amount of debt outstanding is "debt" in a solvency analysis under the Code.[4] But what about unmatured interest on that debt? The term "unmatured interest" is used in the Code's section on allowance of claims.[5] While "[t]he Bankruptcy Code does not define 'unmatured interest,' [the] case law has determined that unmatured interest includes interest that is not yet due and payable at the time of a bankruptcy filing, or is not yet earned."[6] Since unmatured interest on outstanding debt is a "a right to payment ... unmatured," it is a "claim."[7]

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1 11 U.S.C. § 101(32)(A) (2012).
2 *Id.* § 101(12).
3 *Id.* § 101(5)(A).
4 *See, e.g., In re* ORBCOMM Global L.P., No. 00-3636, 2003 WL 21362192, at *8 (Bankr. D. Del. June 12, 2003) (concluding that "for purposes of determining whether a debtor is insolvent under section 547, the liabilities of the debtor must be valued at face value").
5 *See* 11 U.S.C. § 502(b)(2).
6 HSBC Bank USA v. Calpine Corp., No. 07 Civ. 3088, 2010 WL 3835200, at *5 (Bankr. S.D.N.Y. Sept. 15, 2010).
7 *See id.* (supporting the notion that unmatured interest on outstanding debts are "claims," even though the Code does not allow Trustees to recover such claims).

And since there is a "right to payment," there is "liability" on that claim.[8] At least one court has recognized, comparing the use of the word "debt" in two other sections of the Code, that "unmatured interest" is "debt."[9]

But while, as a textual matter, it seems inescapable that "unmatured interest" is "debt" which, like other debt that is not contingent, must be valued at face amount in the test for insolvency under the Code,[10] the virtually unanimous practice of valuation experts—whether in litigation or in advising on transactions or board of director actions—is to ignore unmatured interest in the solvency calculation.[11] Pressed to reconcile this practice with the statutory language, no good answers appear.

I first explain why the statutory definition is problematic, namely, it can imply insolvency for firms that are highly likely, or even certain, to pay their debts. I then point out that while ignoring unmatured interest may avoid absurd outcomes, doing so also may create incentives to prefer certain forms of debt over others, and in particular, higher-yield debt over lower yield debt. Finally, I note:

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[8] *See* 11 U.S.C. § 101(5)(A) (defining a "claim" as a "right to payment"); *see also id.* § 101(12) (defining a "debt" as a "liability on a claim").

[9] *See, e.g., In re* Shelbayah, 165 B.R. 332, 334 (Bankr. N.D. Ga. 1994).

> The term "debt" is defined in 11 U.S.C. § 101(12) as a "liability on a claim." Section 101(5) defines "claim" as a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, *unmatured*, disputed, undisputed, legal, equitable, secured, or unsecured." Thus, a liability on a claim for unmatured interest is a debt . . . . There is no suggestion in the Bankruptcy Code that a defined term such as "debt" means one thing in one section but something else in another section. If a defined term such as "debt" meant something different in sections 523(a)(8) and 1328(a) than the definition in section 101, one would expect at least some mention of that change in meaning. None appears.

Id. (emphasis added).

[10] *See In re* Xonics Photo-Chem., Inc., 841 F.2d 198, 200 (7th Cir. 1988). Even if unmatured interest were treated as a contingent liability, it would still have to be valued at its probability-discounted chance of occurrence. *See id.* ("To value the contingent liability it is necessary to discount it by the probability that the contingency will occur and the liability become real."); *see also In re* Hayden, No. 1:14-BK-11187, 2015 WL 9491310, at *11 (Bankr. C.D. Cal. Dec. 28, 2015) ("'[C]ontingent liabilities must be included in the computation of total indebtedness' for the purpose of computing insolvency.") (internal citation omitted).

[11] This is based off discussions with two valuation expert witnesses whose identities I've chosen to protect. The American Bankruptcy Institute Law Review is not responsible for the accuracy of the sources on file with the author.

(1) how this statutory anomaly is another example of the problem with "balance-sheet" solvency tests that are pervasive in the law, but which miss the economic question of most importance to creditors—can the firm be expected to pay its debts *when due*?; and (2) how the definition of "insolvent" in the Uniform Voidable Transactions Act *might* solve the problem.

I. Too Much Insolvency

Consider a firm that has assets ("property") at a statutory "fair valuation" of 110 and debt outstanding with a face amount of 100. The debt matures in 5 periods (think years) and promises to pay 10 in interest at the end of the next five periods. Under standard valuation practice, the unmatured interest is ignored in determining whether the entity is insolvent under the Bankruptcy Code's definition.[12] In this case, the firm is not insolvent, because its debt of 100 is not greater than its assets of 110.[13] Suppose, however, that we treat the unmatured interest as "debt" as the Code requires.[14] Then, the debt is 150—each of the payments of 10 plus the face amount of 100—and the firm is insolvent, since 150 is greater than its property of 100.[15]

Of course, this makes no economic sense. After all, if unmatured interest is valued at face amount as debt, then no firm—even if it has a 100% chance of paying its unmatured interest payments as they come due, along with its principal repayment obligation—is solvent unless the face amount of its debt *added to* the sum of all its unmatured interest payments is less than the value of its property at

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[13] *See* 11 U.S.C. § 101(32)(A) (defining "insolvent" as a "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation").
[14] *See id.* § 502(b)(2) ("[I]f such objection to a claim is made, the court . . . shall allow such claim in such amount, except to the extent that . . . such claim is for unmatured interest.").
[15] *See id.* § 101 (32)(A).

a fair valuation. This is perhaps the reason that the statutory problem has either gone unnoticed or has been ignored in practice.

I. Perverse Financing Incentives

Ignoring unmatured interest entirely may avoid absurd results, but doing so may also skew the kind of financing we see in the market. Suppose that the market interest rate is 10%, but, instead of issuing debt that pays 10% per period, the firm issues debt that pays 20% per period. We can call it "high-yield" debt. Now, because the market discounts the future payments at the 10% market rate, the firm can raise 100 today by issuing 20% debt in a face amount of 72.5, with a per period coupon of 14.5 (14.5 divided by 72.5 is 0.20 or 20%). By issuing high-yield debt, the firm can raise more money at a lower face amount of debt. If we assume that the firm still has assets of 110, then the firm looks even more solvent now, with "equity" of 38.5 (110 - 72.5) instead of 10 (110 - 100).

By contrast, consider the other extreme of zero-coupon financing. Zero-coupon financing is debt that pays no separate interest payments, but instead pays a larger face repayment at maturity.[16] For example, if the market interest rate was 10%, then the firm could raise 100 by promising 10 per period and 100 at maturity in five periods, or by promising 161.051 at maturity in five periods with no interest payments before then, which is equivalent to a 10% per period return on 100. But note that the uncertain treatment of the "face value" of the zero-coupon debt makes it risky for the firm. Much of that face amount is really unmatured interest, and this is the way it would be treated for

[16] *See* Ettinger v. Merril Lynch, Pierce, Fenner & Smith, Inc., 835 F.2d 1031, 1032 n.1 (3d Cir. 1987) (stating that zero-coupon bonds are debt securities where no interest is paid and at maturity a one-time repayment of principal and accrued interest is made).

allowance of claims in a bankruptcy proceeding.[17] But a solvency analyst might treat the entire face amount as “debt,” leaving the firm highly insolvent, since 110 - 161.051 = -51.051.

II. Discussion and Conclusion

In an article I published eleven years ago in *Business Lawyer*,[18] I pointed out the problem that the law’s different solvency tests can give different answers[19] and I pointed out how the balance sheet test like the one in the Code—so called because it compares “property” (that is, assets) to “debt” as in an accounting balance sheet—is suboptimal because it answers a question—is the current value of the property greater than the face amount of the debt?—that really is not the creditor's primary concern because “[a] creditor cares primarily about the firm's ability to match cash flows and maturing debt obligations in a time consistent manner that matches cash flows to the creditor's expectations of repayment.”[20] I argued then that perhaps balance sheet tests could be justified on the grounds that they give useful evidence that may be easier to estimate than, say, the theoretically-more-relevant ability-to-pay test that requires projecting future cash flows and matching them with maturing obligations.[21] What was hiding from me then—in plain sight—is that the Code’s definition of solvency, if adhered to faithfully, would make no sense at all.

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17 *See, e.g., In re* Doctors Hosp. of Hyde Park, Inc., 508 B.R. 697, 705 (Bankr. N.D. Ill. 2014) (“[C]ourts look to the economic substance of the transaction to determine what counts as interest. This was made clear in the LTV bankruptcy case in the context of an original issue discount (‘OID’). OID is the difference between the face value of a bond and the issue price, and compensates a creditor for a stated interest rate which is too low.”) (internal citation omitted).

18 *See generally* J.B. Heaton, *Solvency Tests*, 62 BUS. LAW. 983 (2007).

19 *See id.* at 984.

20 *Id.* at 1004.

21 *See id.* at 985 (“Liquidation-based solvency tests that look to observable market values rather than projected cash flows might be much easier to apply.”).

The Uniform Voidable Transactions Act,[22] so far enacted in only five states, may have a definition inadvertently dealing with the problem addressed here, in part, by defining a debtor to be insolvent "if, at a fair valuation, the sum of the debtor's debts is greater than the sum of the debtor's assets."[23] Note that now the term "fair valuation" applies to the debt as well as the assets. Depending on how "fair valuation" was applied to debt, it could solve the problem here.[24] Unmatured interest would be debt, but it would be discounted to present value, and economically-equivalent debt would be treated equivalently. But that is not the law under the Code.[25] This short Article highlights the issue and points out the economic problems with a plain language application, one that in the end needs a Congressional fix.

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[22] *See generally* UNIF. VOIDABLE TRANSACTIONS ACT (UNIF. LAW COMM'N 2014).
[23] *Id.* § 2(a).
[24] *See id.* § 2(a) cmt. 1. Presumably the drafters did not intend that market prices for debt would evidence "fair valuation" since in that case no debtor could be insolvent on a market basis. *See id.* (explaining the purpose of subsection (a) is to assess the risk of a debtor not being able to satisfy its liabilities).
[25] *See In re* ORBCOMM Global, L.P., No. 00-3636, 2003 WL 21362192, at *3 (Bankr. D. Del. June 12, 2003) (holding that under section 547, the liabilities of a debtor must be valued at face value).