UNITED STATES BANKRUPTCY COURT
DISTRICT OF DELAWARE

	:	**Chapter 11 Cases**
In re :	:	
	:	**Case No. 08-12229 (MFW)**
WASHINGTON MUTUAL, INC., et. al.,	:	
	:	**Jointly Administered**
DEBTORS	:	
	:	**Re: D.I. 6696, 7483, 8122,**
	:	**8128, 8140**

THE WMB NOTEHOLDERS' REPLY TO THE RESPONSES OF THE DEBTORS, OFFICIAL COMMITTEE OF UNSECURED CREDITORS AND THE PIERS TRUSTEE TO THE WMB NOTEHOLDERS' OBJECTION TO THE DEBTORS' MODIFIED SIXTH AMENDED JOINT REORGANIZATION PLAN

The WMB Noteholders file this limited reply to the responses of the Debtors, Official Committee of Unsecured Creditors and the PIERS Trustee to the WMB Noteholders' Objection to the Modified Sixth Amended Joint Plan of Affiliated Debtors Pursuant to Chapter 11 of the United States Bankruptcy Code (the "Plan") [D.I. 6696]. The WMB Noteholders file this reply in the event the Court decides not to hear argument or closing statements on the WMB Noteholders' Objection. The WMB Noteholders, however, believe that given the issues raised in their Objection—which go to the heart of the interaction between Sections 726 and 510 of the Bankruptcy Code and the proper treatment of post-petition interest in chapter 11 cases—that oral argument would be useful for the Court and respectfully request an opportunity to be heard at the continued hearing on confirmation of the Plan.[1]

[1] In recognition of the volume of pleadings and other material filed in connection with confirmation of the Plan, the WMB Noteholders limit this reply to the central issues in its Objection—that the Plan's proposed payment of post-petition interest to general unsecured creditors and late-filed claims before payment on the WMB Noteholders' subordinated unsecured claims contravenes Sections 726 and 510 of the Bankruptcy Code—and do not address the other points raised in the Objection, *i.e.* that the Plan improperly groups creditors with different claims in the same class and treats those creditors differently. The WMB

ARGUMENT

I. THE PLAN'S PAYMENT OF POST-PETITION INTEREST PRIOR TO PAYMENT OF CLASS 18 CLAIMS IS IMPROPER

A. The Statutory Language of Sections 510(b) and 726(a) Require Payment of the WMB Noteholders' Claims Prior to Payment of Post-Petition Interest.

1. Under the Plan, the WMB Noteholders' direct misrepresentation claims have been subordinated and placed in Class 18 of the Plan, which provides that there will be no payment on the subordinated unsecured claims included therein until "all Allowed Claims and **Postpetition Interest Claims in respect of Allowed Claims** … are paid in full…." Plan at ¶22.1 (emphasis added).[2] This aspect of the Plan is in direct conflict with the legislative history of Section 726, the clear language of Sections 726(a) and 510(b), the case law construing Section 726(a)(5), and this Court's statement that interest cannot be paid on unsecured claims until all unsecured claims are paid (Opinion at *35 (citing 11 U.S.C. § 726(a)), thus rendering this provision of the Plan unconfirmable.

2. The responses of the Official Creditors' Committee, the Debtors and the PIERS Trustee are replete with claims that the WMB Noteholders ignore the fact that Section 726(a) is subject to Section 510 and that Section 510(b) "governs" Section 726. The WMB Noteholders fully recognize and agree that Section 726 is subject to Section 510. They do not dispute that. Nor do they quarrel with the Court's earlier recognition

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Noteholders, however, do not waive those secondary objections and are prepared to address those points at the continued confirmation hearing if the Court wishes to hear argument on them.

[2] To date, no order has been entered subordinating the WMB Noteholders' misrepresentation claims pursuant to the Court's oral decision on January 6, 2011. Due to that ruling, the WMB Noteholders have assumed that their misrepresentation claims will be included in Class 18. It would be inequitable, to say the least, for the Debtors to withdraw their request to subordinate those claims in order to put those claims in class 17(b) of the Plan—which claims are deemed disallowed. The Debtors should be required to confirm that those claims will be included in Class 18.

that the "priority of distributions under Section 726(a) … is expressly subject to subordination under Section 510."

3. The questions, however, are *how* does Section 510 govern Section 726? *In what way* is the distribution scheme in Section 726 governed by Section 510? What *specifically* does Section 510 say about the subordination of distributions under Section 726? The responses to the WMB Noteholders' Objection do not look at the language of Sections 510 and 726 to answer those questions, but instead appear to take the position that once a claim is subordinated under Section 510(b) it loses any place in the Section 726(a) distribution hierarchy.

4. In order to understand the interplay of Sections 510 and 726, we have to look at the statutory language. That really is the beginning and end of the inquiry. Section 726 provides that "Except as provided in Section 510, property of the estate shall be distributed – ", and the section then sets out distribution priorities (a)(1) through (a)(6). Section 726(a)(2) provides for "payment of any allowed unsecured claim" with some exceptions not applicable here. It is indisputable, and this Court has recognized, that, but for subordination, the WMB Noteholders' claims are general unsecured claims payable as second-tier priorities under Section 726(a)(2).

5. But as the WMB Noteholders fully recognize, Section 726 is subject to any exceptions in Section 510. Section 510(b) states that "For the purpose of distribution under this title [*i.e.*, distribution under Section 726], a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under Section 502 on account of such a claim, shall be subordinated to all claims

or interests that are *senior to or equal* the claim or interest represented by such security …" (emphasis added).

6. The WMB Noteholders' claims in connection with their purchase of WMB debt securities were subordinated by the Court pursuant to Section 510(b), and as Section 510(b) clearly provides, for purposes of distribution, those claims are subordinated to all claims that are "senior to or equal the claim or interest represented by such securities." Section 510 does not—as suggested by the responses to the Objection—subordinate the WMB Noteholders' claims to <u>all</u> other claims. It subordinates them only to those claims that are "senior to or equal" the WMB Noteholders' claims. But for subordination under Section 510(b), those claims would be payable as Section 726(a)(2) claims. So Section 510 subordinates the WMB Noteholders' claims to all Section 726(a)(1) (*i.e.*, senior) claims and all Section 726(a)(2) (*i.e.*, equal) claims. Section 510 does not subordinate the WMB Noteholders' claims to any claim below Section 726(a)(2) because any claims below that level are not senior or equal to the WMB Noteholders' Claims. In that sense, Section 510(b) places the WMB Noteholders' claims somewhere between Sections 726(a)(2) and (a)(3) claims—at Section 726(a)(2).1 as it were.

7. The Plan seeks to pay post-petition interest on general unsecured claims before the WMB Noteholders' claims are paid. Under the Bankruptcy Code, post-petition interest is paid fifth in the Section 726 priority distribution waterfall (Section 726(a)(5) reads "fifth, in payment of interest at the legal rate from the date of filing of the petition, on any claim paid under paragraph (1), (2), (3), or (4) of this subsection."). The Plan's payment of post-petition interest on the claims of general unsecured creditors (at Section 726(a)(2)) ahead of payment of the claims of the WMB Noteholders at Section

726(a)(2).1) would effectively elevate the payment of post-petition interest from level (a)(5) to (a)(2). Yes, Section 510 governs Section 726, but it does not go that far.

8. To put it another way, if under the Bankruptcy Code subordinated unsecured claims such as those of the WMB Noteholders were to be paid after other general unsecured creditors received post-petition interest on their claims, the "senior or equal" qualification in Section 510 would be unnecessary and Section 510 would say simply that for distribution purposes, a claim for rescission, damages or contribution in connection with the purchase or sale of a security would be subordinated to all claims except equity. But Section 510 does not say that, and it does have that critical "senior or equal to" qualification. To pay post-petition interest as provided in the Plan, and as urged by the Debtors, Creditors' Committee and PIERS Trustee, literally requires taking a blue pencil to the language of Section 510.

9. In turn, Section 726(a)(5) provides for the payment of post-petition interest on Section 726(a)(1) through (a)(4) claims. The Absolute Priority Rule, however, mandates that claims for interest under Section 726(a)(5) cannot be paid until all the categories above it are satisfied in full—and regardless of how they are denominated, whether as Section 726(a)(2).1 or other otherwise, it is clear from the foregoing analysis that the WMB Noteholders' claims are ahead of Section 726(a)(5) interest claims. To view interest claims as "senior or equal" to a subordinated general unsecured claim requires finding that interest on a claim is somehow a part of the claim. But that position is supported by neither the statutory language of Section 726 nor by the caselaw. First, if post-petition interest were part of a general unsecured claim payable under Section 726(a)(2) along with the underlying claim itself—rather than a distinct

claim, payable separately only if the estate's distributable assets are sufficient to reach the Section 726(a)(5) level—then Section 726(a)(5) would read differently and provide something to the effect of "second, in payment of any allowed unsecured claim, including applicable interest at the legal rate from the date of filing of the petition." But of course Section 726(a)(2) does not say that, nor is there any other reference to the payment of interest in Section 726 other than in Section 726(a)(5). Again, the Plan and its proponents would take a blue pencil to the Code, picking up the language of Section 726(a)(5) and dropping it into each of the payment rungs above it, so that interest is paid alongside the underlying claim.

10. Section 726 places the payment of post-petition interest near the bottom of the distribution waterfall because post-petition interest, whether contractual or not, is not a part of the claim itself. It is an equitable entitlement to compensate for the lost use of funds during the administration of the case. One can make a claim for interest, and such a claim is recognized under the Code, but it is not payable until almost the end of the line. The legislative history of Section 726 itself makes it clear that Congress intended that post-petition interest is not to be paid until all other claims are satisfied and a surplus of assets remains to be returned to the Debtor. S. REP. 95-989, S. Rep. No. 989, 95TH Cong., 2ND Sess. 1978, 1978 U.S.C.C.A.N. 5787, 1978 WL 8531 ("[L]ike prepetition penalties, **such interest will be paid from the estate only if and to the extent that a surplus of assets would otherwise remain** for return to the debtor at the close of the case.") (emphasis added).

B. The Caselaw Supports Payment of the WMB Noteholders' Subordinated Claims Prior to Payment of Post-Petition Interest.

11. The caselaw further supports the WMB Noteholders' position that post-petition interest is payable under Section 726(a)(5) only after all prior claims, including subordinated general unsecured claims, are paid. The PIERS Trustee is correct that there is scant caselaw on this issue.[3] The few that do exist, however, (including those cited by the Creditors' Committee and the PIERS Trustee), support the WMB Noteholders' position. First, as noted in the Objection, in *In re El Paso Refinery, L.P.,* 244 B.R. 613 (Bankr. W.D. Tex. 2000), the Bankruptcy Court considered the question of whether post-petition interest was properly payable under Section 726 on certain unsecured claims prior to payment of a creditor's unsecured claim for post-petition interest and attorney's fees relating to a mechanic's and materialman's lien, which claim had been deemed a general unsecured claim per a consent agreement with the debtor, albeit subordinated to all other general unsecured claims. The Bankruptcy Court concluded that the distribution scheme set out in Section 726 requires the full payment of all unsecured claims, including "garden variety" subordinated claims, prior to the payment of post-petition interest under Section 726(a)(5). The *El Paso Refinery* Court reasoned that payment of interest pursuant to Section 726(a)(5) is not "distribution of a piece of creditors' prepetition secured claims," but is instead an equitable remedy designed to compensate all creditors for the loss occasioned by the estate's detention of money during the bankruptcy case. 244 B. R. at 620-21. As such, "a payment of interest is separate and distinct from the

[3] Clearly one reason for that is that there are comparatively few chapter 11 cases in which sufficient assets exist to even consider paying post-petition such that the issue arises and is litigated.

claim on which it is paid," *id.,* and unsecured, subordinated claims should be paid in full before any equitable distribution of interest.

12. *El Paso Refinery* was a decision issued on the motion of certain general unsecured creditors for reconsideration of the Bankruptcy Court's prior order that payment should be made on creditor Glitch Field Service's subordinated unsecured claim before the distribution of interest to the general unsecured creditors under Section 726(a)(5). On reconsideration, the *El Paso* Court determined it had erred in ruling that Glitch should be paid in full before interest was distributed to the general unsecured creditors because the Court had failed to recognize that Glitch's claim had been subordinated per consent agreement. Under this consent agreement, Glitch's claim for post-petition interest and attorney's fees (which would otherwise be unallowable as a general unsecured claim), was allowed but subordinated to the full distribution on all other allowed general unsecured claims provided under applicable law, which the *El Paso Refinery* Court interpreted as including interest distribution under Section 726(a)(5). The *El Paso Refinery* Court thus contrasted the Glitch subordinated claim, which was the creature of a consent settlement only, with "garden variety" subordinated claims as established under the Bankruptcy Code. 244 B.R. at 624-25. Had Glitch's claim otherwise been an allowable, albeit subordinated, unsecured claim—as the *El Paso* Court initially thought it was and like the claims of the WMB Noteholders here—the Bankruptcy Court made clear it would have to be satisfied in full prior to any distribution of interest on unsecured claims. As the Court said, "If this had been a garden variety subordination claim, then our prior ruling and analysis would have been correct (i.e., subordinated claims are usually paid prior to interest under § 726(a)(5)." *Id.* at 625. The

PIERS Trustee correctly points out that this aspect of the *El Paso Refinery* Court's holding is *dicta*, but that does not detract from its applicability to this case.

13. The cases cited by the PIERS Trustee do nothing to undermine the WMB Noteholders' interpretation of the interplay between Sections 510(b) and 726. The PIERS Trustee cites *In the Matter of Virtual Network Servs. Corp.*, 902 F.2d 1246, 1249 (7th Cir. 1990) and *In re Rago*, 149 B.R. 882, 889-90 (Bankr. N.D. Ill. 1992) for the proposition that the distribution priority found in Section 726(a) is "subject to the provisions of Section 510." The WMB Noteholders do not dispute that fact. However, these cases concern equitable subordination under Section 510(c)(1), s*ee Virtual Network Servs. Corp.*, 902 F.2d at 1249; *Rago*, 149 B.R. at 889, and do not address Section 510(b), much less stand for the proposition that a claim subordinated under Section 510(b) must be subordinated to ***all*** other claims under Section 726(a). Indeed, in *Rago*, the court noted that the court's ability to subordinate claims under Section 510(c)(1) is "wider" and "broader" in scope, than its ability to subordinate claims under Section 510(b), *id.*

14. Similarly, *In re Air Safety Int'l, L.C.*, 336 B.R. 843, 857 (Bankr. S.D. Fla. 2005), does not conflict with the WMB Noteholders' position. It merely states that "a bankruptcy court should follow the priority scheme established by § 726 ***unless*** there is a valid ground for subordination under § 510" (emphasis in original). Again, the WMB Noteholders agree with that. But *In re Air Safety Int'l, L.C.* does not stand for the proposition that claims subordinated under Section 510(b) are placed beneath a claim for interest arising under Section 726(a)(5).

15. Finally, in *In re General Growth Props., Inc.*, No. 09-11977, 2011 WL 2441902, at *3 (Bkrtcy. S.D.N.Y. June 16, 2011), the court, in simply discussing the fact that post-petition interest is permitted in some instances (a fact which the WMB Noteholders do not dispute), noted that allowing post-petition interest is premised on the policy disfavoring a return of excess capital to the debtor. Such policy does nothing to support the payment of post-petition interest to one class of creditor before other classes of creditors receive any distributions at all.

16. The PIERS Trustee also cites cases which expressly affirm the rule that post-petition interest may not be paid unless and until all higher priority claims are paid. In *Household Fin. Corp. v. Hansberry*, 20 B.R. 870, 872-73 (Bankr. S.D. Ohio 1982), PIERS Trustee Br. at 11, which involved a Chapter 13 bankruptcy, the court noted that accrued post-petition interest could be paid from "the estate surplusage." *See also In re Dow Corning Corp.*, 270 B.R. 393, 403-04 (Bankr. E.D Mich. 2001) (noting that "[i]f the estate has more than enough money to pay all four levels [of §726(a)(1)-(4)], then claim holders are entitled to" interest, and explaining that "[a] right to interest which is based on this statute is, by definition, contingent on the estate having funds on hand to make that payment after satisfying all higher-priority claims").

17. The only way that this rule would not apply to give higher priority to the WMB Noteholders' claims over the PIERS' claims for interest is if the PIERS' right to interest is somehow attached to or subsumed under their underlying contract claims, and therefore should be given the same priority as the underlying claims, rather than be treated as separate claims falling under Section 726(a)(5). To support its view, the PIERS Trustee misinterprets language in *Household Fin.*, which states that "a creditor's

contractual right to payment for earned interest, regardless whether earned subsequent to a petition filing, is a 'claim' as that term is broadly defined in the Bankruptcy Code," *id.* PIERS Trustee Br. at 11. The context of *Household Fin.* makes clear that such a "claim" for interest is ***separate and distinct*** from any underlying contract claim. The court concluded that the debtor was not required to pay post-petition interest on a plan calling for "100% payment" where the plan did not expressly require payment of post-petition interest. *Id.* at 873. If the PIERS Trustee's interpretation were correct, the court would not have concluded that payment of interest must be separately provided for in the plan.

18. Finally, the PIERS Trustee cites to the confirmation orders in *In re Dana Corp.*, 06-10354-BRL, Docket No. 7509 (Bankr. S.D.N.Y. Dec. 26, 2007) and *In re Calpine Corp.*, 05-60200-BRL, Docket No. 7237 (Bankr. S.D.N.Y. Dec. 19, 2007) for the proposition that other courts have approved of the distribution of interest before subordinated claims have been satisfied. Merely citing to the orders and plan provisions proves nothing. What was the background? Were objections to this aspect of the plans filed and, if so, on what basis? What did the *Dana* and *Calpine* courts conclude? These aspects of the *Dana* and *Calpine* plans could have been the result of consensual resolution of any number of issues and, without more, it is impossible to draw any conclusions or parallels from these cases.

C. The WMB Noteholders Are Not "Jumping" Ahead of Other Unsecured Claimants.

19. Both the Creditors' Committee and the PIERS Trustee maintain that for the WMB Noteholders to receive a distribution on their claims ahead of the payment of post-petition interest would result in allowing security fraud claimants to "leap frog" and dilute the full recovery of non-subordinated general unsecured creditors and have the

absurd result that a securities rescission claim would jump ahead of subordinated note claims. First, with respect to the Creditors' Committee's "leap frog" claim, the WMB Noteholders are not jumping over anyone. They are waiting in line for payment where Section 510(b) places them, right after payment of general unsecured claims under Section 726(a)(2). The general unsecured creditors will receive full payment on their general unsecured claims under Section 726(a)(2) before the WMB Noteholders receive anything. The general unsecured creditors' claims are not diluted because they have no right to payment of post-petition interest until all Section 726(a)(1)-(a)(4) claims, including the subordinated WMB Noteholders claims which fall somewhere between (a)(2) and (a)(3), have been paid.

20. In the same way, payment on the WMB Noteholders' Claims prior to payment of post-petition interest does not result in the bizarre priority of a rescission claim ahead of a subordinated note claim, as the PIERS Trustee asserts. The WMB Noteholders are not jumping ahead of the PIERS claimants, who will have been paid in full on their underlying claims before the WMB Noteholders. The fact that the PIERS claimants agreed to surrender their distributions to satisfy the claims (including in some cases the post-petition interest claims) of senior creditors to whom they are contractually subordinated is, frankly, their own business and the deal they struck. The PIERS claimants were free to do whatever they wanted contractually, but their freely-contracted obligations do not justify a re-writing of the Bankruptcy Code in order to save them from the consequences of their bargain. The PIERS claimants may not be able to keep any distribution unless they receive post-petition interest because they contracted to pay the Senior's post-petition interest claims out of their own underlying claim recoveries. But

that doesn't change the fact that the PIERS claimants are still being paid in full on their general unsecured claims ahead of the WMB Noteholders—they just agreed to pass that payment up. There is no bizarre result there.

21. Moreover, the PIERS Trustee's dire prediction of an upending of the subordinated debt marketplace seems highly exaggerated at best. First, how often does a scenario like this occur, in which there are funds available to pay post-petition interest? It is only in the rare situation such as this that market expectations, to the extent there are any, may be disappointed. Such a limited and speculative market reaction hardly supports a significant re-writing of the language of the Bankruptcy Code.

22. Finally, both the Creditors' Committee and the PIERS Trustee lament that a ruling in favor of the WMB Noteholders on this issue would scuttle the Plan and send the parties back to the drawing board and negotiating table. But it was the Debtors and other Plan proponents who drafted and supported the Plan's payment of the WMB Noteholders' subordinated Class 18 claims only after payment of post-petition interest. The Plan could readily have provided that Class 18 claims would be payable after interest "as ordered by the Court" or "as provided under the Bankruptcy Code." Those or similar formulations would have provided a measure of built-in flexibility such that if the Court rules in favor of the WMB Noteholders, the Plan would otherwise remain in tact. Yet the Debtors and Plan proponents chose an extreme position, and should not be heard to complain now that if things do not go their way, the wheels will come off the Plan.

II. THE PLAN'S TREATMENT OF LATE-FILED CLAIMS IS IMPROPER

23. Under Section 16.2 of the Plan, late-filed claims are to be paid prior to subordinated, unsecured claims:

> 16.2 Class 12A -- Late-Filed Claims: Commencing on the Effective Date, and subject to the priorities set forth in the Subordination Model, each holder of an Allowed Late-Filed Claim shall receive, in full satisfaction, release and exchange of such holder's Allowed Late-Filed Claim and Postpetition Interest Claim, such holder's Pro Rata Share of Liquidating Trust Interests, in an aggregate amount equal to (a) such holder's Allowed Late-Filed Claim and (b) in the event that all Allowed Claims (other than Subordinated Claims) are paid in full, such holder's Postpetition Interest Claim, … .

As with the Plan's proposed distribution of interest prior to payment of the WMB Noteholders' claims, this provision is directly contrary to 11 U.S.C. §§ 726(a)(2) & (3) and violates the absolute priority rule. Section 726(a) provides that claims are paid "second, in payment of any allowed unsecured claim" and then "third, in payment of any allowed unsecured claim proof of which is tardily filed…." 11 U.S.C. §§ 726(a)(2) & (3). There is no provision in Section 726 under which timely-filed unsecured claims (whether or not subordinated) are to be paid **after** late-filed claims.[4] Further, as discussed above, there is no basis for payment of post-petition interest with respect to late-filed claims prior to payment of allowed subordinated unsecured claims under Section 726(a)(5). Accordingly, Section 16.2 of the Modified Sixth Plan is contrary to law, violates Section 510(b) of the Bankruptcy Code, and should be rejected by this Court.

[4] While unsecured claims that are subordinated to the level of equity under 11 U.S.C. § 510(b) are moved below late-filed claims, *see* Opinion at *35 (holding that post-petition interest that is payable pursuant to Section 726(a)(5) comes before claims subordinated to the level of equity under Section 510(b)), unsecured claims that are merely subordinated, but not to the level of equity, remain unsecured claims and thus come before late-filed claims and interest under the scheme established in Section 726(a).

RELIEF SOUGHT

WHEREFORE, for all the above reasons, the WMB Noteholders request that the Court enter an order denying confirmation of the Plan on the bases set forth in the Objection and herein, and granting such other and further relief as may be just and proper.

Dated: August 10, 2011

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