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Fifth Circuit decides make-whole premiums are disallowed as equivalent of unmatured interest

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In *Ultra Petroleum*, the Fifth Circuit became the first circuit court to determine that claims for payment of a make-whole premium are disallowed under section 502(b)(2) of the Bankruptcy Code as the economic equivalent of unmatured interest. However, because the Ultra debtors were solvent, the Fifth Circuit decided that the make-whole premium was payable to noteholders under the "solvent-debtor exception" to the general rule disallowing unmatured interest.

Introduction

On October 14, 2022, in a much-anticipated decision following more than five years of litigation, the United States Court of Appeals for the Fifth Circuit ruled that the make-whole premium in Ultra Petroleum's master notes purchase agreement (MNPA) was disallowed as the economic equivalent of unmatured interest under section 502(b)(2) of the Bankruptcy Code.[1] The opinion is the first decision by a circuit court determining that a make-whole premium constitutes unmatured interest and departs from several prior lower-court decisions.

However, the Fifth Circuit, in a split decision on the issue, also determined that the make-whole premium in the MNPA was nevertheless payable under the "solvent-debtor exception" to the general rule disallowing claims for unmatured interest because the Ultra debtors had become solvent by the time their plan had been confirmed.[2] The court additionally found that the solvent-debtor exception also requires the payment of post-petition interest at the contract default rate rather than the federal judgment rate, aligning the Fifth Circuit with the Ninth Circuit's recent decision in *In re PG&E Corp.*[3]

This client update follows our previous client updates discussing the treatment of make-whole premiums and post-petition interest in bankruptcy[4] and our *Creditors' Guide to Make-Whole Enforceability in Bankruptcy*.[5]

Background

In 2009 and 2010, Ultra Resources, Inc. issued multiple series of unsecured notes totaling approximately $1.46 billion. In 2016, Ultra Resources, Inc., along with its parent, Ultra Petroleum Corp., and certain other affiliates filed for bankruptcy in the United States Bankruptcy Court for the Southern District of Texas (the "Bankruptcy Court"). A fortuitous upswing in crude oil prices over the course of the debtors' bankruptcy proceedings resulted in the Ultra Petroleum debtors becoming solvent during the bankruptcy and enabled them to propose a plan of reorganization that purported to pay all of their creditors, including the unsecured noteholders, in full, thus rendering such creditors unimpaired and not entitled to vote on the plan.

However, the plan did not provide for the payment of the unsecured noteholders' claim for a make-whole premium and provided for the payment of post-petition interest on their claim at the federal judgment rate[6] rather than the higher contract rate. Certain noteholders objected to the plan, arguing that section 1124 of the Bankruptcy Code required the payment in full of their make-whole premium and post-petition interest on their claims at the applicable contract rate if

they were to be treated by the debtors' plan as "unimpaired."[7] The debtors, in turn, argued that section 502(b)(2) of the Bankruptcy Code, which disallows claims for "unmatured interest" in bankruptcy,[8] precluded collection of the noteholders' make-whole claims, and that any post-petition interest to which the noteholders were entitled should be calculated using the federal judgment rate.

After finding as a threshold matter that the make-whole provision at issue was enforceable as a liquidated damages provision under New York law, the Bankruptcy Court held that the noteholders were entitled to the make-whole amount in order to be deemed unimpaired under the debtors' plan.[9] The Bankruptcy Court reasoned that a confirmed plan (through section 1141(d) of the Bankruptcy Code) results in the discharge of a debtor's debts; by discharging the noteholders' claims without paying them the make-whole amount, it was the debtors' plan that impaired the noteholders, not section 502(b)(2).

On appeal, the Fifth Circuit reversed.[10] The Fifth Circuit agreed that unimpairment under section 1124 is defined relative to whether "the plan" leaves creditors' rights unaltered, not the Bankruptcy Code, but disagreed with the Bankruptcy Court's view that it was the plan (by discharging the noteholders' make-whole claims) that rendered the noteholders impaired. Rather, if the make-whole claims were disallowed as unmatured interest under section 502(b)(2), "the [Bankruptcy] Code—not the plan—is doing the impairing."[11] As such, the Fifth Circuit reasoned that as long as the debtors' plan provided the noteholders what the law (including the Bankruptcy Code's allowance provisions) entitled them to, they could not be considered impaired for purposes of section 1124.[12] The Fifth Circuit remanded to the Bankruptcy Court to decide whether the Bankruptcy Code disallows the make-whole premium or post-petition interest and, if not, how much the debtors must pay the noteholders.

On remand, the Bankruptcy Court determined that the make-whole amount was not unmatured interest (or its economic equivalent) under section 502(b)(2), and therefore was an allowed claim.[13] The court analyzed this issue as a question of fact, and noted that determining whether a make-whole premium was unmatured interest depends on the specific narrow facts of the case and cannot be generalized. The Bankruptcy Court observed that interest can be understood as "consideration for the use or forbearance of another's money accruing over time," and reasoned that because the make-whole amount did not compensate the noteholders for the use or forbearance of their money (and instead compensated them for a breach of a promise to use money, and the cost of reinvesting in a less favorable market), the make-whole amount was more properly characterized as a liquidated damages provision.[14] The Bankruptcy Court also held that the noteholders were entitled to post-petition interest at the higher contractual default rate, not the federal judgment rate provided by the debtors' plan.[15]

The debtors appealed the *Ultra Petroleum III* decision directly to the Fifth Circuit.

The Fifth Circuit decision

Make-whole premiums as unmatured interest

The Fifth Circuit disagreed with the Bankruptcy Court's decision in *Ultra Petroleum III* and ruled that the make-whole premium in the Ultra Petroleum MNPA constituted the economic equivalent of unmatured interest and, as a result, was disallowed under section 502(b)(2) of the Bankruptcy Code.[16]

Section 502(b)(2) of the Bankruptcy Code provides that claims for "unmatured interest" are disallowed in bankruptcy, but "unmatured interest" is not defined in the Bankruptcy Code. The Fifth Circuit and other courts have interpreted that provision broadly to disallow not simply unmatured interest but also claims constituting the "economic equivalent" of unmatured interest as well.[17] Several courts considering the issue prior to the *Ultra Petroleum IV* decision have held make-whole premiums to be a form of liquidated damages approximating actual or anticipated damages, and have treated liquidated damages provisions as conceptually different from "unmatured interest" subject to section 502(b)(2).[18]

The Fifth Circuit started from the premise that make-whole amounts generally, and the one at issue in the Ultra Petroleum MNPA specifically, are "expressly designed to liquidate fixed-rate lenders' damages flowing from debtor default while market interest rates are lower than their contractual rates" and, as a result, are "nothing more than a lender's unmatured interest, rendered in today's dollars."[19] This, the Court reasoned, is precisely the economic equivalent of unmatured interest. While the noteholders conceded that the value of future interest payments is the key input into the make-whole calculation under the MNPA, they argued that the make-whole formula—a present value calculation that discounted the interest payments that the noteholders would have received had the notes remained outstanding—does not render a liquidated damages amount unmatured interest. The Fifth Circuit was unpersuaded, finding instead that the make-whole formula yields precisely the economic equivalent of unmatured interest.[20]

To illustrate, the Fifth Circuit posited a hypothetical "Fake-Whole Amount" that was equal to: (? [all unmatured interest payments] + $1.00) × 1. Observing that this calculation results in nothing more than unmatured interest plus one dollar,

the Fifth Circuit compared this Fake-Whole Amount to the make-whole premium in the MNPA—each "[did] nothing to its unmatured interest component to render the result different in kind."[21]

The Fifth Circuit was also not persuaded by arguments made by the noteholders that adopted Judge Isgur's reasoning in *Ultra Petroleum III*—namely, that "interest" compensates creditors for the use or forbearance of their money accruing over time, and a make-whole premium does not compensate creditors for the use or forbearance of money. To the contrary, the Fifth Circuit opined that a make-whole premium *does* compensate creditors for the use or forbearance of their principal—it compensates them for the *future* use of their money.[22] This, the Fifth Circuit reasoned, is a different way of saying that the interest is unmatured, and unmatured interest is still interest.

Finally, the Fifth Circuit was not persuaded by the argument that if a make-whole premium is a liquidated damages provision, then it cannot be unmatured interest, instead determining that a make-whole amount can be both liquidated damages and the economic equivalent of unmatured interest.[23]

Make-whole premiums as unenforceable penalties

The Fifth Circuit also determined that the make-whole premium in the Ultra Petroleum MNPA was not an unenforceable penalty under New York law, instead finding that the make-whole premium constituted an enforceable liquidated damages provision.[24] In arguing the make-whole amount to be an unenforceable penalty, the debtors had the burden of showing that the "amount fixed is plainly or grossly disproportionate to the probable loss" incurred by the noteholders as a result of the debtors' default under the MNPA.[25] The debtors sought to meet that burden by arguing that the make-whole premium effectively grants a double recovery to the noteholders, as the noteholders were also entitled to receive post-petition interest at the contract rate as a result of the solvent-debtor exception (discussed below).

The Fifth Circuit was unmoved by this argument. The Fifth Circuit found that the make-whole amount and the post-petition interest addressed two different harms: the make-whole amount serves as liquidated damages for the debtors' default; the post-petition interest compensates the noteholders for the debtors' delay in paying them their accelerated principal amount (and the make-whole itself), which had been due and payable upon the commencement of its bankruptcy proceedings.[26] Separate harms warrant separate recoveries, and so the Fifth Circuit rejected the argument that the make-whole premium was unenforceable under this theory.

Solvent-debtor exception

Notwithstanding the Fifth Circuit's ruling that the make-whole premium was disallowed as unmatured interest, the court nevertheless found that the make-whole premium was payable, relying on the "solvent-debtor exception"—an equitable exemption from the general rule disallowing unmatured interest from accruing post-petition. In a split decision on this issue, the Fifth Circuit determined that the solvent debtor exemption pre-dated and survived the 1978 enactment of the Bankruptcy Code.[27] The debtors argued that Congress abrogated the solvent-debtor exception by enacting the Bankruptcy Code without any express exception to the disallowance of claims for unmatured interest.[28] By contrast, the noteholders responded "with equal and opposite force," observing that the solvent-debtor exception had survived the enactment of prior bankruptcy statutes and argued that silence in the Bankruptcy Code should be interpreted as adoption of pre-Code practice.[29]

The Fifth Circuit, finding both sides' arguments reasonable, concluded that the Supreme Court "breaks the tie" in favor of the noteholders, pointing out that abrogation of the solvent-debtor exception requires an "unmistakably clear" statement on the part of Congress.[30]

In addition, the Fifth Circuit ruled that the solvent-debtor exception entitles the noteholders to post-petition interest at the contract rate.[31] The debtors and the noteholders had agreed at the plan confirmation stage that the noteholders were entitled to post-petition interest, but the parties disagreed on the applicable rate required to render the noteholders unimpaired under the plan—the debtors argued for the federal judgment rate, while the noteholders argued for the higher contractual default rate. The Fifth Circuit viewed the legal rate as setting a floor, not a ceiling, for what an impaired (and, by implication, unimpaired) creditor is entitled to receive.[32] Harkening back to section 1124(1) of the Bankruptcy Code, which requires that unimpaired creditors' "legal, equitable, and contractual rights" must remain "unaltered," the Fifth Circuit then determined as a matter of equity that creditors are entitled to contractually specified rates of interest on their claims when a debtor is solvent.

This ruling aligns the Fifth Circuit with the Ninth Circuit, which, in its August 2022 *PG&E* decision, became the first circuit court to decide that creditors treated as unimpaired under a solvent debtor's plan of reorganization are entitled to post-petition interest on their allowed prepetition claims at the applicable contract rate.[33]

Takeaways

Absent a rehearing by the Fifth Circuit *en banc* or the Supreme Court granting *certiorari* to hear an appeal, the Fifth Circuit's *Ultra Petroleum IV* decision may well end the Ultra Petroleum make-whole saga. If so, the decision may have far-reaching consequences. At a minimum, the decision casts significant doubt on the allowance of market-standard yield-protection make-whole premiums for unsecured creditors in the Fifth Circuit (outside of the rare circumstance of a solvent debtor, in which case the solvent-debtor exception may apply). Because the Southern District of Texas remains a popular jurisdiction among large corporate debtors, unsecured creditors may reconsider the value of contractual make-whole provisions in their debt instruments in the event their debtors experience financial distress. The reasoning set forth in the decision may be adopted more broadly in other circuits, and if so could drive financial markets to change the formula for the calculation of a make-whole or potentially even result in the abandonment of make-whole premiums in unsecured debt documents issued by borrowers with significant solvency risk in favor of different economic terms.

The *Ultra Petroleum* decision was rendered in connection with a dispute involving unsecured claims and, therefore, left unaddressed whether disallowance of a claim for payment of a make-whole premium under section 502(b)(2) might impact an oversecured creditor's right to payment of a make-whole premium as either "interest" or "reasonable fees, costs, or charges" provided for under the relevant agreement or state law pursuant to section 506(b) of the Bankruptcy Code. Further, the Fifth Circuit's observation that the absolute priority rule under section 1129(b) "buttress[es]" its conclusion[34] could be interpreted to lend support to an unimpaired senior creditor in an insolvent bankruptcy case that seeks payment of a make-whole premium where junior creditors are receiving a recovery under a plan.

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1 *In re Ultra Petroleum Corp.* ("*Ultra Petroleum IV*"), 51 F.4th 138 (5th Cir. 2022).

2 *Id.*

3 *See In re PG&E Corp. ("PG&E")*, 46 F.4th 1047 (9th Cir. 2022).

4 *See* Divided Ninth Circuit finds solvent debtors owe post-petition interest at applicable contract rate (September 1, 2022); It never Hertz to ask: court declines to dismiss make-whole claims, limits post-petition interest (January 5, 2022); Fifth Circuit questions the enforceability of make-whole and postpetition interest claims in bankruptcy (January 28, 2019); Second Circuit holds momentive noteholders may be entitled to market interest rate on replacement notes, not entitled to make-whole premium (October 23, 2017); Third Circuit finds noteholders have right to payment of make-whole premium after bankruptcy acceleration (November 28, 2016).

5 Creditors' guide to make-whole enforceability in bankruptcy (June 16, 2022).

6 *See* 28 U.S.C. § 1961(a).

7 *See* 11 U.S.C. § 1124(1).

[8] *See* 11 U.S.C. § 502(b)(2).

[9] *See In re Ultra Petroleum Corp. ("Ultra Petroleum I")*, 575 B.R. 361 (Bankr. S.D. Tex. 2017), *rev'd in part, vacated in part*, 913 F.3d 533 (5th Cir. 2019), *opinion withdrawn and superseded on reh'g,* 943 F.3d 758 (5th Cir. 2019), and *rev'd in part, vacated in part*, 943 F.3d 758 (5th Cir. 2019).

[10] *See In re Ultra Petroleum Corp. ("Ultra Petroleum II")*, 943 F.3d 758 (5th Cir. 2019).

[11] *Id.* at 765.

[12] The Fifth Circuit's opinion in *Ultra Petroleum II* was in fact the second opinion issued by the Fifth Circuit in 2019 on this issue. In January 2019, the Fifth Circuit published an opinion reversing *Ultra Petroleum I*, and in that opinion the three-judge panel stated that it was "persuaded" that the make-whole amount was the economic equivalent of interest. 913 F.3d 533 (5th Cir. 2019), *opinion withdrawn and superseded on reh'g*, 943 F.3d 758 (5th Cir. 2019). Following a rehearing, in November 2019, the Fifth Circuit withdrew its January 2019 opinion and published a new opinion that was substantially similar to its January 2019 opinion but removed its remarks about the make-whole amount constituting the economic equivalent of interest.

[13] *See In re Ultra Petroleum Corp. ("Ultra Petroleum III")*, 624 B.R. 178 (Bankr. S.D. Tex. 2020), *aff'd*, 51 F.4th 138 (5th Cir. 2022).

[14] *See generally id.* at 184–91.

[15] *Id.* at 204.

[16] *See Ultra Petroleum IV* at 142.

[17] *See, e.g.*, *In re Pengo Indus., Inc.*, 962 F.2d 543, 546 (5th Cir. 1992).

[18] *See, e.g.*, *Sch. Specialty*, 2013 WL 1838513, at *5 (holding that make-whole premium should not be disallowed as unmatured interest and instead treated as liquidated damages); *U.S. Bank Nat'l Ass'n v. S. Side House, LLC*, 11-CV-4135 ARR, 2012 WL 273119, at *6 (E.D.N.Y. Jan. 30, 2012) (treating prepayment provision as liquidated damages provision); *In re Trico Marine Servs. Inc.*, 450 B.R. 474, 481 (Bankr. D. Del. 2011) (reviewing cases and holding that make-whole premium is akin to a claim for liquidated damages, and not unmatured interest); *In re Hidden Lake Ltd. P'ship*, 247 B.R. 722, 729 (Bankr. S.D. Ohio 2000); *In re Outdoor Sports Headquarters*, 161 B.R. 414, 424 (Bankr. S.D. Ohio 1993); 4 Collier on Bankruptcy ¶ 502.03 (16th ed. 2021) (collecting cases). *But see In re Ultra Petroleum Corp.*, 913 F.3d 533, 548 (5th Cir. 2019) (finding make-whole amount to be the economic equivalent of interest and unmatured because whether the make-whole amount is due on the date of the bankruptcy petition should be determined without giving effect to ipso facto acceleration clauses), *opinion withdrawn and superseded on reh'g*, 943 F.3d 758 (5th Cir. 2019) (leaving the issue of unmatured interest to be decided by the Bankruptcy Court in the first instance); *Ridgewood Apts.*, 174 B.R. at 721 (characterizing a prepayment penalty as unmatured interest because the purpose of a prepayment penalty is to compensate the lender for lost interest, and the prepayment penalty was not yet due at the time the bankruptcy was filed). One bankruptcy court has noted that liquidated damages provisions could potentially also include compensation for unmatured interest. *See In re Doctors Hosp. of Hyde Park, Inc.*, 508 B.R. 697, 706 (Bankr. N.D. Ill. 2014).

[19] *Ultra Petroleum IV* at 146; *see also In re Energy Future Holdings Corp.*, 842 F.3d 247, 251 (3d Cir. 2016) (referring to a make-whole as a "contractual substitute for interest lost on [n]otes redeemed before their expected due date"); *In re MPM Silicones, L.L.C.*, 874 F.3d 787, 801 n.13 (2d Cir. 2017) (same).

[20] *Ultra Petroleum IV* at 149.

[21] *Id.* at 148

[22] *Id.* at 146.

[23] *Id.* at 149.

[24] *Id.* at 156

[25] *Id.* at 157 (citation omitted).

[26] *Id.*

[27] *Id.* at 154.

[28] *Id.* at 152.

[29] *Id.* at 152–53.

[30] *Id.* at 153–54.

[31] *Id.* at 156.

[32] *Id.* at 159.

[33] *See In re PG&E Corp.*, 46 F.4th 1047 (9th Cir. 2022). In his dissent from the majority, Judge Oldham concurred that the make-whole premium was unmatured interest disallowed by section 502, but would have ended the analysis there, opining that the enactment of the Bankruptcy Code abrogated the solvent-debtor exception. "The Code provides that all claims for unmatured interest are disallowed," and "[t]he solvent-debtor exception provides that not all claims for unmatured interest are disallowed. That's a stark contradiction," leading to the dissent to conclude that "[t]he Code overrides the solvent-debtor exception." *Ultra Petroleum IV* at 160 (Oldham, J., dissenting). Judge Oldham's dissent aligns with the dissent in PG&E, in which Judge Ikuta also concluded that the Bankruptcy Code abrogated the solvent-debtor exception entirely.

[34] *Ultra Petroleum IV* at 159.