

## Fifth Circuit's *Ultra Petroleum* Decision Suggests Make-Wholes are Unenforceable in Bankruptcy, Questions Collectability of Contract Rate Postpetition Interest

January 28, 2019

On January 17 2019, the U.S. Court of Appeals for the Fifth Circuit issued a decision strongly suggesting that make-whole premiums are not payable in bankruptcy to unsecured and undersecured creditors. In *In re Ultra Petroleum Corp.*, the Fifth Circuit found “compelling” the debtors’ argument that a make-whole premium owed to certain unsecured noteholders under the prepetition notes purchase agreement should be disallowed as a claim for “unmatured interest” pursuant to section 502(b)(2) of the Bankruptcy Code.<sup>1</sup> This holding departs from the majority view and creates a stark circuit split. While distressed companies may rejoice in this decision, creditors—particularly unsecured and undersecured creditors—will need to reconsider the likelihood of collection of make-whole premiums for distressed companies that are able to file for bankruptcy protection in Texas, Louisiana, or Mississippi, and to evaluate the risk that courts in other circuits follow the Fifth Circuit’s reasoning. Importantly, the *Ultra Petroleum* decision will likely create additional incentives for distressed companies to file for bankruptcy in the Fifth Circuit if potentially large make-whole premiums are payable to unsecured or undersecured creditors.

This Client Memorandum updates our previous memoranda<sup>2</sup> discussing the treatment of make-whole premiums in bankruptcy, with a focus on the new state of play following the Fifth Circuit’s *Ultra Petroleum* decision, and discusses the Fifth Circuit’s guidance on rates of postpetition interest owed to unsecured creditors in solvent-debtor Chapter 11 cases.

### Background

In 2009 and 2010, Ultra Resources, Inc. issued multiple series of unsecured notes totaling approximately \$1.46 billion. Ultra Resources, along with its parent, Ultra Petroleum Corp., and certain other affiliates (collectively, the “**Ultra Debtors**”) filed for bankruptcy on April 29, 2016. Over the course of the bankruptcy proceedings, as a result of a fortuitous upswing in crude oil prices, the Ultra Debtors became solvent and subsequently proposed a plan of reorganization that purported to pay all of their creditors—including the unsecured noteholders—in full, thus rendering them unimpaired and not entitled to vote on the plan. The noteholders nevertheless objected to the plan, arguing, among other things, that the plan did in fact impair their claims because it failed to pay a \$201 million make-whole premium that was triggered by the filing of the Ultra Debtors’ bankruptcy petitions, plus \$106 million in contract rate postpetition interest. However, rather than force resolution of the impairment issue at the plan confirmation stage, the parties agreed that the Ultra Debtors would segregate sufficient cash to pay the disputed amount, and the cash would later be released either to the noteholders or to the Ultra Debtors

---

<sup>1</sup> *In re Ultra Petroleum Corp.*, No. 17-20793, 2019 WL 237365, at \*10 (5th Cir. Jan. 17, 2019).

<sup>2</sup> See [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).

depending on the bankruptcy court's decision of whether payment of the disputed amounts was required to render the creditors unimpaired.

The debtors argued (i) the make-whole premium qualified as unmatured interest and should therefore be disallowed and (ii) if it did not qualify as unmatured interest, the make-whole premium was an unenforceable penalty provision under New York law. In ruling for the noteholders, the bankruptcy court held that (i) New York law did permit the noteholders to recover the make-whole premium and (ii) failure to pay the noteholders' full state law claim rendered them impaired, irrespective of whether the claim is allowable under the Bankruptcy Code. The bankruptcy court thus did not decide whether the Bankruptcy Code disallows the make-whole premium as unmatured interest under section 502(b)(2).

The Ultra Debtors appealed directly to the Fifth Circuit Court of Appeals.

### Contract and State Law Analysis Pre-*Ultra Petroleum*: *Momentive* versus *EFH*

When evaluating the allowability of a claim in bankruptcy, courts start with the terms of the underlying contract and applicable state law.<sup>3</sup> In the Second Circuit's *Momentive* decision<sup>4</sup> and the Third Circuit's *Energy Future Holdings* ("*EFH*") decision,<sup>5</sup> the courts considered the allowability of claims for make-whole premiums based solely upon an analysis of whether the premiums were payable pursuant to the terms of the underlying indentures and New York law.

The facts and indenture language that were the subject of the *Momentive* and *EFH* litigations are strikingly similar. Each case involved the automatic acceleration of the obligations under the relevant indenture as a result of the issuers filing for bankruptcy. The indentures included near-identical optional repayment, acceleration, and default language, provided for a fixed prepayment fee, and were governed by New York law. In each case, the noteholders were repaid prior to the original maturity date—in *Momentive*, through the issuance of replacement notes pursuant to a plan of reorganization, and in *EFH*, through a postpetition refinancing transaction—and argued that the repayment was an "optional redemption" under the terms of the indentures. And in each case, noteholders sought but failed to rescind acceleration.<sup>6</sup>

In determining whether the make-whole premiums were payable, the courts looked to the terms of the indentures and New York law to determine (1) whether there was a "redemption" of the notes, (2) whether the redemption was "optional" and (3) if the redemption was not optional as a result of the automatic acceleration, whether the noteholders could exercise their contractual right to rescind acceleration and thereby obtain a make-whole premium.

#### Momentive

In *Momentive*, the noteholders' principal argument was that the issuance of replacement notes pursuant to a plan of reorganization constituted an "optional redemption" requiring the payment of a make-whole premium. The

---

<sup>3</sup> See 11 U.S.C. §§ 101(5)(A) (defining the term "claim" as "right to payment"); 502(b)(1) (providing that a claim should be allowed "except to the extent that . . . such claim is unenforceable against the debtor and property of the debtor, under any agreement or applicable law for a reason other than because such claim is contingent or unmatured"); *Raleigh v. Illinois Dep't of Revenue*, 530 U.S. 15, 20 (2000) ("The basic federal rule in bankruptcy is that state law governs the substance of claims . . . Congress having generally left the determination of property rights in the assets of a bankrupt's estate to state law . . ."); see also *In re Sch. Specialty, Inc.*, No. 13-10125 KJC, 2013 WL 1838513, at \*2 (Bankr. D. Del. Apr. 22, 2013) ("The inquiry into whether a prepayment provision will be enforced in bankruptcy begins with whether the prepayment provision is enforceable under applicable state law.")

<sup>4</sup> See *In re MPM Silicones, LLC*, 874 F.3d 787 (2d Cir. 2017).

<sup>5</sup> See *In re Energy Future Holdings Corp.*, 842 F.3d 247 (3d Cir. 2016).

<sup>6</sup> The procedural posture and facts related to the *Momentive* and *EFH* decisions are described in our previous memoranda. See note 2.

Second Circuit disagreed on the grounds that acceleration triggered by the issuer's bankruptcy filing changed the notes' maturity date to the petition date and, therefore, any payment on the accelerated notes following the petition date was not a redemption, which had been stipulated to mean payment prior to maturity.

Second, even assuming that the issuance of the replacement notes was a redemption, the Second Circuit held that the redemption would not have been "optional" because the redemption would have been mandatory by operation of the automatic acceleration clause.

Lastly, the court held that the noteholders were barred from invoking their right to rescind acceleration because it would be "an attempt to modify contract rights and would therefore be subject to the automatic stay."<sup>7</sup>

## Energy Future Holdings

Noteholders in *EFH* fared better than those in *Momentive*, as the Third Circuit held that the postpetition refinancing of the notes did constitute an "optional redemption" entitling the noteholders to the payment of a make-whole premium. The facts of *EFH* rendered the debtors notably unsympathetic: when market interest rates declined, the company sought to refinance its outstanding notes. Understanding, however, that refinancing the notes outside of bankruptcy would require payment of a make-whole premium, the company announced a plan to "file for bankruptcy and refinance the Notes without paying any make-whole amount."<sup>8</sup> Six months later, the company filed for bankruptcy in the U.S. Bankruptcy Court for the District of Delaware and, once in bankruptcy, refinanced all of the first lien notes and part of the second lien notes at a much lower interest rate.

The Third Circuit reached a different conclusion than the Second Circuit, holding that a redemption had occurred and was optional. First, the Third Circuit noted that that "New York and federal courts deem 'redemption' to include both pre-and post-maturity repayments of debt" and, as a result, held that the refinancing transaction was a redemption.<sup>9</sup> Second, the Third Circuit held that the redemption was optional even though there was an automatic acceleration because the debtors had the option to reinstate the accelerated notes' original maturity date pursuant to section 1124(2) of the Bankruptcy Code but instead opted to refinance the notes. After finding the make-whole claim was triggered under the indenture and state law, however, the court did not consider any separate basis on which the claim might be disallowed in bankruptcy.

## Post-Momentive State of Play

Since the *Momentive* and *EFH* decisions focused solely on the relevant agreements' effects pursuant to New York law, they did not address in any detail the question of whether make-whole provisions may be *per se* unenforceable in bankruptcy. Some distressed companies have since addressed the *Momentive* risk by clearly and unambiguously providing in new credit instruments that make-whole premiums would be payable in connection with *any* payment, after *any* default or acceleration, including as a result of bankruptcy.<sup>10</sup>

---

<sup>7</sup> *Momentive*, 874 F.3d at 803-04 (quoting *In re AMR Corp.*, 730 F.3d 88, 102 (2d Cir. 2013)).

<sup>8</sup> *EFH*, 842 F.3d at 251 (quoting Energy Future Holdings Corp., Current Report (Form 8-K) (Nov. 1, 2017)).

<sup>9</sup> *Id.* at 255.

<sup>10</sup> Although not discussed in the *Momentive* and *EFH* decisions and mentioned only in passing in the *Ultra Petroleum* decision, other courts have considered whether make-whole premiums are enforceable liquidated damages provisions or unenforceable penalty provisions under New York law. See, e.g., *Sch. Specialty*, No. 13-10125 KJC, 2013 WL 1838513, at \*5 (deciding that the make-whole premium was an enforceable liquidated damages clause); *In re Trico Marine Servs., Inc.*, 450 B.R. 474, 481 (Bankr. D. Del. 2011) (same). A liquidated damages provision in a contract determines (or provides a formula for determining) in advance the measure of damages in the event of a breach. Although typically New York contract law requires courts to enforce unambiguous contract terms, an exception applies where a court is asked to enforce a liquidated damages provision that is found to be a penalty. A liquidated damages provision is enforceable under New York law where the "amount liquidated bears a reasonable proportion to the probable loss and the amount of actual loss is incapable or difficult of precise estimation." *JMD Holding Corp. v. Cong. Fin. Corp.*, 4 N.Y.3d 373, 380 (2005) (quoting *Truck Rent-A-Ctr., Inc. v. Puritan Farms 2nd, Inc.*, 41 N.Y.2d 420, 425 (1977)). Whether a particular make-whole premium will be enforceable is highly dependent on the (cont.)

## Unmatured Interest Analysis: Majority View versus *Ultra Petroleum*

Although the *Momentive* and *EFH* decisions did not address the enforceability of make-whole premiums under the Bankruptcy Code, prior to the *Ultra Petroleum* decision, the issue had been addressed by numerous bankruptcy courts, with the vast majority of those courts finding that make-whole premiums are payable despite section 502(b)(2) of the Bankruptcy Code, which disallows claims for “unmatured interest.” While those bankruptcy courts generally agreed that make-whole premiums are computed by reference to, or intended to compensate for, interest that would be received through the scheduled maturity date,<sup>11</sup> they nevertheless support the view that make-whole premiums “do not constitute unmatured interest because they fully mature pursuant to the provisions of the contract.”<sup>12</sup> In other words, an obligation to pay a make-whole premium is triggered by the prepayment or acceleration itself, so the amount owed has “matured” and constitutes a valid, allowable claim. As a result, outside of the Southern District of Ohio, in which bankruptcy courts had held make-whole premiums to be unmatured interest,<sup>13</sup> prior to *Ultra Petroleum*, it was highly unlikely that a claim for a make-whole premium would be disallowed as unmatured interest.

*Ultra Petroleum* changed that, becoming the first circuit court to depart from the majority view in suggesting that the relevant make-whole premium compensates the noteholders for interest that was unmatured as of the petition date and thus ought to be subject to disallowance under section 502(b)(2). In the decision on review, the bankruptcy court had ruled that a creditor is unimpaired only if it receives all that it is entitled to under state law (regardless of whether the claim is disallowed under the Bankruptcy Code) and, accordingly, limited its analysis to whether the noteholders were entitled to the make-whole premium under New York law, not reaching the question of enforceability in bankruptcy. The Fifth Circuit disagreed, holding instead that a creditor is impaired only if the *plan itself* (not the Bankruptcy Code) alters a creditor’s rights. In other words, if the Bankruptcy Code disallows a claim otherwise enforceable under state law, that claim need not be paid in bankruptcy to deem the creditor unimpaired.

Turning to whether the make-whole premium constitutes “interest” for purposes of section 502(b)(2), the Fifth Circuit stated that it would look to “economic realities, not trivial formalities.”<sup>14</sup> On that basis, the Fifth Circuit suggested that the make-whole premium in question captures the value of and compensates creditors for the loss of future interest payments, and thus is subject to section 502(b)(2) even if it was “not *actually* interest” itself.

(cont.)

jurisdiction of the bankruptcy and the make-whole formula, as bankruptcy courts have reached vastly different conclusions in their analyses of whether make-whole provisions are enforceable liquidated damages provisions or unenforceable penalties under New York law and other, similar state laws. See Scott K. Charles & Emil A. Kleinhaus, *Prepayment Clauses in Bankruptcy*, 15 AM. BANKR. INST. L. REV. 537, 552 (2007). Notably, the U.S. Bankruptcy Court for the District of Delaware has allowed make-whole premiums as liquidated damages provisions under New York law, finding damages under long-term debt instruments to be difficult to quantify at the time the instruments are executed and the measures of damages to be proportionate to the probable loss. See *Sch. Specialty*, No. 13-10125 KJC, 2013 WL 1838513, at \*3; *Trico Marine*, 450 B.R. at 481. The *Ultra Petroleum* bankruptcy court upheld the make-whole premium on these grounds as well. *In re Ultra Petroleum Corp.*, 575 B.R. 361, 368 (Bankr. S.D. Tex. 2017).

<sup>11</sup> See, e.g., *Ultra Petroleum*, No. 17-20793, 2019 WL 237365, at \*10 (“The purpose of a make-whole provision ‘is to compensate the lender for lost interest.’” (quoting COLLIER ON BANKRUPTCY ¶ 502.03 (Richard Levin & Henry J. Sommer eds., 16th ed.))); *Momentive*, 874 F.3d at 801-02 (The “make-whole premium was intended to ensure that [noteholders] received additional compensation to make up for the interest they would not receive if the Notes were redeemed prior to their maturity date.”); but see *Trico Marine*, 450 B.R. at 481 (“[T]he Indenture Trustee’s claim on account of the Make-Whole Premium is akin to a claim for liquidated damages . . . . As such, it is a claim for neither principal nor interest . . . .”). Although several courts, including the District of Delaware in *Trico Marine*, have concluded that a make-whole provision is better viewed as liquidated damages rather than unmatured interest, as the Fifth Circuit notes, these two categories are not mutually exclusive. See *Ultra Petroleum*, No. 17-20793, 2019 WL 237365, at \*11 (citing *In re Doctors Hosp. of Hyde Park, Inc.*, 508 B.R. 697, 706 (Bankr. N.D. Ill. 2014)).

<sup>12</sup> *In re Outdoor Sports Headquarters, Inc.*, 161 B.R. 414, 424 (Bankr. S.D. Ohio 1993).

<sup>13</sup> See *In re Hidden Lake Ltd. P’ship*, 247 B.R. 722 (Bankr. S.D. Ohio 2000); *In re Ridgewood Apartments*, 174 B.R. 712 (Bankr. S.D. Ohio 1994).

<sup>14</sup> *Ultra Petroleum*, at \*10 (citing *In re Pengo Indus., Inc.*, 962 F.2d 543, 546 (5th Cir. 1992)).

Then, the Fifth Circuit opined that the make-whole premium did not mature as a result of the automatic acceleration of the obligations under the indentures upon the filing of the Ultra Debtors’ bankruptcy petitions because the applicable acceleration clause constituted an unenforceable *ipso facto* clause. Without the enforcement of the acceleration clause, in addition to being “interest,” the make-whole claim would be “unmatured” and therefore disallowed.

### Postpetition Interest Rate In Solvent Debtor Chapter 11 Cases

The Ultra Debtors and the unsecured noteholders agreed at the plan confirmation stage that the noteholders were entitled to postpetition interest. The parties, however, disagreed on the applicable rate required to render the noteholders unimpaired—the Ultra Debtors argued for the federal judgment rate, while the noteholders argued for their higher contractual default rate. Since the Bankruptcy Code does not address the rate at which unimpaired unsecured creditors are entitled to postpetition interest in Chapter 11 cases, the Fifth Circuit remanded the issue to the bankruptcy court to decide the appropriate rate, but laid out two possibilities. The first possibility is the federal judgment rate under 28 U.S.C. § 1961, which sets a rate for any money judgment in a federal court by reference to certain treasury yields. The second possibility is an equitably determined rate—based on the premise that bankruptcy courts are courts of equity, and equity may dictate a different interest rate. Although the court did not finally decide the issue, it did express strong skepticism that full contract rate interest would be required.

### Takeaways

The previous split between the Second and Third Circuits on the make-whole issue had the potential to increase forum shopping for distressed issuers with significant potential make-whole obligations. The Fifth Circuit’s *Ultra Petroleum* decision provides an even stronger incentive: a filing in the Fifth Circuit could now enable issuers that have large make-whole obligations, even with perfected “*Momentive*-proofed” contract language, to avoid payment of such claims.

The *Ultra Petroleum* decision leaves undecided the question of whether make-whole premiums may be allowed for oversecured creditors as either “interest” or “reasonable fees, costs, or charges” provided for under the relevant agreement pursuant to section 506(b) of the Bankruptcy Code. Section 506(b) arguments were not available to the *Ultra Petroleum* noteholders because they were unsecured, and this issue was not discussed in either *Momentive* or *EFH* despite the noteholders in those cases being oversecured. Additionally, in the rare case of a solvent debtor, the Fifth Circuit left open the possibility that a make-whole premium may be payable under the “solvent-debtor exception”—a vestige of pre-Bankruptcy Code common law that gave creditors of solvent debtors a right to contract interest—although the Fifth Circuit strongly indicated that it believed the solvent-debtor exception did not survive the enactment of the Bankruptcy Code in its pre-Bankruptcy Code form.

The court’s guidance on collectability of make-whole claims in a bankruptcy proceeding may be summarized, at a high level, as follows:

|   | Solvent Debtor  | Insolvent Debtor  |
|---|---|---|
| <b>Unsecured or Undersecured Creditor</b> | Likely disallowed under section 502(b)(2), although it is possible (but not probable) that the solvent-debtor exception will permit the payment of the make-whole premium.  | Likely disallowed under section 502(b)(2).  |
| <b>Oversecured Creditor</b>               | Likely allowed up to the value of collateral pursuant to section 506(b), although the Fifth Circuit has not opined on whether make-whole premiums are allowable pursuant to section 506(b). It is also possible (but not probable) that the solvent-debtor exception will permit the payment of the make-whole premium. | Likely allowed up to the value of collateral pursuant to section 506(b), although the Fifth Circuit has not opined on whether make-whole premiums are allowable pursuant to section 506(b). |

With respect to postpetition interest required to render a claim unimpaired, the court’s views may be summarized as follows:

|   | Solvent Debtor  | Insolvent Debtor   |
|---|---|--|
| <b>Unsecured or Undersecured Creditor</b> | Either (i) no entitlement to postpetition interest, or (ii) postpetition interest determined at (x) the Federal Judgment Rate or (y) a different rate as determined by the bankruptcy court in its equitable power. | No entitlement to postpetition interest.   |
| <b>Oversecured Creditor</b>               | The contract rate up to the value of collateral pursuant to section 506(b) of the Bankruptcy Code.  | The contract rate up to the value of collateral pursuant to section 506(b) of the Bankruptcy Code. |

---

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

|                              |                     |  |
|------------------------------|---------------------|--|
| <b>Donald S. Bernstein</b>   | <b>212 450 4092</b> | <a href="mailto:donald.bernstein@davispolk.com">donald.bernstein@davispolk.com</a>           |
| <b>Timothy Graulich</b>      | <b>212 450 4639</b> | <a href="mailto:timothy.graulich@davispolk.com">timothy.graulich@davispolk.com</a>           |
| <b>Marshall S. Huebner</b>   | <b>212 450 4099</b> | <a href="mailto:marshall.huebner@davispolk.com">marshall.huebner@davispolk.com</a>           |
| <b>Darren S. Klein</b>       | <b>212 450 4725</b> | <a href="mailto:darren.klein@davispolk.com">darren.klein@davispolk.com</a>                   |
| <b>Brian M. Resnick</b>      | <b>212 450 4213</b> | <a href="mailto:brian.resnick@davispolk.com">brian.resnick@davispolk.com</a>                 |
| <b>Christopher Robertson</b> | <b>212 450 4917</b> | <a href="mailto:christopher.robertson@davispolk.com">christopher.robertson@davispolk.com</a> |
| <b>Damian S. Schaible</b>    | <b>212 450 4580</b> | <a href="mailto:damian.schaible@davispolk.com">damian.schaible@davispolk.com</a>             |
| <b>Eli J. Vonnegut</b>       | <b>212 450 4331</b> | <a href="mailto:eli.vonnegut@davispolk.com">eli.vonnegut@davispolk.com</a>                   |
| <b>Jacob Weiner</b>          | <b>212 450 4906</b> | <a href="mailto:jacob.weiner@davispolk.com">jacob.weiner@davispolk.com</a>                   |

---

© 2019 Davis Polk & Wardwell LLP | 450 Lexington Avenue | New York, NY 10017

This communication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. This may be considered attorney advertising in some jurisdictions. Please refer to the firm’s [privacy policy](#) for further details.