Fifth Circuit Hands Holders of Bankrupt *Ultra Petroleum* Unsecured Bonds a Major Make-Whole Victory While Gutting Make-Whole Entitlements in Louisiana, Mississippi and Texas, Ending Years of Speculation and Legal Wrangling

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The success of *Ultra Petroleum* bondholders' make-whole claims is grounded in the unusual circumstance of a solvent debtor, with the Fifth Circuit unambiguously holding that make-whole entitlements in non-solvent-debtor cases must be disallowed.

Summary

On October 14, 2022,[1] the United States Court of Appeals for the Fifth Circuit (the *"Circuit Court"*) held, principally, that holders (the *"Noteholders"*) of unsecured notes issued pursuant to a Note Purchase Agreement (the *"NPA"*) entered into by chapter 11 debtor Ultra Petroleum's operating subsidiary Ultra Resources, Inc. (*"OpCo"*) were entitled under the NPA to (i) a substantial contractual make-whole payment under the NPA and (ii) post-petition interest on their make-whole at the NPA's default rate (rather than the Federal Judgment Rate).

Critically, the Circuit Court also held that the Noteholders were only entitled to payment of their make-whole claims under the NPA because the Debtor was rendered, during the pendency of its chapter 11 proceeding, "ultra solvent,"[2] and that under normal circumstances ("Bankruptcy is ordinarily for the insolvent."[3]), the Noteholders' make-whole claims would have been subject to disallowance under 11 U.S.C. § 502(b)(2) as claims for "the economic equivalent of unmatured interest."[4]

The Circuit Court's ruling brings the Fifth Circuit into conversation and conflict with the Second Circuit (which has likewise shown skepticism towards make-whole claims, though not to the same degree) and the Third Circuit (which has proven significantly more friendly to make-wholes) and suggests that the issue of make-whole entitlements in chapter 11 proceedings may finally be ripe for Supreme Court consideration.[5]

Background

OpCo issued multiple series of unsecured notes (the *"Notes"*) totaling approximately $1.46 billion pursuant to the NPA.[6] The terms of the NPA permitted OpCo to "prepay" the Notes at 100% of principal plus a make-whole payment calculated as an amount equal to the excess, if any, of the discounted present value of the remaining scheduled payments on the Notes over the amount of the principal being prepaid.[7] The NPA expressly provided that "[u]pon any Notes becoming due and payable [due to acceleration following an Event of Default], whether automatically or by declaration, such Notes [would] forthwith mature and the entire unpaid principal amount of such Notes, plus . . . any applicable Make-Whole Amount determined in respect of such principal amount (to the full extent permitted by applicable law) . . . [would] all be immediately due and payable."[8] The NPA was governed by New York law.[9]

The Debtors, including OpCo, filed chapter 11 bankruptcy petitions in early 2016.[10] As a result of rising commodity prices, by the time the Debtors proposed their plan of reorganization (the *"Plan"*), they were solvent and proposed to pay their unsecured creditors in full, but, in the case of the Noteholders, without their make-whole claim.[11] On March 14, 2017, the Bankruptcy Court confirmed the Debtors' Plan, which treated the Noteholders as unimpaired, without making any final determination on their Make-Whole Claim.[12] Extensive litigation ensued between the Noteholders and the Debtors over the Noteholders' make-whole claims, much of which has been covered in our client alerts referenced in footnote 5 *supra*.

The Debtors have consistently asserted that payment of the Noteholders' make-whole claims is not required because such claims: (i) represent unmatured interest barred by 11 U.S.C. § 502(b)(2) and/or (ii) arise from an unenforceable liquidated damages provision under governing New York law. The Debtors have also consistently asserted that any post-petition interest on the Noteholders' make-whole claims should be assessed, at most, at the Federal Judgment

Rate, which is lower than the NPA's default rate.[13] Noteholders have consistently argued in response that: (i) for the Noteholders' claims to be unimpaired under the confirmed Plan, the Debtors were required to pay their full make-whole claims; (ii) § 502(b)(2) is inapplicable to their make-whole claims because, they argued, their make-whole claims are "simply not unmatured interest;"[14] and (iii) their make-whole claims are fully enforceable under New York law. The Noteholders also argued that post-petition interest should be allowed on their make-whole claims at the NPA's default rate.

The Decision

The Circuit Court, having considered each of the Noteholders' and the Debtors' assertions has now held:

- Noteholders' make-whole claims were claims for the economic equivalent of unmatured interest and, as such, are subject to disallowance under § 502(b)(2) of the Bankruptcy Code.
- Nevertheless, the judicially created solvent-debtor exception to the Bankruptcy Code's prohibition against awards of unmatured interest survived enactment of the current Bankruptcy Code.
- The solvent-debtor exception operated to suspend disallowance of the Noteholders' make-whole claims.
- The make-whole claims were not unenforceable penalties under New York law, but rather constituted enforceable liquidated damages.
- Given Debtors' solvency, postpetition interest on the Noteholders' make-whole claims is to be calculated according to the agreed-upon NPA default rate.

Whether Make-Whole Claims Constitute Unmatured Interest and the Solvent Debtor Exception

The Circuit Court held, following (according to their interpretation) *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'");[15] *In re MPM Silicones, L.L.C.,* 874 F.3d 787, 801 n.13 (2d Cir. 2017) ("same"[16]), and their own precedent in *In re Pengo Indus., Inc.,* 962 F.2d 543, 546 (5th Cir. 1992) that make-whole claims, generally, are "rather precisely the economic equivalent of unmatured interest."[17] The Circuit Court emphasized that the characterization or structuring of such claims is immaterial.[18]

Having so found, the Circuit Court is compelled to conclude that under ordinary circumstances, such claims for unmatured interest (and claims that compensate a creditor for the loss of future interest) must be disallowed under § 502(b)(2).[19]

Nevertheless, the Circuit Court, following a detailed exercise in statutory interpretation and examination of Congressional intent, found that the "historically rooted"[20] and judge-made doctrine of the so-called 'solvent-debtor exception,' which abrogates the Bankruptcy Code's prohibition on granting creditors unmatured interest, survived the enactment of the current iteration of the Bankruptcy Code in 1978.[21] Applying this solvent-debtor exception to the case at bar, the Circuit Court saved the Noteholders' claims from disallowance as a consequence of the Debtors' solvency.

In describing the rationale for the solvent-debtor exception, the Circuit Court noted, "The reason for this traditional, judicially-crafted exception is straightforward: Solvent debtors are, by definition, able to pay their debts in full on their contractual terms, and absent a legitimate bankruptcy reason to the contrary, they should."[22]

Potential Disallowance Under New York Law and Applicable of Rate of Interest

The Circuit Court then dispensed in shorter order the two remaining issues: (i) whether the Noteholders' claims were improper liquidated damages under New York law (no) and (ii) whether the Noteholders should be limited to interest on their claims only at the Federal Judgment Rate rather than the higher NPA rate (also no).

As to the first of these issues, the Circuit Court, citing *JMD Holding Corp. v. Cong. Fin. Corp.,* 4 N.Y.3d 373, 795 N.Y.S.2d 502, 828 N.E.2d 604 (2005), found that under New York contract law, in order to avoid the Noteholders' make-whole claims as improper liquidated damages, the Debtor would need to have demonstrated that the amount of the claimed make-whole was a 'penalty' and that the "amount fixed [was] plainly or grossly disproportionate to the

probable loss" for which the amount substitutes.[23] Without much argument, the Circuit Court determined that the Debtors failed to carry this burden and that the Noteholders' make-whole claims are therefore enforceable under New York law.[24]

As to the final issue, the Circuit Court followed the lower Bankruptcy Court in relying again on the Debtors' solvency in holding that "the Code does not preclude unimpaired creditors from receiving default-rate post-petition interest in excess of the Federal Judgment Rate in solvent-debtor Chapter 11 cases" and that "as a matter of equity, creditors are entitled to contractually specified rates of interest "on" their claims when a solvent debtor is fully capable of paying up."[25]

For More Information

If you would like further information concerning the matters discussed in this article, please contact any of the following authors or the Chapman attorney with whom you regularly work:

David T. B. Audley
Chicago
312.845.2971
audley@chapman.com

Michael Friedman
New York
212.655.2508
friedman@chapman.com

Larry G. Halperin
New York
212.655.2517
halperin@chapman.com

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1 *Ultra Petroleum Corp. v. Ad Hoc Comm. of OpCo Unsecured Creditors (In re Ultra Petroleum Corp.)*, No. 21-20008, — F.4th —, 2022 WL 8025329, at *1 (Oct. 14, 2022) (*"Opinion"*).
2 *Id.* at *8.
3 *Id* at *1.
4 *Id*.
5 For more background on the approach that other courts have taken to make-whole claims as well as for detail about earlier rulings in *Ultra Petroleum* and for more background on make-whole entitlements in chapter 11 proceedings, please see our prior Chapman Client Alerts: In *Hertz*, the Delaware Bankruptcy Court Provides Guidance on Make-Whole Claims and Post-Petition Interest Payable in Solvent Debtor Cases (January 2022), Fifth Circuit Declines to Enforce Make-Whole Provisions in Bankruptcy (March 2019), and Make-Whole Update (*In re: Ultra Petroleum Corp., et al*): Texas Bankruptcy Court Awards Unsecured Bondholders' 'Enormous' Make-Whole Claim, with Interest, Over Solvent Debtors' Objection (October 2017), Momentive vs EFIH: Second Circuit Splits with Third Circuit on Make-Whole; Keeps Pressure on Lenders to Negotiate Express Make-Whole Provisions (October 2017), and Second Circuit Reverses MPM Silicones' "Prime Plus" Formula for Cramdown Interest Rates, Delivering Secured Creditors a Welcome Victory and Resetting Market Expectations (October 2017).
6 Opinion at *2.
7 NPA, §§ 8.2, 8.7.
8 NPA, § 12.1.
9 NPA, § 22.7.
10 Opinion at 1.
11 *Id.*
12 *Id* at 2.
13 *Id* at 3.
14 *Id* at 5.
15 *Id* at 4.
16 *Id.*
17 *Id.*
18 *Id* at 7.
19 *Id* at 6.
20 *Id* at 3.
21 *Id* at 4.
22 *Id* at 9.
23 *Id* at 14.
24 *Id* at 14.
25 *Id* at 16.