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Chapman Client Alert

March 13, 2019 Current Issues Relevant to Our Clients

Fifth Circuit Declines to Enforce Make-Whole Provisions in Bankruptcy

In a break from other recent circuit court decisions, the U.S. Court of Appeals for the Fifth Circuit (the *"Fifth Circuit"*) ruled that amounts due under a make-whole provision contained in a note purchase agreement constituted unmatured interest and were not permitted to be paid to a creditor under the U.S. Bankruptcy Code.[1] Additionally, the Fifth Circuit elected not to determine whether the so-called solvent debtor exception applied, remanding the case to the Bankruptcy Court to resolve. The solvent debtor exception may permit the payment under the Bankruptcy Code[2] of the make-whole amount at issue even if it constitutes unmatured interest. The make-whole amount may have fared differently had the appeal been considered by another U.S. Court of Appeals, as there is now a circuit split on the question of its allowance in bankruptcy.

The Fifth Circuit refused to enforce make-whole provisions in bankruptcy. Creditors should assess the likelihood of their borrower filing a bankruptcy petition in the Fifth Circuit (covering the states of Texas, Louisiana and Mississippi), which may not view make-whole provisions in the same manner as the Second and Third Circuits.

Background

The *Ultra Petroleum* case presents a unique set of facts. Ultra Petroleum Company (*"Holdings"*) is an oil and gas exploration holding company operating through its subsidiaries UP Energy Corporation (*"Energy"*) and Ultra Resources, Inc. (*"Resources"*). Prior to the filing of the petition, Resources issued unsecured notes in the amount of $1.46 billion (the *"Notes"*) to various Noteholders and another $999 million under a revolving credit facility. The Notes were issued at a time when the price for oil was high. After oil prices fell substantially, Holdings and its subsidiaries filed their respective bankruptcy petitions. The debtors were indisputably insolvent when they filed their petitions, but they became solvent during the pendency of their bankruptcy proceedings when oil prices recovered. The Notes are the relevant securities for purposes of this Alert.

The Notes were issued pursuant to a master note purchase agreement (the *"Agreement"*). The Agreement contained provisions for the payment of a make-whole amount both (i) in the event the debtors voluntarily repaid the indebtedness before maturity and (ii) upon an acceleration of the indebtedness following an event of default. The make-whole amount calculation in the note purchase agreement was a typical formulation used in the institutional private placement market over more than 15 years preceding the Ultra transactions.

The debtors filed their bankruptcy plan (the *"Plan"*) and asserted that the holders of the Notes were unimpaired because the Plan paid such holders all amounts to which they were entitled under the Bankruptcy Code. The holders of the Notes asserted that they were impaired because they were entitled to post-petition interest at their contractual default rate and a make-whole amount under the Agreement, which were not provided for in the Plan. The debtors argued that these amounts constituted impermissible post-petition interest under the Bankruptcy Code.

The central focus of the case was whether the Noteholders' claims were in fact impaired under the proposed Plan for failing to include (a) post-petition default interest on the claims at the contractual default rate and (b) the due but unpaid contractual make-whole amount. The Plan, deeming the Noteholders' claims unimpaired, was confirmed, reserving the disputed issue of impairment for a later hearing. If the claims were later deemed to be impaired, the debtors would be required to pay the make-whole amount and default interest at the contractual rate to render the claims unimpaired.

The Bankruptcy Court Decision

The debtors appealed the decision issued by the Bankruptcy Court for the Southern District of Texas,[3] which had ruled that whether the claims were impaired under the Plan was dependent on whether the make-whole provision was enforceable solely under state law. The Bankruptcy Court found that the make-whole provision was enforceable under the state law governing the Agreement (New York), and the failure to pay the make-whole amount rendered the claims impaired. Since the terms of the Plan provided that creditors would be unimpaired, the debtors were required by the Bankruptcy Court to pay the make-whole amount. The

Bankruptcy Court did not address whether the make-whole amount constituted unmatured interest or whether a provision of the Bankruptcy Code itself might disallow the make-whole claim because those determinations were irrelevant to the Bankruptcy Court that based its ruling on impairment by the Plan under state law.

The Fifth Circuit Decision

The Fifth Circuit disagreed. The Fifth Circuit ruled that, for purposes of impairment, a bankruptcy court must consider not only whether the provision is enforceable under state law, but also whether the claim would be permitted under the Bankruptcy Code itself. Based on this ruling, the Fifth Circuit could have remanded the case to the Bankruptcy Court without getting into the merits of the allowability of a claim for a make-whole amount under the Bankruptcy Code. Nonetheless, the Fifth Circuit addressed the allowability of a make-whole claim under the Bankruptcy Code.

The Fifth Circuit 's opinion on the make-whole provision was succinct, focusing more on whether the solvent debtor exception exists than on the merits of the allowance of the make-whole claim itself. The Fifth Circuit reasoned that whether something constitutes unmatured interest is viewed by looking to the economic realities, not trivial formalities.[4] The Fifth Circuit reasoned that the purpose of a make-whole provision generally "is to compensate the lender for lost interest."[5] Reviewing the make-whole provision at issue in this case, the Fifth Circuit found that it too was intended to make up for lost interest, noting that the amount was calculated by subtracting the accelerated principal from the discounted value of the future principal and interest payments: "That captures the value of the interest the Noteholders would have eventually received if the Notes had not been prepaid."[6] Unfortunately, the Fifth Circuit did not appear to consider that the discounting of future principal and interest payments in a rising interest rate environment may result in a make-whole amount of zero, and thus no obligation on the part of a debtor to pay.

As to whether such "interest" is unmatured, the Fifth Circuit implicitly disagreed with established case law from the Second Circuit,[7] without specifically acknowledging such precedent, when it held that whether an amount is unmatured must be determined without reference to any *ipso facto* clause that created the claim. The Court specifically held that the fact there was an acceleration clause in the underlying Agreement (automatically accelerating the indebtedness and requiring payment of the make-whole amount upon the filing of the bankruptcy) did not "change things because [such clause] operates as an *ipso facto* clause by keying acceleration to, among other things, the debtor's decision to file a bankruptcy provision."[8]

Further, although the Fifth Circuit acknowledged the series of cases that have arisen across the country equating the make-whole provision with a liquidated damages clause, the Fifth Circuit merely noted that because a provision may be a liquidated damages clause does not likewise mean the interest is not unmatured.[9] The two conclusions were not mutually exclusive in the Fifth Circuit's view. This portion of the ruling may be particularly disappointing to creditors in light of the extensive efforts made by creditors over the past several decades to develop make-whole calculations designed to provide a reasonable approximation of loss when indebtedness is accelerated prior to its final maturity.

The Fifth Circuit remanded the make-whole issue to the Bankruptcy Court to determine whether a solvent debtor exception exists which would exempt the make-whole provision from the Section 502(b)(2) prohibition against unmatured interest. The Fifth Circuit, however, doubted it did exempt the make-whole.

Conclusion

The status of make-whole provisions in the context of a bankruptcy proceeding is thus clear in the Fifth Circuit, which views make-whole amounts to be unenforceable in bankruptcy as unmatured interest unless a solvent debtor exeption exists. The make-whole provision at issue in this proceeding, however, may have had a different fate in the Second and Third Circuits. Creditors are well-advised to consider the potential bankruptcy jurisdiction of borrowers and, as highlighted in other client alerts, the formulation of liquidated damages following acceleration.

For More Information

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1 *Ultra Petroleum Corporation et al., v. Ad Hoc Committee of Unsecured Creditors of Ultra Resources et al*., Case No. 17-20793 ("*Ultra Petroleum*"). Chapman and Cutler LLP previously reported on the decision rendered by the U.S. Bankruptcy Court for the Southern District of Texas (the *"Bankruptcy Court"*) in a Chapman Client Alert titled "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," dated October 4, 2017, a copy of which can be downloaded at https://www.chapman.com/insights-topic-21.html. Other client alerts on make-whole provisions, including a Chapman Client Alert on the decision in *Energy Futures Holdings Inc.,842 F.32 241 (3rd Cir. 2016)* and the *MPM Silicones, LLC* 874 F.3d 787 (2d Cir. 2017) are likewise available using that link.

2 11 U.S.C. § 502(b)(2). 11 U.S.C. § 101 *et seq*. is hereafter referred to as the *"Bankruptcy Code."*

3 The original decision was made by the Bankruptcy Court, whose decision was appealed directly to the Fifth Circuit.

4 Opinion at 20, citing *In re Pengo Indus., Inc*., 962 F.2d 543, 546 (5th Cir. 1992). *Pengo* was not a case centered on a make-whole provision, but rather was evaluating whether an instrument with original issue discount had unmatured interest. It would seem an argument that OID constitutes unmatured interest would be more compelling.

5 4 *Collier* ¶ 502.03[3][a]; *In re MPM Silicones, LLC*, 874 F.3d at 801–02 & n.13; *Energy Futures*, 842 F.3d at]; *In re Ridgewood Apartments of DeKalb Cty., Ltd*., 174 B.R. 712, 720 (Bankr. S.D. Ohio 1994).

6 Opinion at 21.

7 *MPM Silicones, LLC* 874 F.3d 787 (2d Cir. 2017).

8 Citing *In re Lehman Bros. Inc.*, 422 B.R. 407, 414–15 (Bankr. S.D.N.Y. 2010*)*, *Ipso Facto Clause*, Black's Law Dictionary 957 (Del. 10th ed. 2014); 4 *Collier*, ¶ 502.03[3][b]; H.R. Rep. No. 95-595, at 352–53 (1977); *In re ICH Corp*., 230 B.R. 88, 94 (N.D. Tex. 1999).

9 Opinion at 22.

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