ALERT MEMORANDUM

Fifth Circuit Distinguishes Code Impairment from Plan Impairment, Casts Doubt on Make-Whole Claims

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On January 17, 2019, the U.S. Fifth Circuit Court of Appeals (the "Fifth Circuit" or the "Court") rejected a bankruptcy court's plan impairment analysis in the Ultra Petroleum Corporation bankruptcy case.[1] The Fifth Circuit's decision supports the view previously expressed by various bankruptcy courts and the Third Circuit Court of Appeals that the alteration of a claim by the Bankruptcy Code does not render a claim impaired under section 1124(1).

Although the Fifth Circuit declined to rule on whether the Bankruptcy Code allows the asserted make-whole claims or post-petition interest, remanding these determinations for reconsideration, the Court provided helpful guidance with respect to each issue. First, the Court was persuaded that the asserted make-whole claims would be disallowed as "unmatured interest" under section 502(b)(2) unless a pre-Bankruptcy Code exception, the so-called solvent-debtor exception, survived the enactment of section 502(b)(2). The Court expressed its "doubt" that the solvent-debtor exception remains intact, noting that the exception was motivated by concerns over bad-faith filings that are now addressed by section 1112(b). Second, the Court suggested that the post-petition interest rate on unimpaired claims in Chapter 11 cases could be set by either the general post-judgment interest statute (the federal judgment rate)[2] or a bankruptcy court acting pursuant to its equitable powers.

[1] *In re Ultra Petroleum Corp.*, No. 17-20793 (5th Cir. Jan. 17, 2019) (hereinafter, the "Opinion").
[2] 28 U.S.C. § 1961 (2014).

Background and Procedural History

Ultra Petroleum Corporation (the "Holding Corporation") and its affiliated debtors (collectively, the "Debtors") filed voluntary petitions for relief under Chapter 11 on April 29, 2016. The Debtors had significant prepetition debt obligations, including approximately $1.46 billion of unsecured notes issued pursuant to a Master Note Purchase Agreement (the "Note Agreement") governed by New York law.

Despite this debt burden, the Debtors became solvent during the course of their bankruptcy proceedings as rising oil prices buoyed the Debtors' oil and gas exploration and production businesses. In the U.S. Bankruptcy Court for the Southern District of Texas (the "Bankruptcy Court"), the Debtors sought confirmation of a plan of reorganization that they alleged would pay creditors in full—such creditors would have "unimpaired" claims and lack the ability to object to the plan.

Creditors with claims under the Note Agreement (the "Noteholders") objected and argued that their claims were, in fact, impaired. The Noteholders argued that the plan did not preserve their rights under provisions of the Note Agreement requiring the Debtors to pay (i) a make-whole amount (the "Make-Whole Amount") and (ii) additional post-petition interest at contractual default rates.[3] The Debtors countered that whether a plan impairs state law claims should be determined only after incorporating the Bankruptcy Code's provisions, arguing that make-whole amounts are disallowed as "unmatured interest" under 11 U.S.C. § 502(b)(2) and post-petition interest is limited to the "legal rate" under 11 U.S.C. § 726(a)(5).

The Bankruptcy Court agreed with the Noteholders, holding that valid state law claims must be paid in full to be classified as unimpaired even if the Bankruptcy Code would disallow such claims.[4] The Bankruptcy Court emphasized that it is the plan pursuant to 11 U.S.C. § 1141(d), rather than the disallowance provision in 11 U.S.C. § 502(b)(2), that discharges the state law claims and determines their impairment.[5] In reaching this conclusion, the Bankruptcy Court rejected the Third Circuit's reasoning in *In re PPI Enterprises (U.S.), Inc.*[6]

Having found that the Noteholders were impaired, the Bankruptcy Court concluded that the Make-Whole Amount was permitted under New York law and the Bankruptcy Code does not limit the enforcement of the Note Agreement's contractual post-petition interest rates. Accordingly, the Bankruptcy Court ordered the Debtors to pay the Noteholders the Make-Whole Amount and post-petition interest at the contractual default rates. The Debtors appealed and were granted a direct appeal to the Fifth Circuit.

The Opinion

The Fifth Circuit's opinion vacated and remanded the Bankruptcy Court's order for reconsideration. The Fifth Circuit unequivocally rejected the Bankruptcy Court's analysis of impairment under section 1124(1), choosing instead to "follow the monolithic mountain of authority" holding that alteration of the rights of a claim by the Bankruptcy Code is not impairment by the plan of reorganization for purposes of section 1124(1).

The Court declined to rule on the Make-Whole Amount or post-petition interest rates, noting that the Bankruptcy Court did not properly address these issues because it erred in its impairment analysis. However, the Court's opinion provides helpful guideposts on how it may rule on these issues in future disputes.

With respect to the Make-Whole Amount, the Fifth Circuit stated that the Make-Whole Amount is the

[3] Lenders under a $999 million revolving credit facility similarly objected that their claims were impaired because the plan did not pay post-petition interest at the contractual default rate. *See* Opinion, at 4.

[4] *See In re Ultra Petroleum Corp.*, 575 B.R. 361, 373 (Bankr. S.D. Tex. 2017) (quoting *In re Vill. at Camp Bowie I, L.P.*, 454 B.R. 702, 708 (Bankr. N.D. Tex. 2011), *aff'd*, 710 F.3d 239 (5th Cir. 2013) ("[E]ven the smallest impairment nonetheless entitles a creditor to participate in voting.")).

[5] *In re Ultra Petroleum Corp.*, 575 B.R. at 373.

[6] 324 F.3d 197 (3d Cir. 2003).

economic equivalent of interest.[7] Moreover, that interest was unmatured as of the date of the Debtors' bankruptcy filing because the acceleration clause causing the Make-Whole Amount to become immediately due and payable was an unenforceable *ipso facto* clause keyed to the Debtors' decision to file for bankruptcy. Therefore, the Noteholders' make-whole claims would be barred by section 502(b)(2)'s disallowance of claims for unmatured interest. The Court remanded to the Bankruptcy Court to consider whether a pre-Bankruptcy Code exception to section 502(b)(2)'s general rule applies to permit the payment of unmatured interest where the debtor is solvent, as in this case. However, the Court suggested that an argument relying on the so-called solvent-debtor exception would be unlikely to prevail in light of section 1112(b), which, like the solvent-debtor exception was intended to do, protects creditors against bad-faith filings.

On the issue of the appropriate post-petition interest rate, the Court commented on the lack of rate-setting guidance for unimpaired Chapter 11 claims in either section 726(a)(5) or pre-Code practice. While section 726(a)(5) provides for payment of post-petition interest at the "legal rate" within the distribution waterfall for cases in Chapter 7, the closest Chapter 11 analog only applies to impaired classes of claims.[8] The Court proposed applying the general post-judgment interest rate set by 28 U.S.C. § 1961 as one "potential path . . . [to] fill that vacuum." As an alternative approach, the Court suggested a bankruptcy court could act in equity to set the interest rate where "the Code's reticulated statutory scheme has [not] displaced the bankruptcy courts' equitable authority."

Implications of the Fifth Circuit's Decision

The Fifth Circuit's decision adds to the weight of authority measuring impairment against the claim allowed under the Bankruptcy Code. In particular, the Court's opinion reinforces the Third Circuit's decision in *PPI*. In *In re PPI Enterprises (U.S.), Inc.*, a landlord-creditor asserted that his claim was impaired by a plan of reorganization that failed to pay him the full amount of rent he was owed over the life of the lease—an amount in excess of Bankruptcy Code's cap on lease-termination damages under § 502(b)(6).[9] The Fifth Circuit agreed with the *PPI* court's holding that "a creditor's claim outside of bankruptcy is not the relevant barometer for impairment."

The decision also highlights that courts continue to scrutinize make-whole claims in the context of bankruptcy. Unlike the Bankruptcy Court, which did not directly address the issue, the Fifth Circuit found that *ipso facto* acceleration clauses that trigger make-whole or default interest provisions are unenforceable in bankruptcy. The Court observed that the Noteholders "cite nothing [for the] proposition" that an acceleration clause triggered by a bankruptcy filing is not an *ipso facto* clause simply because there are other possible triggering events.

Finally, the rate of post-petition interest for unimpaired claims in Chapter 11 remains a live issue, with the Fifth Circuit directing the Bankruptcy Court to provide further guidance on remand. The Court approvingly described Judge Sontchi's holding "that the [bankruptcy court] may award post-petition interest . . . under its equitable power" in *In re Energy Future Holdings Corp.*[10] as "well-reasoned." Therefore, although the Court laid out two approaches in its opinion, the Court may have indicated its preference

[7] *See* Opinion at 20 (citing *In re MPM Silicones, L.L.C.*, 874 F.3d 787, 801-802 & n.13 (2d Cir. 2017) ("[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.")).

[8] *See* 11 U.S.C. § 1129(a)(7) (providing that a court shall confirm a plan only if "each impaired class of claims or interests . . . will receive or retain under the plan . . . a value . . . not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title").

[9] 324 F.3d 197, 201–02, 204 (3d Cir. 2003).

[10] 540 B.R. 109, 124 (Bankr. D. Del. 2015).

for a rate set in equity rather than an expanded use of the general post-judgment interest rate.

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