ALERT MEMORANDUM

# Bankruptcy Court in *Ultra Petroleum*, on Remand, Finds Make-Whole Not Disallowed Under Bankruptcy Code

*December 16, 2020*

On October 27, 2020, the U.S. Bankruptcy Court for the Southern District of Texas (the "Bankruptcy Court") again addressed the question of whether the Bankruptcy Code allows claims for make-whole amounts, issuing a memorandum opinion (the "Opinion")[1] in the *In re Ultra Petroleum* case on remand from the U.S. Fifth Circuit Court of Appeals (the "Fifth Circuit"). As discussed in our prior memoranda,[2] on November 26, 2019, the Fifth Circuit issued an opinion (the "New Opinion"), withdrawing and superseding its earlier January 17, 2019 opinion (the "Prior Opinion").[3] In the New Opinion, the Fifth Circuit held that the alteration of a claim by the Bankruptcy Code does not render a claim impaired under section 1124(1) of the Bankruptcy Code, but remanded to the Bankruptcy Court the questions of whether the Bankruptcy Code disallows certain claims for make-whole amounts and post-petition interest.

On remand, the Bankruptcy Court held that (i) the make-whole amount represents liquidated damages, not unmatured interest or its economic equivalent, and is therefore allowed under the Bankruptcy Code, and (ii) the solvent-debtor exception allows the payment of post-petition interest at the contractual default rates. On December 1, 2020, the Bankruptcy Court certified its Opinion for direct appeal to the Fifth Circuit,[4] indicating that the debate about the allowance of claims for make-whole amounts may be far from over.

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[1] *In re Ultra Petroleum Corp.*, No. 20-32631 (S.D. Tex. Oct. 26, 2020), *amended* (Oct. 27, 2020) [ECF 1874].
[2] *See* *Fifth Circuit Distinguishes Code Impairment from Plan Impairment, Casts Doubt on Make-Whole Claims* (Feb. 26, 2019) and *Fifth Circuit Issues New Opinion in Ultra Petroleum, Withdrawing Guidance on Make-Whole Claims* (Dec. 12, 2019).
[3] *In re Ultra Petroleum Corp.*, 913 F.3d 533 (5th Cir. 2019), *withdrawn and superseded*, 943 F.3d 758 (5th Cir. 2019).
[4] *In re Ultra Petroleum Corp.*, No. 20-32631 (S.D. Tex. Dec. 1, 2020) [ECF 1897].

## Background and Procedural History

Ultra Petroleum Corporation and its affiliated debtors (collectively, the "Debtors") filed voluntary petitions for relief under Chapter 11 on April 29, 2016.[5] 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 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.[6] 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.[7] The Bankruptcy Court emphasized that it is the effectiveness of 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.[8] In reaching this conclusion, the Bankruptcy Court rejected the Third Circuit's reasoning in *In re PPI Enterprises (U.S.), Inc.*[9]

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 did 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 Fifth Circuit New Opinion

In its Prior Opinion, the Fifth Circuit vacated and remanded the Bankruptcy Court's order for reconsideration. The Fifth Circuit rejected the Bankruptcy Court's impairment analysis, holding that the alteration of a claim by the Bankruptcy Code does not render a claim impaired under 11 U.S.C. § 1124(1). The Fifth Circuit declined to rule on the questions of whether the Bankruptcy Code allows the asserted make-whole and post-petition interest claims, but offered significant guidance on how it might rule on each issue. The Prior Opinion is discussed in further detail in our previous memorandum.[10]

The Noteholders filed a joint petition for rehearing *en banc*.[11] The Fifth Circuit granted the petition for

[5] Note that Ultra Petroleum Corporation subsequently filed a second voluntary chapter 11 petition in the Southern District of Texas on May 14, 2020. (Case No. 20-32631, ECF No. 1).

[6] 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* Prior Opinion, at 4.

[7] *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.")).

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

[9] 324 F.3d 197 (3d Cir. 2003).

[10] *See Fifth Circuit Distinguishes Code Impairment from Plan Impairment, Casts Doubt on Make-Whole Claims*, *supra* note 2.

[11] Appellees' and Intervenors' Joint Petition for Rehearing

rehearing *en banc* as a petition for panel rehearing, and on November 26, 2019, issued a New Opinion that withdrew is Prior Opinion.

The Fifth Circuit's New Opinion reaffirmed its holding from its Prior Opinion that the alteration of a claim by the Bankruptcy Code does not render a claim impaired under section 1124(1), but withdrew most of the guidance that it offered in its Prior Opinion regarding the treatment of make-whole claims under 11 U.S.C. § 502(b)(2), the vitality of the pre-Bankruptcy Code solvent-debtor exception and the appropriate interest rate to calculate the asserted post-petition interest.

The Fifth Circuit preserved in its entirety the portion of its Prior Opinion which held, "follow[ing] the monolithic mountain of authority," that the alteration of a claim by the Bankruptcy Code does not render a claim impaired under section 1124(1). The Court reiterated that "[w]here a plan refuses to pay funds disallowed by the Code, the Code—not the plan—is doing the impairing."

With respect to the allowance of the Make-Whole Amount, the Fifth Circuit's Prior Opinion noted that the Make-Whole Amount is the "economic equivalent of 'interest,'" suggesting that make-whole claims might be disallowed under 11 U.S.C. § 502(b)(2). This language was withdrawn in the New Opinion. Similarly, the Prior Opinion featured a lengthy discussion of the provenance and continued vitality of the solvent-debtor exception, a pre-Bankruptcy Code exception to section 502(b)(2)'s general rule that applies to permit the payment of unmatured interest where the debtor is solvent. Although in its Prior Opinion the Fifth Circuit suggested that an argument relying on the solvent-debtor exception would be unlikely to prevail, in the New Opinion the Fifth Circuit concluded that its "review of the record reveals no reason why the solvent-debtor exception could not apply," remanding the question of the exception's applicability to the Bankruptcy Court. [12]

Finally, the Fifth Circuit's opinion also remanded to the Bankruptcy Court the question of the appropriate post-petition interest rate, withdrawing the language in its Prior Opinion on the lack of rate-setting guidance for unimpaired Chapter 11 claims, as well as its prior suggestion that the Bankruptcy Court could apply the general post-judgment interest rate set by 28 U.S.C. § 1961.

## Bankruptcy Court Opinion

On remand, the Bankruptcy Court addressed two questions: first, whether "the Bankruptcy Code disallow[s] a contractual claim for 'make-whole' liquidated damages when an interest-bearing obligation is prepaid," and second, whether "the Bankruptcy Code permits a solvent debtor to forego contractual obligations to an unimpaired class of unsecured creditors, but still pay a distribution to its shareholders."[13]

*Allowance of Make-Whole Amount*

The Bankruptcy Court first found that the Make-Whole Amount represents liquidated damages, not unmatured interest or its economic equivalent, and is therefore allowed under section 502(b)(2). Although the Bankruptcy Court had found in its prior opinion that the Noteholders were owed the Make-Whole Amount, that finding was based on the Bankruptcy Court's rejection of *PPI* and conclusion that "[i]t is the plan that results in the discharge of the state-law based Make-Whole Amount—not section 502(b)(2)."[14] On remand, the Bankruptcy Court emphasized that "[t]he Fifth Circuit made clear that an unimpaired creditor is entitled to the full amount of his claim allowed under the Bankruptcy Code. [The Debtors are] obligated to distribute to the [Noteholders] all amounts validly

En Banc (Jan. 31, 2019).

[12] In a footnote, the Court suggested that that "it is possible a bankruptcy court's equitable power to enforce the solvent-debtor exception is moored in 11 U.S.C. § 1124's command that a 'plan leave[] unaltered . . . equitable . . . rights.'" *See In re Ultra Petroleum Corp.*, 913 F.3d at 12, n. 2.

[13] *In re Ultra Petroleum Corp.*, No. 16-03272, slip op. at 1 (Bankr. S.D. Tex. Oct. 26, 2020).

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

owed under state law, minus any amounts disallowed by the Bankruptcy Code."[15]

The Bankruptcy Court then engaged in a lengthy analysis to define the term "unmatured interest" as "consideration for the use or forbearance of another's money, which has not accrued or been earned as of a reference date."[16] The Bankruptcy Court distinguished the Make-Whole Amount from unmatured interest because it "does not compensate the [Noteholders] for [the Debtors'] use or forbearance of the [Noteholders'] money, it compensates the [Noteholders] for [the Debtors'] breach of a promise to use money."[17]

The Bankruptcy Court's analysis focused in part on the formula used to calculate the Make-Whole Amount, to find that it operates as a liquidated damages provision, as opposed to 'consideration for the use or forbearance' of the Noteholders' money. Because the Make-Whole Amount was calculated using a formula that discounted the remaining payments to their net present value on the petition date, the Bankruptcy Court found that "[t]he Make-Whole Amount compensates the Note Claimants for the cost of reinvesting in a less favorable market" because the Make-Whole Amount could equal zero when reinvestment rates are high.[18]

The Bankruptcy Court also observed that, in contrast to interest, the Make-Whole Amount does not accrue over time. In addition, the Bankruptcy Court noted that while interest (in contrast to liquidated damages) is typically expressed as accruing as a percentage accruing over time, the use of Treasury Rates in the calculation of the Make-Whole Amount here was not dispositive.

*Solvent Debtor Exception and Post-Petition Interest*

Turning to the question of the appropriate calculation of post-petition interest, the Bankruptcy Court concluded that the adoption of the Bankruptcy Code did not abrogate the solvent-debtor exception, and that it entitled the Noteholders to post-petition interest at the default rates.

The Bankruptcy Court traced the evolution of the pre-Bankruptcy Code solvent-debtor exception. Rooted in English law, the solvent debtor exception provided an exception to the general bankruptcy rule that interest stops accruing on the petition date, which exception would apply where a debtor's assets exceeded its liabilities. The Bankruptcy Court tracked the exception across the adoption of the Bankruptcy Act of 1898 and of the Bankruptcy Code in 1978, finding that although not expressly codified, the solvent-debtor exception continues to survive. The Bankruptcy Court concluded that the Noteholders were entitled to post-petition interest, finding that "the solvent-debtor exception is not simply a judicial gloss allowing courts to bypass section 502(b)(2). Instead, the exception recognizes that the equitable prong of section 1124 applies differently when the debtor is solvent."[19] The Bankruptcy Court did not reach the question whether the meaning of "legal rate" under section 726(a)(7) means the federal judgment rate or a contractual rate, because it found that the Noteholders had a right to receive interest at the contractual default rates even if "at the legal" rate means the federal judgment rate.[20]

## Implications of the Bankruptcy Court Opinion

Despite the Bankruptcy Court's detailed analysis, uncertainty about the continued collectability of make-whole claims remains. The Bankruptcy Court's holding and analysis that the Make-Whole Amount is not unmatured interest or its equivalent allowed under section 502(b)(2) now appropriately tees up the question for appeal. Assuming the appeal proceeds, it remains to be seen whether the Fifth Circuit will follow the holding it initially adopted in its withdrawn Prior Opinion, which suggested make-whole claims are "unmatured interest" and therefore unenforceable in bankruptcy, or adopt the majority view, followed by

[15] *In re Ultra Petroleum Corp.*, No. 16-03272, slip op. at 7 (Bankr. S.D. Tex. Oct. 26, 2020).
[16] *Id.* at 12.
[17] *Id.* at 8.
[18] *Id.* at 14–19.
[19] *Id.* at 40.
[20] *Id.* at 41.

the Bankruptcy Court Opinion, that make-whole claims are allowed under section 502(b)(2).

Similarly, in its Prior Opinion the Fifth Circuit, in language withdrawn in its New Opinion, suggested without holding that the solvent-debtor exception would not provide for payment of post-petition interest, instead indicating that the Bankruptcy Court should address the question in the first instance.[21] It will be worth watching if and how the Fifth Circuit addresses the applicability and operation of the solvent-debtor exception to make-whole claims.

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[21] *In re Ultra Petroleum Corp.*, 913 F.3d at 547.