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No Premium Recovery Guarantees For 5th Circ. Lenders

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On Jan. 17, 2019, the U.S. Court of Appeals for the Fifth Circuit issued its opinion in In re Ultra Petroleum Corp.[1] reversing the conclusion of the U.S. Bankruptcy Court for the Southern District of Texas that certain unsecured creditors of Ultra Petroleum Corp. were "impaired" creditors under the Bankruptcy Code. Ultra was insolvent at the commencement of its Chapter 11 case but ultimately became solvent during the case.

Perhaps most importantly, the Fifth Circuit also concluded that because the applicable "make-whole" payment provisions constituted unmatured interest, the make-whole was only recoverable by the creditors if the "solvent-debtor" exception survived Congress' enactment of Section 502(b)(2). While the Fifth Circuit remanded this specific question to the bankruptcy court to answer in the first instance, even if such exception existed it would not impact the vast majority of cases in which the debtor is insolvent and equity is "out of the money."

The formulation of the make-whole provision in Ultra's governing note agreement was essentially tied to the discounted value of the remaining scheduled principal and interest payments with respect to called principal minus the called principal — a very common formulation used in the market over the past several years. As a result, if the debtor is insolvent, any creditor with a make-whole may need to identify another exception to Section 502(b)(2)'s prohibition against unmatured interest. The only conceivable exception is Section 506(b), which permits an oversecured creditor to recover post-petition interest, fees, costs and charges accrued during the pendency of the bankruptcy case to the extent of the collateral value remaining after payment of its prepetition claim. Yet, under the Fifth Circuit's reasoning as discussed below, Section 506(b) does not permit recovery of post-emergence amounts. Hence in the Fifth Circuit, Section 506(b) is unlikely to protect a make-whole that reflects the present discounted value of post-emergence interest payments.

Finally, the Fifth Circuit turned to the creditors' claim for post-petition interest, finding that the Bankruptcy Code says nothing about post-petition interest on unimpaired claims for Chapter 11 cases and that it is "not clear what should fill that vacuum." The Fifth Circuit overturned the bankruptcy court's award of interest at the contractual rate and remanded this issue for the bankruptcy court's determination.

The Bankruptcy Court Decision

This case arose out of an anomalous instance in which Ultra had become solvent during its bankruptcy case due in part to a rise in commodity prices after the petition date. Therefore, Ultra ultimately proposed a Chapter 11 plan that would pay all unsecured claims in full, including post-petition interest. The plan treated the creditors as unimpaired and, as a result, the creditors were "conclusively presumed to have accepted the plan."[2] However, certain unsecured creditors objected to the plan and their treatment as holders of unimpaired claims because the plan failed to provide for the payment of both the make-whole premium contemplated by the note agreement and post-petition interest at the contractual default rate. Ultra argued, among other points, that creditors were unimpaired because the make-whole premium represented unmatured interest, which Section 502(b)(2) of the Bankruptcy Code expressly disallows, and that the Bankruptcy Code limits post-petition interest to the federal judgment rate.

The bankruptcy court held in favor of the creditors. In doing so, the bankruptcy court rejected the Third Circuit precedent in In re PPI Enterprises (US) Inc.[3] In PPI Enterprises, the Third Circuit noted that impairment of claims should be considered only under the Bankruptcy Code, rather than the plan of reorganization. Therefore, according to the Third Circuit, a claim is unimpaired if the plan provided for payment of the claim in the full amount allowed by the Bankruptcy Code. In contrast, the bankruptcy court held that only the plan, not any claim disallowance provisions in the Bankruptcy Code, can impair creditors. The court further found that since Ultra's plan provides that the creditors are unimpaired and shall be paid whatever amount necessary to render them unimpaired, nonpayment of amounts under the note agreement would render the affected claims impaired — even if the Bankruptcy Code otherwise disallows such payment. Accordingly, the bankruptcy court awarded more than $300 million of the make-whole amount and post-petition interest at the contractual default rate. Ultra appealed directly to the Fifth Circuit.

The Fifth Circuit Decision

The Creditors' Claims May Not Have Been Impaired

The Fifth Circuit reversed and remanded the bankruptcy court's decision that the creditors' claims were impaired. The key issue the Fifth Circuit examined was whether "the Rich man's creditors are 'impaired' by a plan that paid them everything allowed by the Bankruptcy Code."[4] The Fifth Circuit stated that it would "follow the monolithic mountain of authority holding the [Bankruptcy] Code — not the plan of reorganization — defines and limits the claim in these circumstances."[5] Citing the only Court of Appeals case addressing the issue,[6] numerous reported bankruptcy court opinions and the leading treatise, the Fifth Circuit held that the plan does not have to pay the creditor amounts that are disallowed under the Bankruptcy Code in order for a creditor to be deemed unimpaired.[7]

The Make-Whole Constituted Disallowed Unmatured Interest Under Section 502(b)(2)

Had the Fifth Circuit stopped at this juncture, the ruling may not have been particularly notable. But the Fifth Circuit did not.

Instead, the Fifth Circuit specifically found that the interest for which the make-whole amount would compensate was unmatured as of the Chapter 11 petition filing date, and therefore the claim for the make-whole itself was disallowed under Section 502(b)(2) of the Bankruptcy Code, absent an applicable

exception. The Fifth Circuit further concluded that this exception could only be the solvent-debtor exception — assuming the provision survived the enactment of the Bankruptcy Code, which the Fifth Circuit "doubt[s] it did." The Fifth Circuit did not directly address whether a make-whole could be allowed under Section 506(b)'s exception for reasonable charges and fees, as the creditor in Ultra was unsecured. However, as noted below, the Fifth Circuit's other findings and reasoning may preclude such an argument.

First, the Fifth Circuit noted that the make-whole was the "economic equivalent of 'interest'" — particularly as it was "calculated by subtracting the accelerated principal from the discounted value of the future principal and interest payments." Second, the Fifth Circuit found that the make-whole was unmatured, as it was not due as of the date of the filing and the note agreement's automatic acceleration clause, which provided that all amounts under the note agreement including the make whole were due and payable immediately and automatically upon the commencement of the bankruptcy case, "doesn't change things" as if so applied it would operate as an unenforceable ipso facto clause.

Finally, the Fifth Circuit found prior published decisions on this issue — none of which were rendered at the circuit level — to be unpersuasive. The Fifth Circuit noted that some courts had found such interest to now be matured pursuant to the provisions of the contract; an argument dismissed as the Fifth Circuit concluded that "ipso facto clauses count for nothing when deciding maturity under Section 502(b)(2)." The Fifth Circuit also noted that other courts "have concluded make-whole provisions are better viewed as liquidated damages rather than unmatured interest" but then found that "those categories are not mutually exclusive." Indeed, the Fifth Circuit noted that the creditors' principal argument was that the make-whole amount was "not actually interest" and that the creditors argued that "it compensates the noteholders not for the use of their money, but for [Ultra's] forbearance from using that money" as well as that "it is paid in a lump sum rather than earned over time." The Fifth Circuit found this argument unpersuasive, noting that the make-whole amount need not "be unmatured interest" but only that "it walks, talks and acts like unmatured interest."

The only argument the Fifth Circuit found somewhat persuasive was that the solvency of the debtor should create an exception to the disallowance of the claim. While the Fifth Circuit remanded the issue to the bankruptcy court for decision, it noted that even if the solvent-debtor exception were to still exist in some contexts, the solvent-debtor exception likely would not be an exception to Section 502(b)'s disallowance because the Bankruptcy Code requires solvent debtors to pay post-petition interest "on" a claim, rather than "as part of" a claim — a distinction with additional important ramifications as will be discussed in more detail below.[8]

The Creditors Should Receive Post-Petition Interest on a Claim, but not as Part of a Claim

The parties did not dispute that some post-petition interest was due — the question was how much. The Fifth Circuit noted that the 1994 amendments to the Bankruptcy Code repealing then Section 1124(3) clarified that the Bankruptcy Code permitted a creditor post-petition interest on a claim but not as part of a claim.[9] Indeed, the Fifth Circuit noted that "Congress knew how to write about interest as part of a claim when it wanted to" and that Section 502(b)(2) refers to a "claim … for unmatured interest."

However, after a review of pre-Bankruptcy Code case law, the court concluded the "modern concept of post-petition interest on a claim had no analogy under pre-code law." Consequently, the Fifth Circuit found that it was left with two options: the general post-judgment interest statute or equity. The Fifth Circuit remanded this choice to the bankruptcy court for further determination; however, before so

doing, the Fifth Circuit clarified its view that the creditors have no "legal right to post-petition interest at the default rates," as no New York law required them to receive post-petition interest, and the "contractual rates at issue here governed interest paid on amounts owed under the contract, not interest on a bankruptcy award."

Implications

The opinion clarifies that unsecured creditors of an insolvent debtor (and likely even a solvent debtor) will not be entitled in the Fifth Circuit to recover a make-whole amount if the make-whole amount is a substitute for unmatured interest. Moreover, the Fifth Circuit's rationale that post-petition interest should only be paid on a claim rather than as part of a claim would further restrict any argument that a secured creditor should be in a different spot on this issue than an unsecured creditor. This is because Section 506(b) permits an oversecured creditor to recover "interest on a claim," and thus would only permit recovery of post-petition interest incurred during the pendency of the bankruptcy case.

Thus, while the Fifth Circuit's opinion directly addressed the allowability of make-whole/prepayment premiums for unsecured creditors in solvent debtor cases, its reasoning casts doubt on the allowability of such premiums even for oversecured creditors. Just as the Ultra unsecured creditors needed to find an exception (i.e., the solvent-debtor exception) to Section 502(b)(2)'s general proscription against unmatured interest, so too must an oversecured creditor in an insolvent debtor case find an exception. As noted above, an exception under Section 506(b) appears to be unlikely given the Fifth Circuit's reasoning and conclusions, which appear to restrict Section 506(b) to only permitting recovery of post-petition interest, fees, costs, and charges incurred during the pendency of the bankruptcy case and not to the extent reflective of future interest payments that extend long beyond the debtor's emergence from bankruptcy. An oversecured creditor may seek to argue that a make-whole premium reflects liquidated damages and hence is really a "charge" under Section 506(b) rather than future interest, but that argument would be challenged by the Fifth Circuit's statement that make-wholes that "walk, talk and act" like unmatured interest should be disallowed as unmatured interest under Section 502(b)(2).

Importantly — unlike the rulings of Momentive,[10] AMR,[11] and EFH[12] — there is no easy path to simply "drafting around" the Fifth Circuit's finding in Ultra Petroleum Corp. that if the make-whole, prepayment, or other premium "walks, talks, and acts" like unmatured interest, then it may be subject to disallowance. As the Fifth Circuit appears to be the first circuit court to rule on this issue, it is unclear whether other circuits, or bankruptcy or district courts outside the Fifth Circuit, will follow. Nonetheless, the ruling serves as a powerful caution to all lenders — both secured and unsecured — that recovering a make-whole, prepayment or other premium remains no guarantee during a bankruptcy case.

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[1] In re Ultra Petroleum Corp., Case 17-80793, Doc. 00514799021 (5th Cir. Jan. 17, 2019).

[2] See 11 U.S.C. § 1126(f).

[3] In re PPI Enterprises (U.S.) Inc., 324 F 3d 197, 206-07 (3d Cir. 2003) (PPI).

[4] In re Ultra Petroleum Corporation at 2.

[5] Id.

[6] In re PPI Enterprises (U.S.) Inc., 324 F 3d 197, 206-07 (3d Cir. 2003) (PPI).

[7] In re Ultra Petroleum Corporation at 5.

[8] Id. at 17.

[9] Id.

[10] In re MPM Silicones LLC, 874 F.3d 787 (2d. Cir. 2017) (Momentive).

[11] In re AMR Corp., 730 F.3d 88 (2d Cir. 2013) (AMR).

[12] In re Energy Future Holdings Corp., 842 F.3d 247 (3d Cir. 2016) (EFH).