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Fifth Circuit To Weigh Enforceability of Make-Whole Premiums in Chapter 11

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A recent bankruptcy case now on appeal is being closely watched for the significant economic repercussions it could have on debtors and creditors alike. On October 26, 2020, in *In re Ultra Petroleum Corp.*, the U.S. Bankruptcy Court for the Southern District of Texas held that the debtor must pay (1) the make-whole premium owed under its debt documents and (2) post-petition interest at the contractual default rate.

The decision represents the latest foray by a bankruptcy court into two disputed areas of law that can materially impact creditor recoveries as well as a debtor's flexibility in confirming a plan of reorganization. If it withstands appeal in the U.S. Court of Appeals for the Fifth Circuit, *Ultra* will represent a victory for sophisticated creditors and will become a significant consideration for prospective debtors when evaluating their optimal filing venue.

Background

Ultra Petroleum Corporation is an oil and gas exploration and production company. Between 2008 and 2010, Ultra Resources, Inc. — Ultra Petroleum's operating subsidiary — issued $1.46 billion of unsecured notes under a note purchase agreement and borrowed another $999 million under a revolving credit facility. After a precipitous decline in oil prices, on April 29, 2016, Ultra Petroleum and certain of its affiliates (collectively, the "Debtors") filed for Chapter 11 in the Bankruptcy Court.

During the pending bankruptcy, oil prices rebounded to such a degree that the Debtors became "massively solvent." As a result, the Debtors proposed a plan to pay the creditors under the notes agreement and revolving credit facility (together, the "Funded Debt Creditors") the "outstanding principal owed on those obligations, pre-petition interest at a rate of 0.1%, and post-petition interest at the federal judgment rate." The Debtors argued that this treatment would pay the Funded Debt Creditors in full, leaving them unimpaired and unable to vote on the reorganization plan.

The Funded Debt Creditors objected, arguing that they were impaired because the plan did not provide for payment of the make-whole amount and post-petition interest at the contractual default rate. Under the notes agreement, filing for bankruptcy was an event of default, which entitled the noteholders to the make-whole amount and default interest. The revolving credit facility did not contain a make-whole premium but did require default interest upon filing for bankruptcy. The amounts at stake were significant. The Funded Debt Creditors claimed that the make-whole amount was $201 million and post-petition interest totaled $186 million.

On September 21, 2017, the Bankruptcy Court issued an opinion allowing the make-whole amount and post-petition interest at the default rates. The Bankruptcy Court reasoned that, to be unimpaired, the Funded Debt Creditors must be paid everything they are owed under state law, even if such payments are otherwise disallowed by the Bankruptcy Code. Following a direct appeal by the Debtors, the Fifth Circuit reversed and remanded to the Bankruptcy Court to decide the appropriate post-petition interest rate and whether the Bankruptcy Code disallows the make-whole amount.

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Bankruptcy Court's Remand Decision

On remand, the Bankruptcy Court considered two principal questions: first, whether the make-whole amount was disallowed under the Bankruptcy Code because it constituted unmatured interest; and second, whether the "solvent-debtor exception" exists such that a solvent debtor must pay unimpaired, unsecured creditors post-petition interest at the contractual rate.

Make-Whole Amount Issue

The Bankruptcy Court held that the make-whole amount represented liquidated damages, not unmatured interest. Resorting to the ordinary meaning of the term "interest," the court determined that interest means consideration for the "use or forbearance of another's money accruing over time." The make-whole amount compensates the noteholders for any actual loss suffered due to prepayment of the notes — namely, the cost of reinvesting in a less favorable market — and not for the use or forbearance of the noteholders' money. The court observed that, unlike interest, the make-whole amount is a one-time payment that fixes the noteholders' damages at the time of prepayment and does not accrue over time.

In rejecting the Debtors' argument that the make-whole amount was the economic equivalent of unmatured interest, the Bankruptcy Court concluded that a mere reference in a make-whole formula to interest rates does not convert it into the economic equivalent of interest. The make-whole amount was not directly tied to the interest that would have been owed under the notes agreement absent prepayment. Based on the make-whole amount formula, if the "market was substantially more favorable at the time of prepayment, the Make-Whole Amount could equal zero dollars." The make-whole amount therefore approximates the noteholders' damages based on the timing of the prepayment and the applicable reinvestment rate. Because the make-whole amount constituted liquidated damages, not unmatured interest, it was not disallowed under the Bankruptcy Code. Consequently, the Debtors had to pay the make-whole amount in full.

Solvent-Debtor Exception Issue

The Bankruptcy Court held that the solvent-debtor exception exists and therefore requires the Debtors to pay post-petition interest at the contractual default rate. The court offered both historical and equitable support for this conclusion: The solvent-debtor exception has been widely recognized for centuries, including after the enactment of the Bankruptcy Code, and nothing in the legislative history or the Bankruptcy Code "suggests that Congress intended to defang the solvent-debtor exception."

Additionally, the Bankruptcy Court reasoned that the rationale for this exception is rooted in sound equitable principles: A solvent debtor should pay its debts in full before distributing value to shareholders. And to pay a creditor in full, a debtor must pay what is owed under its contractual arrangement with a creditor. Barring unimpaired, unsecured creditors of a solvent debtor from receiving their bargained-for interest would allow a debtor's shareholders "to realize an unjust windfall." Thus, to leave the Funded Debt Creditors unimpaired, the Bankruptcy Court concluded that the Debtors must pay post-petition interest at the default rate as provided for under the notes agreement and revolving credit facility.

Implications

In light of the *Ultra* decision, a company contemplating a bankruptcy filing should closely consider whether the Southern District of Texas is the optimal venue if, under its debt documents, a make-whole premium is owed to its unsecured (or undersecured) creditors upon filing for bankruptcy. The Bankruptcy Court endorsed a narrow view of unmatured interest and its economic equivalents; seemingly, under the *Ultra* decision, it is hard to envisage a make-whole premium that would qualify as unmatured interest (and therefore would not have to be paid by a debtor).

However, it bears noting that the *Ultra* decision rests on a careful analysis of the contractual make-whole language at issue. For example, the Bankruptcy Court emphasized that the make-whole amount was a liquidated damages provision crafted to compensate the noteholders for the cost of reinvesting the prepaid principal at the time of prepayment. Depending on prevailing market interest rates, the make-whole amount could have resulted in no payment at all. There is no guarantee that a make-whole payment that lacks these features will be treated in the same manner. Moreover, the make-whole amount in *Ultra* was triggered by the event of default that occurred when the Debtors filed for Chapter 11, not a prepayment or optional redemption in advance of maturity. This drafting distinction is significant and allowed the noteholders to avoid the issue that disqualified the make-whole payment in the U.S. Court of Appeals for the Second Circuit's 2017 *In re MPM Silicones, LLC* decision, which held that because maturity accelerated to the petition date upon a Chapter 11 filing, the debt could not be prepaid or redeemed.

The final resolution of the *Ultra* make-whole premium dispute is far from complete. The Fifth Circuit issued a decision in January 2019 that, while later withdrawn, is noteworthy because it conflicts with the *Ultra* decision. In it, the Fifth Circuit signaled that make-whole premiums owed to unsecured creditors are, as a matter of law, disallowed under the Bankruptcy Code. How the Fifth Circuit will view the make-whole issue when it returns in the coming year remains to be seen.