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5th Circ. Ch. 11 Ruling Could Be Good And Bad For Creditors

By **Theresa Foudy and Alexander Severance** (October 21, 2022, 2:46 PM EDT)

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For decades, there has been a significant split in authority as to the enforceability of yield maintenance, or make-whole, premiums in Chapter 11 cases.

While some courts have held that such premiums are enforceable as valid claims for liquidated damages, others have held that such premiums are the economic equivalent of unmatured interest and, thus, unrecoverable under Section 502(b)(2) of the U.S. Bankruptcy Code.

During this period, courts have also hotly debated the appropriate rate to use in calculating a creditor's entitlement to post-petition interest.

Some note that, in so-called solvent debtor scenarios, unsecured creditors are entitled to recover post-petition interest on their claims at their contractual rate or a state's statutory rate, while others have held that only the federal judgment rate — a typically lower rate — applies.

On Oct. 14, the U.S. Court of Appeals for the Fifth Circuit[1] released its latest **decision** in the In re: Ultra Petroleum Corp. case, providing important precedent on both of these oft-litigated issues.

Recoverability of Make-Whole Premiums in Bankruptcy

In larger Chapter 11 bankruptcies, make-whole premiums can account for tens, or even hundreds, of millions of dollars.

Given the significant impact such claims can have on recoveries by junior creditors and equity holders, it is perhaps unsurprising that there has been extensive litigation on their enforceability, which in turn has led to two judicial perspectives.

As the Fifth Circuit outlined in their since-superseded 2019 decision in Ultra, in one camp sit those lower courts — including in the Second, Third, Seventh, and Ninth Circuits — who have held that make-whole premiums are enforceable notwithstanding Section 502(b)(2)'s disallowance of claims for unmatured interest.

Though their rationales differ — some have found a make-whole premium to be akin to liquidated

damages,[2] while others have held that make-whole premiums fully mature upon a bankruptcy filing[3] — all agree that the premiums are, by implication of their respective conclusions, not barred as "unmatured interest" under Section 502(b)(2) of the Bankruptcy Code.

In the other camp are those courts that have found make-whole premiums to be the economic equivalent of unmatured interest, as their intended purpose is to compensate creditors for "the value of the interest the [creditors] would have eventually received if the [debt] had not been prepaid."[4]

Post-Petition Interest in Solvent Debtor Cases

Likewise, there has been an ongoing split in authority on the applicable post-petition interest rate for unsecured creditors' claims.

As the Fifth Circuit also noted in their 2019 decision in Ultra, courts have reached consensus that, in many cases, "creditors are entitled to some post-petition interest."[5]

That said, the ambiguity in Section 726(a)(5) of the Code, which requires post-petition interest on unsecured claims to be paid at the legal rate, has produced a separate mass of conflicting decisions.[6]

In one corner, some courts, including the U.S. Court of Appeals for the Ninth Circuit in the 2021 In re: PG&E Corp. case, have held that the contractual rate is to be applied. To allow otherwise could encourage debtors to file Chapter 11 petitions "to escape their obligations to pay interest at rates that are unfavorable."[7]

However, other recent decisions, such as In re: Hertz Corp. in the U.S. Bankruptcy Court for the District of Delaware, have found that the federal judgment rate should apply to unsecured creditors' post-petition interest claims for reasons of efficiency, fairness, predictability and uniformity within the bankruptcy system.[8]

Background of Ultra Decision

These live debates explain the heightened interest in Ultra.

In 2016, the Ultra debtors filed a petition for Chapter 11 relief, at a time when they were insolvent. However, during the post-petition period, buoyed by rising commodity prices, the debtors became solvent and thus proposed a plan in which all creditors were to be unimpaired.[9]

An ad hoc committee of unsecured noteholders asserted that they were entitled to the payment of a make-whole premium under the terms of the applicable note purchase agreement and to post-petition interest at their contractual default rate.

In 2017, the U.S. Bankruptcy Court for the Southern District of Texas overruled the debtors' objection that any make-whole premium would constitute unmatured interest disallowed under Section 502(b)(2) of the Bankruptcy Code, finding that, in order to be unimpaired under the Bankruptcy Code, a creditor must receive whatever it would be entitled to under state law, regardless of whatever limitations the Bankruptcy Code would otherwise impose upon the allowed amount of the claim.

The Bankruptcy Court similarly found that, in order to be unimpaired, the noteholders needed to receive the rate of interest that they were entitled to under state law.

On appeal, the Fifth Circuit vacated this opinion in January 2019. Following the Third Circuit's holding in In re: PPI Enterprises (US), Inc., the Fifth Circuit held that a creditor is not impaired so long as it receives the full amount of its claim, as limited by operation of the Bankruptcy Code.

The Fifth Circuit then remanded the case to the Bankruptcy Court for determination of whether the Bankruptcy Code limited the noteholders' entitlements to a make-whole premium and post-petition interest at their contractual rate, although in so doing, the Fifth Circuit strongly suggested in dicta that the make-whole premium should be disallowed as unmatured interest barred by Section 502(b)(2), and that there was no entitlement to post-petition interest at the contractual rate pursuant to the so-called solvent debtor exception.

However, the Fifth Circuit subsequently granted a petition for rehearing, and superseded its own decision with a new opinion that maintained the holding on impairment but removed any dicta on entitlement to make-whole premiums or post-petition interest at the contract rate.

On remand, the Bankruptcy Court issued a new decision in October 2020, finding that the noteholders' claim for a make-whole premium was not disallowable under Section 502(b)(2) and that the noteholders were entitled to post-petition interest at their contractual default rate under the solvent debtor exception.

This led to another appeal that, in turn, led to the Fifth Circuit's current opinion.

Fifth Circuit's Opinion in Ultra

In the latest Ultra opinion, a divided three-judge panel affirmed the Bankruptcy Court's opinion and found that the noteholders were entitled to both the make-whole premium and post-petition interest at the contractual default rate.

In doing so, however, the court held that make-whole premiums are the economic equivalent of unmatured interest and, thus, generally disallowable under Section 502(b)(2) of the Bankruptcy Code.

Nonetheless, the court found that the solvent debtor exception survived the enactment of the Bankruptcy Code and entitled the noteholders to both the otherwise disallowable make-whole premium and post-petition interest at the contractual default rate.[10]

The Fifth Circuit's opinion begins by siding with Ultra to find that make-whole premiums are generally disallowed under Section 502(b)(2) of the Bankruptcy Code.[11] Rejecting the noteholders' arguments on this point, the Fifth Circuit first noted that the test for disallowance under Section 502(b)(2) included not just unmatured interest per se, but also the economic equivalent thereof.[12]

The court noted that, "[o]therwise, the Code's disallowance of unmatured interest would be susceptible to easy end-run by canny creditors."[13]

While recognizing that "[c]ontractual make-whole amounts, like the one at issue here, are expressly designed to liquidate fixed-rate lenders' damages flowing from debtor default while market interest rates are lower than their contractual rates," the Fifth Circuit then held that, in order to be allowable, something transformative must occur in the calculation of an amount demanded by creditors other than simply discounting future interest payments.[14]

Pointing to the make-whole calculation in the debtors' credit agreement, it observed that no such transformation had occurred. Rather, the formula in question "yield[ed] precisely the 'economic equivalent' of [the noteholders'] unmatured interest," as it was simply the sum of the remaining interest payments discounted by an agreed upon reinvestment rate.[15]

The Fifth Circuit also rejected the noteholders' contention that, by constituting liquidated damages, the make-whole premium could not be the economic equivalent of unpaid interest, highlighting a "non-overlapping space in the Venn Diagram between liquidated damages and unmatured interest" and holding that the amount in question could be (and was) both.[16]

From this point on, however, the Fifth Circuit's majority opinion aligned with the noteholders.

While noting that "[i]n the ordinary case, the Bankruptcy Code would disallow a make-whole amount that functionally equates to unmatured interest," the court held that "this is not the ordinary case" because Ultra was solvent and, "when a debtor is able to pay its valid contractual debts, traditional doctrine says it should – bankruptcy rules notwithstanding."[17]

This is so, because, while "[w]ith an insolvent debtor, halting contractual interest from accruing serves the legitimate bankruptcy interest of equitably distributing a limited pie among competing creditors ... [w]ith a solvent debtor, that legitimate bankruptcy interest is not present."[18]

After recounting its historical recognition, the Fifth Circuit confirmed that the solvent debtor exception had survived the enactment of the Bankruptcy Code in 1978, as Congress has not expressly abrogated the exception in the statutory text.[19]

Thus, under U.S. Supreme Court precedent to the effect that if Congress had intended to change pre-code practices, Congress would have stated so explicitly, the court found that the solvent debtor exception is alive and well — at least in the Fifth Circuit.

It then turned to the debtors' alternative argument that, regardless of its enforceability under the solvent debtor exception, the make-whole premium constituted a penalty barred by the contract's governing law — in this case, New York.

Dispensing with the debtors' contention that the amount provided for "double recovery" alongside the noteholders' interest claim, the Fifth Circuit reasoned that these claims "address[ed] two different harms" and, thus, "warrant[ed] separate recoveries."[20] This conclusion eliminated any of the debtors' remaining barriers and allowed the Fifth Circuit to uphold the make-whole premium's enforceability.

The Fifth Circuit further agreed with the noteholders that the parties' contractual rate – and not the federal judgment rate – governed the amount of post-petition interest to which the noteholders were entitled.

The majority's reasoning was straightforward: "Creditors are entitled to what they bargained for with this solvent debtor, and the Code does not preclude the contractual interest rate."[21]

In so finding, the Court noted that, regardless of what the legal rate might be under Section 726(a) of the Bankruptcy Code, the statutory text of Section 1129 of the Code — in part, governing the amount creditors are to receive under a confirmable plan — only sets a floor, rather than a ceiling, of what

creditors must be paid.[22]

Therefore, the Bankruptcy Code did "not preclude unimpaired creditors from receiving default-rate post-petition interest in excess of the Federal Judgment Rate in solvent-debtor Chapter 11 cases."[23]

Implications of Ultra

Despite the noteholders ultimately prevailing in this specific case, the Fifth Circuit's Ultra decision is a blow to creditors seeking to enforce traditional make-whole or yield maintenance premiums in bankruptcy cases.

The Fifth Circuit is the first court of appeals to find that make-whole premiums are disallowable under Section 502(b)(2) of the Bankruptcy Code.

Going forward, creditors will need to convince courts that either the Fifth Circuit's reasoning should not be followed or that the creditors are differently situated than the noteholders were in Ultra — perhaps by arguing that they are oversecured creditors separately entitled to recover their make-whole premium under Section 506(b) of the Bankruptcy Code.

On the flip side, the Fifth Circuit's conclusion that the solvent debtor exception is good law and allows for make-whole premiums and post-petition interest at the contractual default rate is a victory for creditors.

This decision comes on the heels of the Ninth Circuit's recent ruling in In re: PG&E Corp., in which a majority of the circuit judges reached a similar conclusion.[24]

Such alignment may indicate an emerging consensus that creditors may invoke contractual default rates in calculations for post-petition interest, at least in solvent debtor scenarios.

Conclusion

Notwithstanding Ultra's idiosyncrasies, the Fifth Circuit's opinion is of significance to creditors and debtors alike, as it provides meaningful precedent on the enforceability of make-whole premiums and, separately, the relevant rate for calculating post-petition interest in solvent debtor cases.

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[1] The Fifth Circuit has appellate jurisdiction over federal courts located in Louisiana, Mississippi, and Texas.

[2] See In re Skyler Ridge, 80 B.R. 500, 508 (Bankr. C.D. Cal. 1987).

[3] See In re Trico Marine Servs., Inc., 450 B.R. 474, 480-81 (Bankr. D. Del. 2011); In re Calpine Corp, 365 B.R. 392, 399 (Bankr. S.D.N.Y. 2007); In re Lappin Elec. Co. Inc., 245 B.R. 326, 330 (Bankr. E.D. Wis. 2000).

[4] See In re Ultra Petroleum Corp., 913 F.3d 533, 547-48 (5th Cir. 2019), (citing In re Doctors Hosp. of Hyde Park, Inc., 508 B.R. 697, 705 (Bankr. N.D. Ill. 2014)).

[5] Id. at 549.

[6] Section 726(a)(5) requires "payment of interest at the legal rate" on various claims filed in Chapter 7 liquidation proceedings. 11 U.S.C. § 726(a)(5). However, the "legal rate" is not defined. Moreover, section 1129(a)(7)(A)(ii) imports this requirement into Chapter 11 cases (including Ultra), mandating that impaired creditors "receive... not less than the amount [they] would so receive... if the debtor were liquidated under chapter 7[,]" including interest paid "at the legal rate" under section 726(a)(5). 11 U.S.C. §§ 726(a)(5), 1129(a)(7(A)(ii). Some Chapter 11 claimants have relied on these requirements (and their accompanying ambiguity) to assert that Congress intended "payment... at the legal rate" to mean a contractual rate valid under state law, while others have argued that Congress' use of the term "legal rate" "typically refers to a statutory rate" – in bankruptcy cases, the federal judgment rate. 6 COLLIER ON BANKR. ¶ 726.02[5] (16th ed. 2022). In Ultra, the difference in these rates amounted to $186 million.

[7] See In re Dvorkin Holdings, LLC, 547 B.R. 880, 898 (N.D. Ill. 2016); see also In re PG&E Corp., 46 F.4th 1047, 1061 (9th Cir. 2022).

[8] See In re Hertz Corp., 2021 WL 6068390 at *16-17 (Bankr. D. Del. 2021).

[9] Ironically, following its emergence from bankruptcy, Ultra Petroleum quickly went insolvent again, filing another Chapter 11 petition on May 14, 2020.

[10] The Fifth Circuit did not issue a unanimous decision. U.S. Circuit Judge Andrew S. Oldham issued a dissenting opinion in which he agreed with the majority's analysis that make-whole premiums are generally disallowed as the economic equivalent of unmatured interest. However, he then split from the majority in concluding that the solvent debtor exception did not survive the 1978 enactment of the Code and that, by extension, the exception could not be invoked to require payment either of the make-whole premium or of the contractual rate of interest.

[11] See In re Ultra Petroleum Corp., No. 21-20008, 2022 WL 8025329, at *4 (5th Cir. Oct. 14, 2022).

[12] Id. at *5.

[13] Id. at *4.

[14] Id. at *4, 7.

[15] Id. at *7.

[16] Id.

[17] Id. at *8.

[18] Id. at *9 (citation omitted).

[19] Id. at *11.

[20] Id. at *14.

[21] Id. at *17.

[22] Id. at *16.

[23] Id. (emphasis added).

[24] See In re PG&E Corp., 46 F.4th at 1051.