Proskauer

Special Alert: Fifth Circuit Targets Make-Whole Claims in Bankruptcy

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In an important decision to private credit lenders, the Fifth Circuit Court of Appeals held that a make-whole premium for an unsecured creditor tied to future interest payments is the "functional equivalent of unmatured interest" and not recoverable under Section 502(b)(2) of the Bankruptcy Code. *Ultra Petroleum Corp. v. Ad Hoc Committee of OpCo Unsecured Creditors (In re Ultra Petroleum Corp.)*, No. 21-20008 (5th Cir. Oct. 14, 2022) ("*Ultra*").[1] Ordinarily, the story ends here. But, because the debtor was solvent, the court nevertheless required payment of the make-whole under the so-called "solvent debtor" exception, an equitable exception to Section 502(b)(2)'s general prohibition on unmatured interest. Most bankruptcy cases, however, do not involve solvent debtors. Consequently, the decision has significant implications for lenders that extend credit with an expectation that make-whole claims are enforceable in bankruptcy.

Importantly, the good news is that the Fifth Circuit's decision addressed only the rights of an *unsecured* creditor. We believe that there is a legal basis for a *secured* creditor to recover a make-whole (or a prepayment premium) based on the rights in Section 506(b) of the Bankruptcy Code, which allows for the payment of "interest on such claim, and any reasonable fees, costs, or charges" when the creditor is oversecured (*i.e.*, the value of the collateral exceeds the claim amount).

Relevant Facts

Ultra is a natural gas company. It filed bankruptcy in 2016 as a result of a sharp decline in gas prices. During the bankruptcy case, gas prices spiked. Ultra's fortunes reversed course and it became "massively solvent." Ultra proposed a reorganization plan that would pay all creditors in full with an important caveat: Ultra objected to the allowance of a roughly $200 million make-whole premium (the "Make-Whole Amount") to certain noteholders ("Noteholders") owed nearly $1.5 billion under a Master Note Purchase Agreement ("MNPA"). Ultra argued the Make-Whole Amount should be disallowed as unmatured interest, which generally is not recoverable under Section 502(b)(2) of the Bankruptcy Code. The bankruptcy court determined that the Make-Whole Amount was allowable as liquidated damages (rather than unmatured interest). Ultra appealed.[2]

A. Disallowance of Make-Whole Amount as Unmatured Interest

The court began its analysis with the text of the Bankruptcy Code. Section 502(b)(2) disallows claims for "unmatured interest," which the court interpreted to include the "*economic equivalent* of unmatured interest." The court then turned to the general purpose of a make-whole provision, stating that make-wholes "are expressly designed to liquidate fixed-rate lenders' damages flowing from debtor default while market interest rates are lower than their contractual rates. Lenders' damages equal the present value of all their future interest payments. In other words, a make-whole amount is nothing more than a lender's unmatured interest, rendered in today's dollars. . . . It is—rather precisely—the 'economic equivalent of unmatured interest.'" Decision at 8–9. The Fifth Circuit then turned to and forcefully rejected three arguments raised by the Noteholders.

1. **Not Interest.** The Noteholders argued that interest is "consideration for the *use or forbearance* of another's money accruing over time." The Make-Whole Amount, they argued, is not interest because it does not compensate for "use or forbearance" of money; it compensates for the breach of a promise to use money. The Fifth Circuit disagreed. It found that "the Make-Whole Amount *does* constitute compensation for 'use or forbearance' of [Noteholders'] principal—it compensates [Noteholders] for the *future* use of their money, albeit use that will never actually occur because of Ultra's default. This is simply another way of saying that the interest is *unmatured*. And unmatured interest is still interest." *Id*. at 9–10.
2. **Not Unmatured**. Even if the Make-Whole Amount is interest, the Noteholders argued it was not unmatured because the entitlement to the Make-Whole Amount was crystalized upon the bankruptcy filing. Again, the Fifth Circuit disagreed, finding that the MNPA's acceleration provision triggering the Make-Whole Amount

"was an *ipso facto* clause that is not to be considered in assessing whether the payment it triggered had matured. . . . But, more to the point, a make-whole amount contractually triggered by the bankruptcy petition cannot antedate the same bankruptcy petition. First the petition is filed; then the make-whole amount becomes due—first the cause; then the effect." *Id.* at 10. Thus, the Make-Whole Amount arose after the filing of the petition date and therefore subject to disallowance as unmatured interest under § 502(b)(2).

3. **Liquidated Damages.** The Noteholders finally argued that the Make-Whole Amount is not the "economic equivalent of unmatured interest," but instead is liquidated damages. The Fifth Circuit harshly criticized this argument, finding it to be untenable. The Fifth Circuit was hyper-focused on the formula used to calculate the Make-Whole Amount and the fact that the "key input" was unmatured interest.[3] The Noteholders "posit that the formula somehow transmogrifies its inputs, including the key input—unmatured interest—into something fundamentally different on the other side of the equals sign. . . . In fact, the Make-Whole Amount's formula yields *precisely* the 'economic equivalent' of [Noteholders'] unmatured interest." *Id*. at 13–14. "The formula simply accounts for the time-value of money: A dollar today is worth more than a dollar tomorrow. . . . To create the 'economic equivalent' of that unmatured interest *today*, the sum of those payments must be discounted by a factor representing an appropriate reinvestment rate—what the [Noteholders] could earn on comparable securities in the present market." *Id*. at 14. The Noteholders also asserted that the Make-Whole Amount functions "more like ordinary damages to compensate them for transaction costs involved in securing a comparable loan." *Id.* While the court acknowledged that a make-whole could be structured to compensate for the costs of "find[ing] someone else to use the capital" (like a brokers' fee) and acknowledged that "liquidated damages *can* compensate for anticipated transaction costs that are *not* unmatured interest[,]" it found the Make-Whole Amount here purely based on unmatured interest. *Id.* at 15.

B. Resurrecting the Claim Through the "Solvent Debtor" Exception

While the Noteholders' unmatured interest arguments fell flat, they managed to find a saving grace in Ultra's fortuitous solvency turnaround. The Fifth Circuit found that the "solvent-debtor" exception survived the Bankruptcy Code's enactment in 1978,[4] operated to suspend Section 502(b)(2)'s disallowance of claims for unmatured interest, and required full payment of the Make-Whole Amount to the extent it was a valid contractual obligation under applicable state law.

Ultra argued that the Make-Whole Amount was invalid because it was an unenforceable penalty under New York law. This argument was based on a double-recovery theory stemming "from the fact that the MNPA 'allows the Noteholders to charge ongoing interest on the accelerated principal at the default rate.' Since [the Noteholders] already get contractual interest on the accelerated principal, the argument goes, the Make-Whole Amount, which compensates [the Noteholders] for future interest payments that would have been made on the *same* accelerated principal, gives [the Noteholders a] double recovery." *Id.* at 28. The Fifth Circuit disagreed, finding the "argument withers under scrutiny." *Id.* at 29. Specifically, the court explained that the "Make-Whole Amount and the post-petition interest address two different harms. The Make-Whole Amount serves as liquidated damages for Ultra's breach; the post-petition interest compensates for Ultra's lag in paying the accelerated principal (and the Make-Whole itself), which were already due and payable for the duration of the bankruptcy. Separate harms warrant separate recoveries; accordingly, the Make-Whole Amount is not unenforceable on this theory." *Id*. at 29. As a result, the court concluded that the Make-Whole Amount constituted an enforceable liquidated damages clause under New York law enforceable notwithstanding Section 502(b)(2) solely because of Ultra's solvency.

Practical Implications

1. **Expect More Make-Whole Litigation**. Make-whole claims are frequently targeted for disallowance in bankruptcy cases (with inconsistent results) and this decision puts claims by unsecured lenders for make-wholes squarely in the cross-hairs. Other circuit level decisions that have addressed make-whole clauses in indentures have largely focused on the contractual language triggering the entitlement to payment and not explicitly recovery under Section 502(b)(2).[5] At the lower court level, many of the bankruptcy judges who have directly tackled Section 502(b)(2) have found that make-whole premiums are allowable under the Bankruptcy Code as liquidated damages, and not unenforceable unmatured interest.[6] But the decisions are not uniform, with some courts reaching the opposite conclusion.[7] Most recently, the Delaware bankruptcy court in the Hertz case refused to adopt a bright line rule that make-whole premiums are unmatured interest, and instead found the issue is factual in nature.[8] It remains uncertain whether other circuits will follow the Fifth Circuit's approach.
2. **Crystalize the Right to Payment Before the Filing.** To maximize the odds of recovering a make-whole or prepayment premium in a bankruptcy case, if at all possible, crystalize the contractual right to payment *before* the borrower files

bankruptcy. Doing so will avoid the argument that right to payment was "unmatured" as of the filing date.

3. **Pandora's Box**. Perhaps most troubling is that this decision opens the door to many other potential issues. For instance, how would a court treat an *oversecured* creditor seeking to recover a make-whole or prepayment premium with the right to payment of "interest on such claim, and any reasonable fees, costs, or charges" under Section 506(b)? The decision does not directly address this question, but the Fifth Circuit's rationale for paying unmatured interest to an unsecured creditor of a solvent debtor should apply to an oversecured creditor with a statutory right to the payment of interest and reasonable fees under Section 506(b). Another question is how a court would treat a creditor that seeks to recover a make-whole by relying upon the "absolute priority rule" under Section 1129(b)(2)(B)(ii), requiring payment in full on its claim before any subordinate class receives any distribution under a reorganization plan (or under a subordination agreement)? What are the implications of this decision on the enforceability of prepayment premiums in a credit agreement which are calculated as a fixed fee or a fixed percentage of the principal to be repaid (as opposed to a fee based on a formula where the "key input is unmatured interest")? What about a premium that matures *after* the bankruptcy filing by reason of a prepayment? It is difficult to predict how courts will interpret the Fifth Circuit's *Ultra* decision (in and outside the Fifth Circuit) when faced with different facts, but it certainly opens up a host of issues.

Our Private Credit and Private Credit Restructuring Group will continue to consider the *Ultra* decision and its many implications for our clients and will be following up with additional alerts that consider these and other related issues.

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[1] A link to the decision can be found here (the "Decision").

[2] Ultra also maintained that it would pay post-petition interest at the Federal Judgment Rate (at the time, 0.54%) as opposed to the higher contractual rate required under the MNPA and a separate revolving credit facility. The rate differential exceeded $100 million. The Fifth Circuit determined that the creditors were entitled to post-petition interest at the contractual default rate rather than the lower Federal Judgment Rate. We will address this portion of the decision in a separate alert.

[3] According to the Decision, "the MNPA defines the Make-Whole Amount as 'the excess, if any, of the Discounted Value of the Remaining Scheduled Payments with respect to the Called Principal of such fixed rate Note over the amount of such Called Principal.' The 'Remaining Scheduled Payments' are the payments of interest and principal that would have occurred absent OpCo's default. These payments are summed and discounted to their present value using a discount factor 50 basis points over the yield to maturity of Treasury securities comparable in risk profile to the OpCo Notes. From this figure is subtracted the 'Called Principal'—the unpaid balance of the Notes' principal that was accelerated on default. The Make-Whole Amount is any resultant positive number." *Id.* at 4 n.3

[4] One of the three circuit judges on the panel dissented, maintaining that the solvent debtor exception did not survive the adoption of the Bankruptcy Code.

[5] *See In re Energy Future Holdings Corp.*, 842 F.3d 247 (3d Cir. 2016) (a debtor's refinancing of its first and second lien notes during its Chapter 11 case triggered the obligation to satisfy the make-whole payments contemplated to be more than $431 million by at least one of the indentures); *In re AMR Corp.*, 730 F.3d 88 (2d Cir. 2013) (denying make-whole claim solely based on contractual interpretation without reference to Section 502(b)(2) and with lower court stating "there is no dispute that make whole amounts are permissible" when contractually triggered even in bankruptcy context); *In re MPM Silicones, L.L.C.*, 874 F.3d 787 (2d Cir. 2017) (denying make-whole based on a contractual interpretation without reference to Section 502(b)(2)).

[6] *In re School Specialty, Inc.*, No. 13-10125 (KJC), 2013 WL 1838513, at *5 (Bank. D. Del. 2013) (agreeing with Trico and holding that make-whole premium should not be disallowed as unmatured interest); *In re Trico Marine Servs. Inc.*, 450 B.R. 474, 481 (Bank. D. Del. 2011) (reviewing cases and concluding that the "Court is persuaded by the soundness of the majority's interpretation of make-whole obligations, and therefore finds that the Indenture Trustee's claim on account of the Make-Whole Premium is akin to a claim for liquidated damages, not for unmatured interest."); *In re 360 Inns, Ltd.*, 76 B.R. 573, 576 (Bankr. N.D. Tex. 1987) ("[T]he prepayment penalty was not unmatured interest as contemplated in § 502(b)(2), inasmuch as the prepayment penalty was activated and matured once the plan of reorganization proposed to prepay [the lender's] debt."). *In re 1141 Realty Owner, LLC*, 598 B.R. 534 (Bankr. S.D.N.Y. 2019); *Noonan v. Fremont Fin. (In re Lappin Elec. Co.)*, 245 B.R. 326, 330 (Bankr. E.D. Wis. 2000) ("[T]his court is in agreement with a majority of courts that view a prepayment charge as liquidated damages, not as unmatured interest or an alternative means of paying under the contract."); *In re Outdoor Sports Headquarters, Inc.*, 161 B.R. 414, 424 (Bankr. S.D. Ohio 1993) ("Prepayment amounts, although often computed as being interest that would have been received through the life of a loan, do not constitute unmatured interest because they fully mature pursuant to the provisions of the contract."); *In re Skyler Ridge* , 80 B.R. 500, 508 (Bankr. C.D. Cal. 1987) ("Liquidated damages, including prepayment premiums, fully mature at the time of breach, and do not represent unmatured interest.") *See also* 4 Collier on Bankruptcy ¶ 502.03 (16th ed. 2021) (collecting cases).

[7] *In re Doctors Hosp. of Hyde Park, Inc.*, 508 B.R. 697, 705–06 (Bank. N.D. Ill. 2014) (holding that yield maintenance premium was a liquidated damages provision in the nature of disallowable unmatured interest); *In re MPM Silicones LLC*, No. 14-22503 (RDD), 2014 WL 4436335, at *17–18 (Bankr. S.D.N.Y. Sept. 9, 2014) (concluding that noteholders claim to a make-whole based on debtor's breach of no call provision was unmatured interest disallowed under § 502(b)(2)), *aff'd in part and rev'd in part on other grounds*, 874 F.3d 787 (2d Cir. 2017); *In re Ridgewood Apts.*, 174 B.R. 712, 721 (Bank. S.D. Ohio 1994) (prepayment penalty could be disallowed as unmatured interest because it was meant to compensate lender for loss of interest income).

[8] *Wells Fargo Bank v. Hertz Corp. (In re Hertz Corp.)*, No. 20-11218, 2021 WL 6068390 (Bankr. D. Del. Dec. 22, 2021).

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