October 25, 2022

Fifth Circuit Holds That Make-Whole Amount Constitutes Unmatured Interest

On October 14, 2022, the U.S. Court of Appeals for the Fifth Circuit issued its long-anticipated opinion *Ultra Petroleum Corp.* v. *Ad Hoc Committee of OpCo Unsecured Creditors* (*In re Ultra Petroleum Corp.*), – F.4th –, 2022 WL 8025329 (5th Cir. Oct. 14, 2022) in which it held, in a 2-1 decision, that the Bankruptcy Code disallows the contractual make-whole amount at issue (the "Make-Whole Amount") as the economic equivalent of unmatured post-petition interest; however, in the unique circumstances of the case, the court further held that (1) given the debtors' solvency and the continued viability of the solvent-debtor exception, the Debtors were required to pay the amount regardless,[1] and (2) post-petition interest should be calculated at the contractual, not Federal Judgment, rate.[2]

Relevant Case Background

In early 2016, Ultra Petroleum Corporation and its affiliates (collectively, "Ultra" or the "Debtors"), a family of natural gas exploration and production companies, filed for bankruptcy protection while deeply insolvent.[3] During the course of the chapter 11 cases, natural gas prices soared and the Debtors became "supremely solvent."[4] The Debtors proposed a $2.5 billion chapter 11 plan pursuant to which they paid their creditors all of their outstanding principal and all pre-petition interest in full in cash, plus post-petition interest at the Federal Judgment Rate for the duration of the chapter 11 cases.[5] The Debtors classified creditors as unimpaired under their plan, deemed them to accept the plan, and did not allow them to vote.[6] Two groups of creditors objected, arguing that they were (1) entitled to the Make-Whole Amount, and (2) owed post-petition interest at a contractually specified rate that was materially higher than the Federal Judgment Rate.[7] The creditors asserted that this entitled them to recover an additional $387 million and, as a result, they were impaired and entitled to vote to reject the plan.[8]

---

1 *But see Ultra Petroleum Corp.* v. *Ad Hoc Committee of OpCo Unsecured Creditors* (*In re Ultra Petroleum Corp.*), – F.4th –, 2022 WL 8025329 at *17 (5th Cir. Oct. 14, 2022) (Oldham, C.J., dissenting) ("In my view, the solvent-debtor exception didn't survive the adoption of the Bankruptcy Code.").

2 *See id*. at *1. Section 502(b)(2) of the Bankruptcy Code disallows "claim[s] . . . for unmatured interest." 11 U.S.C. § 502(b)(2).

3 *See id*. at *1.

4 *See id*.

5 *See id*.

6 *See id*.

7 *See id*. at *2. As the Fifth Circuit noted, a make-whole premium, like the one at issue, is a contractual amount due under certain debt agreements that is calculated to give lenders the present value of the interest payments they would have received on their debt securities but for the Debtors' chapter 11 filing. *See id.* at *4.

8 *See id*. at *1.

The parties agreed that the make-whole dispute could be resolved post-confirmation, subject to the Debtors funding a $400 million reserve to cover the alleged shortfall.[9] After trial, the bankruptcy court allowed the Make-Whole Amount, holding that (1) the Debtors failed to prove that either the Make-Whole Amount or the default interest amount were unenforceable liquidated damages under New York law; (2) the Debtors had to pay the Make-Whole Amount in the full amount permitted under state law to render the creditors unimpaired, even if the Bankruptcy Code independently disallowed some or all of the claim (e.g., as unmatured interest); and (3) the Debtors also had to pay post-petition interest at the contractual rate to render the claims unimpaired.[10]

On appeal ("*Ultra I*"), the Fifth Circuit disagreed with the bankruptcy court's conclusion that a creditor is impaired if a plan does not provide the creditor with all it would receive under state law, even if the Bankruptcy Code independently disallows claim amounts that state law would otherwise provide outside of bankruptcy.[11] The Fifth Circuit found that the impairment analysis focuses on what the *plan* does, not what the Bankruptcy Code does, and that alteration of a creditor's rights by the Bankruptcy Code is not impairment.[12] The Fifth Circuit accordingly remanded the case to the bankruptcy court to adjudicate whether the Bankruptcy Code disallows (a) the Make-Whole Amount as being "unmatured interest" under section 502(b)(2) of the Bankruptcy Code and (b) the claims for post-petition interest at the contractual rate because section 726(a)(5) of the Bankruptcy Code limits post-petition interest to the Federal Judgment Rate.[13]

On remand, the bankruptcy court again agreed with the creditors that the Make-Whole Amount was an allowed claim that had to be paid in full and post-petition interest should be paid at the contract rate.[14] A second appeal followed ("*Ultra II*").

The Fifth Circuit Ruling

In *Ultra II*, the Fifth Circuit considered: *first*, whether section 502(b)(2) of the Bankruptcy Code disallows the Make-Whole Amount as impermissible unmatured interest; *second*, if it does, whether the solvent-debtor exception applies and requires its payment regardless; and *third*, whether post-judgment interest should be calculated at the contractual or Federal Judgment rate.[15]

---

9 *See id*. at *2.

10 *In re Ultra Petroleum Corp.*, 575 B.R. 361, 366–75 (Bankr. S.D. Tex. 2017).

11 *In re Ultra Petroleum Corp.*, 943 F.3d 758, 760 (5th Cir. 2019).

12 *See id.* at 764-64. A number of other courts agree with this position. *See Solow* v. *PPI Enters. (U.S.), Inc. (In re PPI Enters. (U.S.), Inc.)*, 324 F.3d 197, 203 (3d Cir. 2003) (holding that a creditor's claim is not impaired where "the Bankruptcy Code, not the Plan, is the only source of limitation" on the creditor's rights); *Wells Fargo Bank, N.A.* v. *The Hertz Corp (In re The Hertz Corp.)*, 637 B.R. 781, 794 (Bankr. D. Del. Dec. 22, 2021) ("[T]he Court concludes that any modification of the Noteholders' claim to unmatured interest ... is an impairment of the Noteholders' contract claims by operation of section 502(b)(2) of the Bankruptcy Code, not the Debtors' Plan. Consequently, the Noteholders' claims are not impaired within the meaning of section 1124(1)."); *In re LATAM Airlines Grp. S.A.,* No. 20-11254 (JLG), 2022 WL 2206829, at *9 (Bankr. S.D.N.Y. June 18, 2022) ("It is settled that a creditor's legal, equitable, and contractual rights under section 1124(1) are subject to the Bankruptcy Code's own limitations on claim allowance, including limitations on the allowance of postpetition interest.")

13 *See* 943 F.3d at 760.

14 *In re Ultra Petroleum Corp.*, 624 B.R. 178, 181-84 (Bankr. S.D. Tex. 2020). The bankruptcy court held that it represented liquidated damages and should not be disallowed under section 502(b)(2) of the Bankruptcy Code as unmatured interest (or its economic equivalent). It further determined that the solvent-debtor exception applied to the Debtors' cases, and that a solvent debtor was required to pay post-petition interest at the applicable contractual rate to render its creditors unimpaired. *See id*.

15 The bankruptcy court granted the Debtors' motion for certification of direct appeal, and the Fifth Circuit granted the Debtors' petition to do so. *See Ultra*, 2022 WL 8025329 at *3, fn. 6.

The Make-Whole Amount Constitutes Disallowed Unmatured Interest under Section 502(b)(2) of the Bankruptcy Code
Citing binding Fifth Circuit precedent, the court held that section 502(b)(2) of the Bankruptcy Code disallows claims for unmatured interest as well as claims for the "economic equivalent" of unmatured interest.[16] It then found that the Make-Whole Amount was nothing more than the objecting creditors' unmatured interest, rendered in today's dollars, and was in fact "rather precisely the 'economic equivalent of unmatured interest'."[17] As a result, the Fifth Circuit concluded that the Make-Whole Amount was disallowed under section 502(b)(2) of the Bankruptcy Code.[18]

In reaching its conclusion, the Fifth Circuit rejected the objecting creditors' various arguments that the Make-Whole Amount was something other than unmatured interest or its economic equivalent. [19] In doing so, among other things, the court used a "Fake Whole" formula to illustrate the economic substance of the Make-Whole Amount as interest.[20] Using this "Fake-Whole" formula,[21] which was nothing more than unmatured interest plus one dollar, the court rationalized that the disputed Make-Whole Amount was conceptually no different than the Fake-Whole Amount. Indeed, the Make-Whole Amount yielded "precisely the economic equivalent of the creditors' unmatured interest," discounted for the time-value of money.[22] Simply inputting the unmatured interest amount into a formula, therefore, did not "transmogrif[y]" its economic reality as the economic equivalent of unmatured interest.[23]

The Fifth Circuit also rejected the objecting creditors' argument that the Make-Whole Amount functioned more like ordinary damages meant to compensate the lenders for the transaction costs involved in securing a comparable loan.[24] The relevant distinction between the two, the court found, was whether the Make-Whole Amount merely compensated for the search and transaction costs of "seeking to find someone else to use the capital," or went further and compensated for the loss of future interest.[25] Agreeing that liquidated damages could in some cases compensate for anticipated transaction costs that are *not* unmatured interest, the court cautioned that the opposite could also be true. Thus, a make-whole amount could constitute *both* liquidated damages and still be unmatured interest. The court concluded that the Debtors' Make-Whole Amount was precisely that – unlike a pure transaction-costs liquidated damages amount, the Make-Whole Amount constituted both liquidated damages and was the "economic equivalent of unmatured interest." Indeed, the court found that this was its entire point.[26]

The Solvent-Debtor Exception Survived the Bankruptcy Code's Enactment and Required the Debtors to Pay the Make-Whole Amount in Ultra's Chapter 11 Cases
Having determined that the Make-Whole Amount was indeed a claim for unmatured interest or its economic equivalent disallowed under the Bankruptcy Code, the Fifth Circuit next considered whether the solvent-debtor exception survived the

16 *id.* at *4.

17 *Id*. (citing *In re Pengo Indus., Inc.*, 962 F2d 543, 546 (5th Cir. 1992) (citations omitted)).

18 *See id*.

19 *See id.* at *5.

20 *See id.* at *7.

21 Fake-Whole Amount = (∑ [all unmatured interest payments] + $1.00) x1. *See id.*

22 *Id.*

23 *See id.* at *6.

24 *See id.* at *7.

25 *See id.* (citations omitted).

26 *See id.*

Bankruptcy Code's enactment and required its payment nonetheless. It concluded that the pre-Bankruptcy Code doctrine governing a solvent debtor's obligations remained good law.[27]

The solvent-debtor exception is an equitable doctrine that arguably applies in the case of a solvent debtor. The doctrine provides that when a debtor is solvent (i.e., when its assets exceed its liabilities), bankruptcy's ordinary suspension of post-petition interest is itself suspended.[28] Solvent debtors are able to pay their debts in full on their contractual terms, and absent a legitimate bankruptcy reason to the contrary, they should do so.[29] The Fifth Circuit explained that in the case of an insolvent debtor, suspending contractual interest from accruing serves the legitimate bankruptcy interest of equitably distributing estate assets among competing creditors as of the petition date.[30] The Fifth Circuit recognized that "[w]ith a solvent debtor that legitimate bankruptcy interest is not present."[31] Solvent debtors are therefore typically excepted from the general rule disallowing unmatured interest from accruing post-petition, a result that the Fifth Circuit found flows from fundamental principles of bankruptcy law.[32]

The Fifth Circuit rejected the Debtors' argument that Congress abrogated the solvent-debtor exception when it enacted the Bankruptcy Code.[33] Relying on Supreme Court precedent interpreting the Bankruptcy Code, the Fifth Circuit followed other courts that have held that Congressional abrogation of a prior bankruptcy practice requires "an unmistakably clear statement on the part of Congress," and that "any ambiguity will be construed in favor of prior practice."[34] The court concluded that the 1978 Bankruptcy Code did not clear this high hurdle, and that nothing suggested that Congress intended to "defang" the solvent-debtor exception.[35] It therefore held that the solvent-debtor exception is "alive and well," and because the Debtors were "massively" solvent, it applied in the Debtors' case. For that reason, the Debtors had to pay the contractual Make-Whole Amount even though it was otherwise disallowed unmatured interest.[36]

The Make-Whole Amount Constituted Enforceable Liquidated Damages Under Applicable Non-Bankruptcy Law on Which Contractual Post-Petition Interest Must be Paid

The Fifth Circuit also addressed the Debtors' arguments that the Make-Whole Amount should be disallowed as an unenforceable penalty under New York law, and that even if allowed, post-petition interest should only be paid at the Federal Judgment Rate of interest, rather than at its contractual rate.[37]

Section 502(b)(1) of the Bankruptcy Code disallows "claim[s] [that are] unenforceable against the debtor. . . . under any agreement or applicable law."[38] Accordingly, if New York law prohibits enforcement of the Make-Whole Amount as an

---

27 *See Id*. at *8.

28 *See id*.

29 *See id*.

30 *See id.* at *9.

31 *Id.* at *10.

32 *See id.*

33 *See id*.

34 *See id.* at *11. See our Client Alert here for a discussion of the Ninth Circuit's recent conclusion to the same effect in *In re PG&E Corp.*, Case No. 21-16043 [ECF 49-1](5th Cir. 2022).

35 *See id*.

36 *See id.* at *13.

37 *See id.* at *14.

38 11 U.S.C. § 501(b)(1).

unenforceable penalty, the claim would be disallowed and could not be resuscitated by the solvent-debtor exception.[39] The Fifth Circuit therefore analyzed the Make-Whole Amount under New York law, which requires a party seeking to avoid liquidated damages as a penalty to show that the amount fixed is plainly or grossly disproportionate to the probable loss incurred.[40] The Fifth Circuit concluded that the Debtors failed to meet their burden in this regard because the Make-Whole Amount served as liquidated damages for the Debtors' breach, calculated in reference to the creditors' lost interest payments, and on which post-petition interest was appropriately due to compensate the creditors for the Debtors' lag in paying the accelerated principal and the Make-Whole itself. The court found that these "separate harms warranted separate recoveries," did not amount to "double recoveries," and were, therefore, enforceable under New York law and not barred by section 502(b)(1) of the Bankruptcy Code.[41]

Turning to the question of the applicable rate of post-petition interest, the Fifth Circuit concluded that the contractual default rate was appropriate in the Debtors' cases. The court rejected the Debtors' statutory argument that the Bankruptcy Code's chapter 11 plan confirmation provisions required payment on claims "at the legal rate" (i.e., at the Federal Judgment Rate) because chapter 11 incorporates section 726(a)(5) of the Bankruptcy Code into its "best interests" test.[42] Section 726(a)(5) of the Bankruptcy Code specifies what a creditor receives if a debtor is liquidated and provides that before a solvent debtor's equity holders get any distribution from the estate, creditors must be paid interest on their claims "at the legal rate" accrued from the petition date.[43] The Fifth Circuit reasoned that the reference to "the legal rate" was not dispositive in Ultra's case because it only sets a floor – not a ceiling – for what an impaired (and by implication, unimpaired) creditor must receive under the chapter 11 plan confirmation provisions of the Bankruptcy Code.[44] Importantly, the court held, the Bankruptcy Code does not preclude *unimpaired* creditors from receiving default-rate post-petition interest in excess of the Federal Judgment Rate in solvent-debtor cases.[45]

Conclusion

In *Ultra Petroleum*, the Fifth Circuit has joined the Ninth Circuit[46] in holding that the solvent debtor exception survived the enactment of the Bankruptcy Code, and both circuit courts are now in conflict with the U.S. Bankruptcy Court for the District of Delaware,[47] which applied the Federal Judgment Rate of interest in a solvent debtor case. No other circuit-level courts outside the Fifth Circuit, however, have taken a definitive position on whether make-whole amounts constitute unmatured interest or its economic equivalent.[48] In *Hertz*, the Delaware Bankruptcy Court discussed that a make-whole amount *might*, depending on how it is formulated, constitute unmatured interest and that disguising a make-whole amount as liquidated damages will not save it

39 *See Ultra*, 2022 WL 8025329 at *14.

40 *See id.* (citing *JMD Holding Corp.* v. *Cong. Fin. Corp.*, 4 N.Y.3d 373, 795 N.Y.S.2d 502, 828 N.E.2d 604, 609 (2005)).

41 *See id*.

42 A chapter 11 plan must satisfy the "best interests" test to be confirmable. 11 U.S.C. § 1129(a)(7). The "best interests" test requires that each holder of a claim in a class either accept the plan or receive property under the plan of a value, as of the effective date of the plan, which is not less than such holder would receive in a chapter 7 liquidation. *See id.* Section 726(a), in turn, specifies what a creditor would get if the debtor were liquidated. 11 U.S.C. § 726(a)(5).

43 11 U.S.C. § 726(a)(5); s*ee Ultra*, 2022 WL 8025329 at *16.

44 *See Ultra*, 2022 WL 8025329 at *16.

45 *See id.*

46 *In re PG&E Corp.*, 46 F.4th 1047, 1061 (9th Cir. 2022). Read our coverage of this case and its analysis of the solvent-debtor exception here.

47 *In re The Hertz Corp.*, 637 B.R. 781 (Bankr. D. Del. Dec. 22, 2021).

48 While other circuit-level courts have considered contractual make-whole provisions in bankruptcy, they did not rule on whether the make-whole amounts at issue constituted disallowed unmatured interest under section 502(b)(2) of the Bankruptcy Code. *See, e.g., Matter of MPM Silicones, L.L.C.*, 874 F.3d 787, 803 (2d Cir. 2017); *In re Energy Future Holdings Corp.*, 842 F.3d 247 (3d Cir. 2016).

from scrutiny.[49] It remains to be seen whether other courts will follow the Fifth Circuit's reasoning disallowing make-whole claims as impermissible unmatured interest. These issues prove ripe for further adjudication by the appellate courts or possibly even Congressional action—both of which will take some time.

* * *

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Jacob A. Adlerstein
+1-212-373-3142
jadlerstein@paulweiss.com

Paul M. Basta
+1-212-373-3023
pbasta@paulweiss.com

Brian Bolin
+1-212-373-3262
bbolin@paulweiss.com

Robert Britton
+1-212-373-3615
rbritton@paulweiss.com

Kelley A. Cornish
+1-212-373-3493
kcornish@paulweiss.com

Alice Belisle Eaton
+1-212-373-3125
aeaton@paulweiss.com

Brian S. Hermann
+1-212-373-3545
bhermann@paulweiss.com

Christopher Hopkins
1-212-373-3334
chopkins@paulweiss.com

Kyle J. Kimpler
+1-212-373-3253
kkimpler@paulweiss.com

Alan W. Kornberg
+1-212-373-3209
akornberg@paulweiss.com

Elizabeth R. McColm
+1-212-373-3524
emccolm@paulweiss.com

Andrew M. Parlen
+1-212-373-3141
aparlen@paulweiss.com

Andrew N. Rosenberg
+1-212-373-3158
arosenberg@paulweiss.com

John Weber
+1-212-373-3656
jweber@paulweiss.com

Kenneth S. Ziman
1-212-373-3733
kziman@paulweiss.com

Associate Omid Rahnama contributed to this client memorandum.

[49] *In re The Hertz Corp.*, 637 B.R. 781, 789-790 (Bankr. D. Del. Dec. 22, 2021).