Fifth Circuit Suggests Claims for Make-Whole Amounts Should Be Disallowed

The Situation On January 17, 2019, the Fifth Circuit strongly suggested that claims for make-whole damages be characterized as "unmatured interest" and that claims for postpetition interest on unsecured debt be limited in bankruptcy proceedings.

The Result The court's decision appears to be one that favors debtors over lenders.

Looking Ahead It is unclear if the court's reasoning will be adopted by other jurisdictions and/or in cases with differing factual and legal grounds.

In *Ultra Petroleum Corp., et al. v. Ad Hoc Committee of Unsecured Creditors of Ultra Resources, Inc., et al. (In re Ultra Petroleum Corp.)*,—F.3d—, No. 17-20793, 2019 WL 237365 (5th Cir. Jan. 17, 2019), the Fifth Circuit strongly suggested that, regardless of the enforceability of make-whole and default interest provisions under the relevant credit documents and applicable state law: (i) claims for make-whole damages triggered by a bankruptcy filing should be characterized as claims for "unmatured interest" and thus disallowed pursuant to section 502(b)(2) of the Bankruptcy Code and (ii) claims for postpetition interest on unsecured debt are unlikely to be calculated by reference to contractual default rates. Although the decision may prove to be a boon for debtors and a bane for lenders in the Fifth Circuit, it is unclear if the court's reasoning will be adopted by other jurisdictions.

The United States Bankruptcy Court for the Southern District of Texas had determined that: (i) a "model form" make-whole provision triggered by a bankruptcy filing created an enforceable $201 million liquidated damages claim under New York law; (ii) the Bankruptcy Code did not limit the noteholders' entitlement to $186 million in postpetition interest at the contractual default rate from the solvent debtors; and (iii) the debtors' plan impaired the noteholders' claims by refusing to pay them these contractual amounts owed under state law.

The Fifth Circuit (i) reversed the order holding that the debtors' plan impaired the unsecured noteholders' claims and (ii) vacated and remanded for reconsideration determinations by the bankruptcy court that noteholders were entitled to recover such contractual amounts.

The Fifth Circuit observed that the bankruptcy court "never decided whether the Code disallows the make-whole amount as 'unmatured interest' under section 502(b)(2) or what section 726(a)(5)'s 'legal rate' of interest means"; i.e., the bankruptcy court improperly focused on whether the noteholders' claims were *enforceable* under state law to the occlusion of an inquiry into whether those claims were *allowable* under the Bankruptcy Code.

First, the Fifth Circuit determined—in keeping with the majority of applicable case law—that a plan's incorporation of the Bankruptcy Code's disallowance provisions did not render the noteholders' claim impaired, stating that "a creditor's claim outside of bankruptcy is not the relevant barometer for impairment; we must examine whether the plan itself is a source of limitation on a creditor's legal, equitable, or contractual rights…. Where a plan refuses to pay funds disallowed by the Code, the Code—not the plan—is doing the impairing."

Second, the Court turned to the begged question of whether the Code did, in fact, disallow the noteholders' claims for make-whole amounts and postpetition interest at the default rate (eschewing discussion of the enforceability of the noteholders' claims under the relevant documents and state law, which issues had been the focus of recent conflicting

circuit-level decisions in *MPM Silicones* and *Energy Future Holdings*). Although ultimately remanding the issues to the bankruptcy court for reconsideration, the decision expresses the view that, in the Fifth Circuit: (i) claims for make-whole payments triggered upon the bankruptcy filing of a debtor likely will be characterized as claims for the economic equivalent of "unmatured interest" and thus disallowed pursuant to section 502(b)(2) of the Bankruptcy Code (regardless of their enforceability under state law) and (ii) absent a court's use of its equity powers, claims for postpetition interest on unsecured claims based on contractual default rates are likely to be reduced to the typically much lower federal postjudgment interest rate under 28 U.S.C. § 1961.

The Fifth Circuit's decision appears to be one that favors debtors over lenders. Less certain is whether that decision will be adopted in other jurisdictions, as there are numerous grounds (both factual and legal) upon which a future court might depart from the Fifth Circuit's conclusions. For example, the make-whole provision at issue in *Ultra Petroleum* was expressly calculated by reference to, and plainly served as a proxy for recovery of, the lenders' future interest payments. The question whether a make-whole provision that is not expressly calculated by reference to future interest is characterized as liquidated damages for termination or additional principal, and/or expressly incorporates measures of damages distinct from interest (e.g., opportunity costs; transactions costs), would be characterized as "walk[ing], talk[ing], and act[ing] like unmatured interest" (in the Fifth Circuit's formulation). Lending lawyers may be well advised to bear these considerations—and the pitfall of *Ultra Petroleum*—in mind when drafting future credit agreements.

Moreover, a future court may not adopt the Fifth Circuit's characterization of make-whole provisions as unmatured interest in disguise. The majority of courts to address the issue (which precedent is given little attention by the *Ultra Petroleum* panel) have determined that make-whole payments are properly characterized as fully matured liquidated damages and thus *not* unmatured interest, rendering section 502(b)(2) inapplicable. Indeed, the lack of unanimity on this threshold question may prompt courts to invoke the Ninth Circuit's precedent from *Thrifty Oil Co. v. Bank of America*, which found that "[w]here the specific characteristics of a transaction create uncertainty as to whether a claim includes unmatured interest, federal courts do not base their decisions on economic theories of interest." Circuit disagreement on this point may ultimately result in a split requiring resolution by the United States Supreme Court.

Further, in contrast to the unsecured lenders in *Ultra Petroleum*, oversecured lenders should remember that contractual make-whole payments and postpetition interest may be recoverable from the value of their collateral under section 506(b) of the Bankruptcy Code (which expressly provides that contractual interest and charges are part of the secured creditor's allowed secured claim to the extent of the creditor's oversecurity). The fact that make-whole payments are commonly considered "charges" by courts addressing the allowance of a secured creditor's claim under section 506(b)—and not "interest" under that section—might further inform a future court's analysis of what constitutes disallowable "interest" under section 502(b)(2).

Finally, the context of *Ultra Petroleum*—i.e., amounts allowable to unimpaired creditors by solvent debtors—and the Court's focus on the creditors' impairment leaves open the question of whether differing results might be reached in differing contexts, especially with respect to the allowance of postpetition interest. The Fifth Circuit makes clear that neither the "best interests of creditors" test of section 1129(a)(7) nor the "absolute priority rule" of section 1129(b) applied in *Ultra Petroleum*, where the creditors were unimpaired and the bankruptcy court did not apply a "cramdown" analysis, respectively. In the contexts of the best interests test (where considerations of equity likely do not apply) and the absolute

priority rule (which has no specific rule regarding interest and often incorporates nonstatutory components), future courts may adopt a different approach to claim allowance.

Two Key Takeaways

1. The Fifth Circuit's decision in *Ultra Petroleum* makes the Fifth Circuit unattractive to unsecured or undersecured lenders asserting claims for make-whole payments and default rate postpetition interest.

2. Whether the decision will be adopted by courts in other jurisdictions and/or in cases with differing facts remains to be seen.

Lawyer Contacts

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