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Alert

Ultra Petroleum Bankruptcy Court Allows Make-Whole Premium and Postpetition Interest at Contractual Default Rate

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On Oct. 27, 2020, Judge Marvin Isgur for the U.S. Bankruptcy Court for the Southern District of Texas held that (1) a make-whole premium was not interest or unmatured interest and thus not subject to disallowance, (2) a make-whole claim was enforceable as liquidated damages under New York law and (3) the solvent debtor exception survived the enactment of the Bankruptcy Code and the Noteholders were entitled to postpetition interest at the contractual default rate.

The Bankruptcy Court's decision has been certified for direct appeal to the Fifth Circuit.

The *Ultra* opinion helps creditors because it may make it more difficult for debtors to argue that make-whole premiums should be disallowed as claims for unmatured interest under Section 502(b)(2) of the Bankruptcy Code. Although this decision was issued in the Southern District of Texas, it will likely be persuasive precedent in other jurisdictions as part of the long-running litigation over make-whole claims. *In re Ultra Petroleum Corp.*, No. 20-32631 (S.D. Tex. Oct. 26, 2020), amended (Oct. 27, 2020) [ECF 1874].

Background and Procedural History

In *Ultra*, the confirmed plan of reorganization did not provide for payment of a contractually triggered make-whole premium or postpetition interest at the contractual default rate, despite the debtors' solvency during the case as a result of increased oil and commodity prices. The Noteholders argued that the plan impaired their valid state law claims for liquidated damages (e.g., the make-whole premium) and that the solvent debtor exception required the Debtors to pay postpetition interest at the contractual default rate.

The Bankruptcy Court initially agreed with the Noteholders. The Fifth Circuit reversed in part and directed the Bankruptcy Court to determine whether the make-whole premium constituted unmatured interest and to decide the appropriate postpetition interest rate on remand.

Analysis

Unmatured Interest. The Bankruptcy Court first addressed whether the make-whole premium constituted unmatured interest as defined by section 502(b)(2) of the Code. That provision states that claims are disallowed to the extent they are for "unmatured interest" (a term the Code does not define).

Reasoning that "interest" is "widely understood as consideration for the use or forbearance of another's money accruing over time," the Bankruptcy Court found that the make-whole premium was not interest because it instead "compensates the Note Claimants for [the Debtor's] breach of a promise to use

money." The Court held that because the make-whole amount did not represent a claim for interest, by definition it could not be a claim for "unmatured interest." *In re Ultra Petroleum Corp*. at *8.

Liquidated Damages. The Bankruptcy Court then found that the make-whole premium was an enforceable liquidated damages claim under New York law. The court emphasized that the premium was a "one-time charge" that fixed the Noteholders' damages when triggered. Because it did not accrue over time, but was immediately payable upon redemption, the make-whole amount was properly considered liquidated damages under the law of New York and other states.

The court also considered whether the make-whole premium was a claim for the "economic equivalent" of unmatured interest. These claims compensate lenders for the "delay and risk involved with lending money." The court found that a make-whole premium did not compensate lenders for the delay and risk inherent in lending money and thus was not unmatured interest; rather, the make whole premium set damages resulting from the borrower's choice not to use the loan. *Id*. at *6.

Solvent Debtor Exception and Postpetition Interest Rate. The Bankruptcy Court next addressed whether the solvent debtor exception survived enactment of the Bankruptcy Code and held that it did. The solvent debtor exception requires that, "absent compelling equitable considerations," solvent estates pay creditors in full before the debtor and its equity holders recover a surplus. Judge Isgur found that the solvent debtor exception applied because it is a fundamental equitable principle of bankruptcy law and Congress expressed no intent to abandon it when it passed the Bankruptcy Code. *Id*. at *32.

Having determined that the solvent debtor exception applied, the Bankruptcy Court next considered the appropriate rate of postpetition interest to award the Noteholders. The Bankruptcy Court reviewed Section 726(a)(5) of the Bankruptcy Code, which allows creditors to receive postpetition interest at the "legal rate" prior to any surplus being returned to the debtor.[1] Courts are split as to whether the "legal rate" of interest means the federal judgment rate or the contractual default rate.

The Bankruptcy Court stated that awarding interest at the currently very low federal judgment rate would "contraven[e] the purpose of the solvent-debtor exception," and that, in solvent estate cases, the Bankruptcy Court's responsibility was "merely to enforce the contractual rights of the parties." Because limiting postpetition interest recovery to the federal judgment rate "would curtail the [Noteholders'] recovery, while allowing [Debtor] and its equity holders to escape bankruptcy with a windfall," the Bankruptcy Court held that postpetition interest had to be calculated at the contractual default rate to avoid an inequitable result. *Id*. at *42.

Takeaways

- The *Ultra* ruling is helpful to lenders because (at least in the Southern District of Texas) it effectively takes away a debtor's argument that a make-whole premium that is otherwise valid under state law should be disallowed as a claim for unmatured interest.

[1] Although Section 726(a)(5) applies in the context of liquidations under Chapter 7, most courts have found it to be applicable to creditors of solvent debtors in Chapter 11 through the "best interest of creditors" test in Section 1129(a)(7), which, in turn, provides that impaired creditors in a Chapter 11 case receive property of the same value that they would have received in a Chapter 7 liquidation. *See* Section 1129(a)(7); *In re Ultra Petroleum Corp.* at *19 ("Section 1129(a)(7), commonly known as the best interest of creditors test, prohibits confirmation of a chapter 11 plan if a dissenting impaired class would receive less than it would in a chapter 7 liquidation.")

- In recent years, many courts have weighed in on make-wholes, including the Second and Third Circuits in *Momentive* and *In re Energy Future Holdings Corp.*, respectively. However, those courts did not address whether a make-whole premium constituted unmatured interest; they largely addressed whether make-whole premiums were due under the terms of the debt documents as a matter of state law and contract interpretation.
- *Ultra* reiterates, like *Momentive* and *EFC*, that counsel must be careful when drafting debt documents containing make-whole premiums. Based on the decision, lender's counsel would be wise to include language in the indenture providing that the make-whole premium represents an approximation of actual pecuniary damages (and thus constitutes liquidated damages), rather than interest compensating the lender for the debtor's use of the borrowed funds. As Judge Isgur observed, liquidated damages are not interest and thus cannot be disallowed under Section 502(b)(2).
- Finally, when it comes to the postpetition interest rate, forum and choice of law clauses are critical considerations for lenders. Although courts in New York, Delaware, and Texas award postpetition interest at the contract rate, some bankruptcy courts — particularly in California — hold that the proper "legal rate" of interest is the federal judgment rate, rather than the contractual default rate, even in solvent debtor cases.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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