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Houston Bankruptcy Court Determines That a Make-Whole Claim Is Not Disallowed by the Bankruptcy Code and the Solvent Debtor Exception Still Exists Under the Bankruptcy Code

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This article discusses a decision by the U.S. Bankruptcy Court for the Southern District of Texas that addresses make-whole claims and the solvent debtor exception.

The U.S. Bankruptcy Court for the Southern District of Texas, sitting in Houston, in *Ultra Petroleum I* held that unsecured noteholders could include in their allowed claims: (i) a contractual make-whole claim, and (ii) a claim for post-petition interest at the contractual default rate (at least in the unique situation where the Debtors had become solvent during their former bankruptcy case and had exited under a Chapter 11 plan that sought to unimpair and pay in full their unsecured note claims).[1]

As to the first issue, the bankruptcy court held that the contractual make-whole claim, a significant prepayment premium that came due if the debt was accelerated, refinanced or retired prior to maturity, constituted valid liquidated damages, rather than statutorily disallowed unmatured interest.

As to the second issue, the bankruptcy court held that the so-called "solvent debtor exception," a judge-made doctrine that requires solvent debtors to pay interest on the claims of creditors before equity may obtain any recovery, required an unimpaired class of unsecured creditors to be paid post-petition interest at their contractual default rates, rather than the much lower federal judgment rate.

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[1] *In re Ultra Petroleum Corp., et al*, No. 16-03272, slip op. at 6 (Bankr. S.D. Tex. Oct. 27, 2020) (hereinafter, the "Memorandum Opinion"). The Memorandum Opinion amends the court's prior October 26, 2020 Opinion to fix typographical errors.

CASE BACKGROUND

Ultra Petroleum Company and its subsidiaries (the "Debtors") are upstream oil and gas producers. The Debtors originally filed Chapter 11 petitions in 2016 due, in part, to commodity price deterioration. But during the pendency of the original bankruptcy cases commodity prices rebounded sharply, making the Debtors solvent. As such, the Debtors proposed a Chapter 11 plan which the Debtors asserted would pay creditors in full.

The Debtors' bankruptcy filing, however, had resulted in an automatic acceleration of the maturity of the Debtors' outstanding debt pursuant to the terms of the debt financing documents and triggered a contractual obligation of the Debtors to pay the stated make-whole claim thereunder. Because the Debtors' proposed Chapter 11 plan failed to provide for payment of the make-whole claim or post-petition interest at the contractual default rate, the creditors objected to the plan, arguing that although treated as unimpaired under the plan, their claims were in fact impaired.

The bankruptcy court agreed with the creditors, concluding that, under state law, such creditors were entitled to receive their full contractual entitlements in order for their claims to be unimpaired, including payment of the make-whole claim and payment of post-petition interest at the contractual default rate.

THE FIFTH CIRCUIT OPINION

The Debtors sought a direct appeal to the U.S. Court of Appeals for the Fifth Circuit, which issued an opinion on January 17, 2019, holding in part that the challenged make-whole claim constituted unmatured interest under Section 502(b)(2) of the Bankruptcy Code. That opinion was subsequently withdrawn and superseded by a November 26, 2019 opinion.[2]

The Fifth Circuit held that if the Bankruptcy Code impairs a creditor's recovery, such as by disallowing a creditor's claim for unmatured interest or by capping a creditor's recovery by statute, a plan can still leave the creditor's claim unimpaired by first applying the Bankruptcy Code's allowance provisions to reduce the amount of the creditor's claim and then paying or treating the lesser amount as unimpaired.[3]

The Fifth Circuit remanded the case to the bankruptcy court to determine (i) whether the make-whole claim at issue was disallowed under the Bankruptcy

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[2] *In re Ultra Petroleum Corp.*, 943 F.3d 758 (5th Cir. 2019).

[3] *Id.* at 763.

Code as unmatured interest, and (ii) whether the so-called "solvent-debtor exception" survived enactment of the Bankruptcy Code and would require the then solvent Debtors to pay post-petition interest to unsecured creditors and, if so, at what rate.[4]

THE BANKRUPTCY COURT'S OPINION ON REMAND

On remand, the bankruptcy court determined that the creditors' contractual make-whole claim was not disallowed by the Bankruptcy Code.

The bankruptcy court first reiterated its prior ruling, which was not disturbed by the Fifth Circuit on appeal, that the make-whole claim was not an impermissible penalty under New York law.

The bankruptcy court then addressed whether the make-whole claim should be disallowed as unmatured interest under Section 502(b)(2). The bankruptcy court answered in the negative, holding that the make-whole claim was not unmatured interest. Unlike interest, the court reasoned, the make-whole claim does not compensate the creditors for the Debtors' use or forbearance of the creditors' money, but instead compensates the creditors for the Debtors' "breach of a promise to use money."[5] It liquidates the creditors' damages and compensates the creditors "for the cost of reinvesting in a less favorable market" capital that was repaid early.[6]

Also unlike interest, which accrues over time, a make-whole is a "one-time charge which fixes the [noteholders'] damages when it is triggered."[7] Accordingly, the bankruptcy court determined the make-whole claim was part of the noteholders' allowed claim under the Bankruptcy Code.

The bankruptcy court then considered whether the creditors were allowed post-petition interest at the agreed contractual rate, despite being unsecured creditors. The general rule in bankruptcy is that secured creditors are entitled to post-petition interest, if over-secured by the value of their collateral, but unsecured or under-secured creditors are not.[8] This rule is not without exception, at least in the unusual situation where a debtor becomes solvent during the pendency of a bankruptcy case.

Prior to the enactment of the Bankruptcy Code in 1978, the "solvent-debtor exception" allowed unsecured creditors to receive post-petition interest in

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[4] *Id.* at 766.

[5] Memorandum Opinion, slip op. at 8.

[6] *Id.*, slip op. at 14.

[7] *Id.*, slip op. at 16.

[8] 11 U.S.C. §§ 506(b), 502(b)(2).

bankruptcy cases under the old Bankruptcy Act, but with the enactment of the Bankruptcy Code in 1978, only over-secured creditors were specifically allowed to receive post-petition interest. The bankruptcy court noted that despite the Bankruptcy Code's silence as to unsecured creditors, "[t]he Supreme Court has made clear that it 'will not read the Bankruptcy Code to erode past bankruptcy practice absent clear indication that Congress intended such a departure.' "[9] Moreover, "[t]he solvent-debtor exception ensures that the debtor does not receive a windfall at the expense of its creditors."[10]

The bankruptcy court, accordingly, found that the "solvent-debtor exception" applied to include post-petition interest as part of the creditors' allowed unsecured claim.

As to the issue of what rate to use to calculate post-petition interest payments, the bankruptcy court determined that the contractual default rate, rather than the much lower federal judgment rate, applied in the rare solvent-debtor cases, because to hold otherwise would allow the Debtors and their equity to "escape bankruptcy with a windfall."[11]

The bankruptcy court further reasoned that limiting an unimpaired class of creditors, who are denied the right to vote, to the lower federal judgment rate would treat "an unimpaired class worse than an impaired class of unsecured creditors[,]" who have the right to vote.

PARTING REMARKS

Under the confirmation order in *Ultra Petroleum I*, the bankruptcy court established a reserve of $400 million in cash in a segregated account that was encumbered by security interests and control agreements in favor of the make-whole claimants. The Debtors exited Chapter 11 in 2017 and thereafter incurred new debt. Their solvency was short-lived. The one-two punch of a precipitous decline in commodity prices and the COVID-19 pandemic caused the Debtors to file Chapter 11 a second time on May 14, 2020.

On August 22, 2020, the bankruptcy court confirmed a Chapter 11 plan in the second bankruptcy, eliminating nearly $2 billion of first lien, second lien and unsecured debt. All were impaired. The first lien creditors received 97.5 percent of the new equity in exchange for their secured claims and the second lien creditors received the remaining 2.5 percent, each subject to dilution. The

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[9] *Memorandum Opinion*, slip op. at 32 (citation omitted).

[10] *Id.*

[11] *Id.*, slip op. at 42.

second lien creditors will also receive 45 percent of any proceeds received by the reorganized Debtors in the make-whole litigation from *Ultra Petroleum I*. The unsecured debt claims will receive a pro rata share of $3 million, plus nine percent of any proceeds received by the Debtors in the make-whole litigation.

Reorganized *Ultra* had settled some of the make-whole claims in the years leading up to its second bankruptcy filing and the bankruptcy court's recent ruling, but there remains enough unsettled claims and cash in the reserve account to justify another round of appeals. On December 1, 2020, the bankruptcy court certified for direct appeal to the Fifth Circuit the reorganized Debtors' appeal of the Memorandum Opinion.