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5th Circ. Ultra Petroleum Ruling Poses Key Debtor Question

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On Nov. 26, 2019, the U.S. Court of Appeals for the Fifth Circuit held in Ultra Petroleum Corp. v. Ad Hoc Committee of Unsecured Creditors of Ultra Resources[1] that the U.S. Bankruptcy Code limits in certain respects the right of creditors to enforce contractual claims for a "make-whole" premium owed under a note agreement as the result of the debtor's prepayment of the notes. The Ultra Petroleum case may ultimately lead to a decision addressing the unresolved questions of whether, and in what circumstances, a claim for a make-whole premium must be disallowed as "unmatured interest" under Section 502(b)(2) of the Bankruptcy Code.

The Ultra Petroleum decision arose out of unusual facts, which were that the debtors (an oil and gas exploration and production company) entered bankruptcy insolvent, and later became solvent as the result of a "lottery-like" rise in commodity prices. The question giving rise to the appeal in the case was whether the debtors' Chapter 11 plan "impaired" the claims of its noteholders by not providing for payment of a make-whole premium owed to the noteholders that became "immediately due and payable" under the note agreement when the debtors filed bankruptcy. The make-whole premium amount was determined based on a formula set forth in the note agreement, which was designed to compensate the noteholders for depriving them of the right to maintain their investment in the notes without being prepaid.

The debtors argued that the make-whole premium was a claim for "unmatured interest," which would be disallowed in full under Section 502(b)(2) of the Bankruptcy Code.[2]

The term "unmatured interest" is not defined under the Bankruptcy Code. In its January 2019 opinion in the same case — withdrawn and superseded by its Nov. 26 opinion — the Fifth Circuit said that Section 502(b)(2) disallows claims that are the "economic equivalent" of unmatured interest. Other courts have noted that unmatured interest includes interest that is not yet due and payable at the time the bankruptcy case is filed or that is not yet earned.[3] While the Fifth Circuit's

withdrawn opinion did not hold definitively that the make-whole premium constituted the economic equivalent of unmatured interest, t
he court said it was "persuaded" by the debtors' argument to that effect. However, the court also suggested, again without deciding, that the pre-Bankruptcy Code "solvent-debtor" exception may operate as a carveout from the general rule that claims for unmatured interest are disallowed. The withdrawn opinion, however, is not binding on the bankruptcy court on remand.

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Accordingly, the debtors' Chapter 11 plan proposed to pay the noteholders the outstanding principal of the notes, prepetition interest at a rate of 1% and post-petition interest at the federal judgment rate — but not the make-whole premium. The debtors proposed this treatment in spite of the fact that they had become solvent after filing their Chapter 11 petition, and stakeholders that were junior to the noteholders would receive a distribution.

The debtors argued that their proposed treatment did not "impair" the noteholders' claims. In the debtors' view, the result under Section 1126(f) of the Bankruptcy Code was that the noteholders were conclusively deemed to have accepted the plan and did not have the right to vote whether to accept or reject it. For their part, the noteholders argued that their claims were impaired — thus entitling them to vote on the plan — because their contractual right to the make-whole premium had been altered.

As the Fifth Circuit explained, Section 1124(1) of the Bankruptcy Code provides that "a class of claims or interests" is not impaired if "the plan ... leaves unaltered the [claimant's] legal, equitable and contractual rights." Under what the court described as the "plain text" of the statute, a claim is impaired only if "the plan" itself alters the creditor's legal, equitable or contractual rights. The fact that the Bankruptcy Code independently disallows part of a claim by statute — for instance, on the basis that it seeks unmatured interest — does not render the claim "impaired" for purposes of Section 1124(1).

The Fifth Circuit's decision was issued on a direct appeal from the U.S. Bankruptcy Court for the Southern District of Texas because it determined the case raised important and unsettled questions of law. The bankruptcy court, for its part, had taken a contrary view, finding that unimpairment requires that a creditor receive all it is entitled to receive under applicable nonbankruptcy law and by contract, without regard to whether the Bankruptcy Code disallows something the creditor would otherwise be entitled to receive outside of bankruptcy. As such, the bankruptcy court ordered the debtors to pay the make-whole premium, without ever addressing the question of whether the make-whole premium was a claim for unmatured interest that must be disallowed.

The Fifth Circuit therefore remanded the case to the bankruptcy court to consider whether the make-whole premium under the note agreement constitutes unmatured interest that must be disallowed under Section 502(b)(2) of the Bankruptcy Code. In remanding the case, the Fifth Circuit also observed that it "sees no reason why the solvent-debtor exception could not apply" and suggested that a bankruptcy court "might," absent compelling equitable considerations, enforce the parties' contractual rights and require the payment of the make-whole premium because the debtors are solvent.

The Fifth Circuit did suggest, however, that the application of the equitable "solvent debtor" exception must only be exercised within the parameters of the Bankruptcy Code, under the U.S. Supreme Court's decision in Law v. Siegel.[4] In light of Siegel and similar case law, whether the bankruptcy court

therefore might apply the solvent debtor exception in a way that limits noteholders' recovery to some level of interest determined by reference to a state or federal judgment rate — rather than by reference to the parties' contractual rights — remains to be seen. Without expressing a view, the Fifth Circuit further noted that a bankruptcy court's equitable power to enforce the solvent debtor exception may be moored in Section 1124's requirement that a plan leave equitable rights unaltered.

Given the legal and economic significance of the questions left to be resolved in light of the Fifth Circuit's latest decision in this case, debtors and creditors alike — both within the Fifth Circuit and around the country — are likely to watch closely how the bankruptcy court addresses these questions in the coming months.

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[1] Ultra Petroleum Corp. v. Ad Hoc Committee of Unsecured Creditors of Ultra Resources (In re Ultra Petroleum Corp.), __ F.3d ___, 2019 WL 6318074 (5th Cir. 2019). The Fifth Circuit's opinion withdrew and superseded its January 2019 opinion in Ultra Petroleum Corp. v. Ad Hoc Comm. of Unsecured Creditors of Ultra Res. (In re Ultra Petroleum Corp.), 913 F.3d 533 (5th Cir. 2019).

[2] The debtors also argued that the make-whole premium was an unenforceable liquidated damages provision under New York law.

[3] See In re Arcade Publ'g, 455 B.R. 373, 378 (Bankr. S.D.N.Y. 2011).

[4] Law v. Siegel, 571 U.S. 415 (2014).