Ultra Petroleum Refuels Grounds for Challenging Make-Whole Amounts, Postpetition Interest, and Other Fees

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Over the past decade, low interest rates and a string of pro-lender bankruptcy decisions on make-whole provisions—a type of contractual prepayment penalty that offers yield protection to a lender in the event of debtor's early repayment—have resulted in the increasing prevalence of make-wholes in commercial loan documents and bond indentures, particularly in the distressed lending arena. A debtor's make-whole obligations are typically substantial and often threaten to overwhelm the claims pool in a Chapter 11 case and significantly dilute potential distributions to general unsecured creditors. With lenders (both secured and unsecured) in recent cases seeking to recover hundreds of millions of dollars in make-whole amounts, these provisions have quickly garnered multi-faceted, high-stakes challenges by creditors' committees and other constituencies in Chapter 11 cases. The Fifth Circuit's January 2019 decision in *Ultra Petroleum*,[1] which strongly suggests that make-whole provisions constitute unmatured interest, is a positive development for trade creditors that may benefit from the disallowance of such claims under the Bankruptcy Code.

What is a Make-Whole Provision? A make-whole provision is a type of contractual prepayment penalty that offers yield protection to a lender in the event a borrower repays a loan prior to its scheduled maturity date by ensuring a guaranteed return at the time they agree to provide the financing. Under one school of thought, such provisions are viewed as a fee charged in exchange for a borrower's option to prepay its debt. Others view the premium as compensation to a lender in exchange for the loss of future interest that would have accrued but for the prepayment. While some make-whole provisions are based on "yield maintenance" formulas that estimate the damages to lenders resulting from prepayment, others are fixed at a percentage of the amount of the prepayment.[2]

Courts will generally enforce make-whole provisions where: (i) at the time of contracting, it appears that actual damages will be difficult to determine and (ii) the liquidated damages amount is not 'plainly disproportionate' to the possible loss.[3]

Postpetition Interest and Fees. An overview of the Bankruptcy Code's treatment of postpetition interest and fees is helpful in framing the *Ultra Petroleum* decision. Generally speaking, section 502(b)(2) of the Bankruptcy Code provides that creditors are not entitled to recover postpetition interest—that is, interest on a prepetition debt that accrues after the date the debtor's bankruptcy petition is filed. One exception to this general rule is that oversecured creditors are entitled to recover postpetition interest and reasonable postpetition fees, costs, and charges including attorneys' and other professional fees, make-whole amounts, late fees, and court costs, but only to the extent the value of its collateral exceeds the value of its claim against the debtor.[4] A second exception to the general rule is in the rare event of a solvent debtor—in which case, case law[5] has been interpreted to stand for the proposition that undersecured and unsecured creditors can receive postpetition interest at the "legal rate."

Courts are Split on the Make-Whole Analysis. The primary arguments against a lender's recovery of make-whole amounts in bankruptcy are: (i) the make-whole claim is unenforceable as a penalty (as opposed to a reasonable and enforceable *liquidated damages* provision) under applicable non-bankruptcy law; (ii) the make-whole claim is unmatured interest and

1 In re *Ultra Petroleum Corp*., 913 F.3d 533 (5th Cir. 2019).

2 Scott K. Charles, Emil A. Kleinhaus, *Prepayment Clauses in Bankruptcy,* 15 Am. Bankr. Inst. L. Rev. 537, 538 (2007).

3 See *In re Sch. Specialty, Inc*., No. 13-10125 KJC, 2013 WL 1838513, at *2 (Bankr. D. Del. Apr. 22, 2013).

4 11 U.S.C. 506(b).

5 Courts have interpreted the relevant legislative history as establishing that a creditor denied post-petition interest is "impaired, entitling [that creditor] to vote for or against the plan of reorganization." See *In re Ultra Petroleum Corp.*, 913 F.3d 533 (5th Cir. 2019).

therefore disallowed under section 502(b)(2) of the Bankruptcy Code; and (iii) with respect to secured claims, the make-whole provision is not reasonable under section 506(b) of the Bankruptcy Code.

Prior to *Ultra Petroleum*[6], the circuit courts that addressed a lender's ability to recover make-whole amounts from a debtor had focused on the provision's enforceability under applicable *non-bankruptcy law*[7], creating a split between the Second and Third Circuits on whether the automatic acceleration of debt caused by a bankruptcy filing triggers payment of a make-whole. Significantly, however, neither court had directly addressed whether a make-whole[8] provision could be disallowed pursuant to the *Bankruptcy Code*.

Most cases to consider this precise issue have concluded that claims based on make-whole provisions are not claims for unmatured interest. The majority decisions that reach this conclusion generally reason that "[p]repayment amounts, although often computed as being interest that would have been received through the life of the loan, do not constitute unmatured interest because they fully mature pursuant to the provisions of the contract."[9]

A small minority of bankruptcy courts, on the other hand, have held that make-whole claims are unmatured interest because they generally seek to compensate a lender for future interest payments due to early repayment of debt.[10] Significantly, in *Ultra Petroleum*, the Fifth Circuit sided with this minority, finding that section 502(b)(2) disallows any claim that is the economic equivalent of unmatured interest. The court reasoned that Fifth Circuit precedent advocates a form over substance analysis of "unmatured interest" by looking to economic realities as opposed to trivial formalities, and found that the purpose of a make-whole provision is to compensate a lender for lost interest.[11] The Fifth Circuit explicitly noted that the acceleration clause in the note agreement was an unenforceable *ipso facto* clause, in that it tied acceleration to the debtor's decision to file a bankruptcy petition. Thus, the *Ultra Petroleum* ruling legitimizes arguments for the per se disallowance of make-whole claims under the Bankruptcy Code, and will have considerable impact on the allowability of a lender's make-whole claim in courts within the Fifth Circuit.

Postpetition Fees. In addition to its make-whole analysis, the *Ultra Petroleum* Court addressed the unsecured lender's entitlement to postpetition interest. The parties in *Ultra Petroleum* had agreed that the creditors were entitled to postpetition interest under the solvent debtor exception, but had not agreed on the applicable rate of interest.[12] Moreover, in the context of the solvent debtor exception, courts are split over the meaning of the "legal rate", with some courts applying the federal judgment rate fixed by statute,[13] and others applying the contract rate

6 *In re Ultra Petroleum Corp.*, 913 F.3d 533 (5th Cir. 2019).

7 Notably, a claim against a debtor will be allowed unless it falls within one of the nine enumerated exceptions under section 502(b). When such an objection is asserted, a claim will be allowed, except to the extent that such claim is unenforceable against the debtor and property of the debtor, under any agreement. 11 U.S.C. § 502(b)(1).

8 In *In re MPM Silicones, L.L.C.*, 874 F.3d 787, 803 (2d Cir. 2017) the Second Circuit held that the make-whole clause was not triggered because, among other things, the redemption provision, which contemplated optional redemption and payment required by operation of an automatic acceleration clause was not an optional redemption. *Momentive* is directly at odds with the Third Circuit's decision in *In re Energy Future Holdings Corp.*, 842 F.3d 247 (3d Cir. 2016), which addressed a redemption provision substantially similar to that in *Momentive*. The Third Circuit held that the make-whole claim was triggered under the indenture and state law, reasoning that the redemption was optional notwithstanding the automatic acceleration because the debtors had the option to reinstate the accelerated notes' original maturity date, yet chose to refinance the notes.

9 *In re Outdoor Sports Headquarters, Inc.*, 161 B.R. 414, 424 (Bankr. S.D. Ohio 1993); In re Skyler Ridge, 80 B.R. 500, 508 (Bankr. C.D. Cal. 1987); In re 360 Inns. Ltd., 76 B.R. 573, 576 (Bankr. N.D. Tex. 1987).

10 *In re Ridgewood Apartments* of DeKalb Cnty., *Ltd*., 174 B.R. 712, 720 (Bankr. S.D. Ohio 1994) ("Absent actual prepayment by the Debtor, [the lender's] claim for a prepayment penalty could be no more than a contingent liability. Further, because the contingent claim is for interest which is not yet due at the time the bankruptcy was filed (because prepayment had not occurred), it would not be allowed to an undersecured creditor [under 11 U.S.C. § 502(b) (2)]."")

11 *In re Ultra Petroleum Corp*., 913 F.3d 533, 547 (5th Cir. 2019).

12 Under facts that the Fifth Circuit described as anomalous, oil prices rose during the bankruptcy proceedings. "Crude oil approached $80 per barrel, and the Petroleum companies became solvent again. So, the debtors proposed a rare creature in bankruptcy—a reorganization plan that (they said) would compensate the creditors in full." *Id*. at 538.

13 *See Onink v. Cardelucci (In re Cardelucci)*, 285 F.3d 1231 (9th Cir. 2002); *In re Energy Future Holdings Corp*., 540 B.R. 109, 113-14 (Bankr. D. Del. 2015).

(even the default rate, depending on the balance of the equities in a particular case).[14]

Although the Fifth Circuit did not decide the issue, it made clear that in the event the bankruptcy court determines that the solvent debtor exception survived (which it intimated was unlikely), there were two options for interpreting the "legal rate" thereunder: (i) the court may award postpetition interest under the general post-judgment interest statute, 28 U.S.C. § 1961, which allows interest "on any money judgment in a civil case recovered in a district court" and sets a rate by reference to certain Treasury yields; and (ii) the court may award postpetition interest at an appropriate rate if it determines to do so under its equitable power.

Notably, several recent decisions provide reminders that the language of a contractual fee provision in a loan document can function to restrict a secured creditor's ability to recover postpetition fees, regardless of its oversecured status.[15] In *Emerald Grande*,[16] for example, the debtor obtained financing through secured loans documented by construction loan agreements, promissory notes, and related security instruments. The lender filed a proof of claim asserting a secured claim for the balances due on its construction loans. Toward the end of the case, the secured lender, who had been actively involved in the bankruptcy case, filed an amended claim asserting over $150,000 in accrued attorney's fees and expenses pursuant to the relevant loan documents, which provided for the recovery of attorneys' fees incurred in connection with the enforcement of the loan documents or collection thereunder in the event of the Debtor's nonpayment.[17]

The court disallowed the secured creditor's legal fees and expenses incurred in connection with its challenging an administrative expense claim, monitoring a third party bankruptcy case, seeking the dismissal or conversion of the debtor's case, and performing certain clerical work because the underlying loan documents limited the secured creditors' recovery of attorney fees to those incurred in connection with the enforcement of the secured claim.[18]

Conclusion. As illustrated by the decisions above, courts have broad discretion to award postpetition interest, fees, and other similar payments to creditors. Identifying a lender's claims for make-whole amounts, postpetition interest, and other fees, and understanding their propriety in the relevant circumstances can significantly impact a general unsecured creditor's strategy and success in connection with a customer's Chapter 11 filing. To this end, credit professionals should carefully review and identify the key terms in their customers' loan documents (both secured and unsecured) and try to maintain a general knowledge of the law to stay informed regarding available leverage points and the incentives of the parties involved.

The Fifth Circuit's January 2019 decision in *Ultra Petroleum* has refueled the arguments available in opposition to lenders' make-whole claims and, along with several other cases placing limits on the collectability of lenders' postpetition interest and attorneys' fees, may provide renewed hope for general unsecured creditors who, in many cases, have come to bear the cost of ensuring lenders are made whole. The decision also makes it significantly more likely that a debtor with substantial make-whole obligations will seek to file its petition within the Fifth Circuit.

A creditor's ability to evaluate its position and strategize accordingly will help to inform pre-bankruptcy credit decisions, foster a practical understanding of when active participation in a Chapter 11 case is most cost effective, and will help in efforts to increase the potential distribution to general unsecured creditors.

14 *See Official Comm. of Unsecured Creditors v. Dow Corning Corp.* (In re Dow Corning Corp.), 456 F.3d 668, 674-80 (6th Cir. 2006); *Colfin Bulls Fundings* A, LLC v. *Paloian (In re Dvorkin Holdings, LLC)*, 547 B.R. 880, 891-98 (N.D. Ill. 2016).

15 *See, e.g. In re Sundale, Ltd*., 483 B.R. 23 (Bankr. S.D. Fla. 2012) (disallowing, in part, claim for oversecured creditor's attorney's fees as unreasonably excessive).

16 *In re Emerald Grande, LLC*, No. 17-BK-21, 2019 WL 1421429, at *1 (Bankr. N.D.W. Va. Mar. 27, 2019).

17 *Id*. at *2

18 *Id*. at *5.

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