Updates
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Fifth Circuit Rules on “Impairment” Under Chapter 11 Plan, Provides Guidance on Make-Whole Payments and Default Interest

A recent decision clarified the concept of impairment when a plan of reorganization provides for creditors to receive 100% of their allowed claims. The U.S. Court of Appeals for the Fifth Circuit held that creditors are unimpaired if they receive the full amount allowable under the Bankruptcy Code regardless of whether that amount is less than the creditors' rights under *state* law. *In re Ultra Petroleum Corporation* also included a discussion of creditors' rights to recover a "make-whole payment" and default interest but remanded those issues back to the bankruptcy court for further decisions.

Background

Ultra Petroleum and its subsidiaries were oil and gas producers that filed for Chapter 11 relief after the price of oil collapsed. During the bankruptcy, oil prices recovered enough to make them solvent. The debtors proposed a plan of reorganization (the Plan) to pay the full amount of all creditors' allowed claims under the Bankruptcy Code. The debtors argued that this treatment rendered the claims "unimpaired" and creditors were thereby deemed to accept the Plan under Section 1126(f) of the Bankruptcy Code. Certain noteholders nevertheless objected, arguing that they were in fact impaired because the Plan did not provide for every dollar that they would receive under state law. Specifically, the Plan did not provide for payment of either the "make-whole amount" or default rate interest during the bankruptcy case. The Bankruptcy Court for the Southern District of Texas agreed with the objecting creditors and ruled that their claims were "impaired" because the Plan would not pay every dollar that the creditors would be entitled to receive under state law. The Fifth Circuit's decision reversed the bankruptcy court.

The applicable Note Agreement provided that a prepayment triggers the "make-whole amount", which was designed to "provide compensation for the deprivation of" a noteholder's "right to maintain its investment in the Notes free from repayment." The "make-whole amount" was calculated based on a formula which discounted the remaining schedule payments at an assumed reinvestment yield of 0.5% over the comparable U.S. Treasury obligations, then subtracted the called principal balance from this discounted figure. Some of the loan documents also included a default rate of interest at a default rate of the higher of 2% over the normal rate or 2% above prime; the other loan documents provided for default interest at 2% above the otherwise applicable rate. The creditors claimed that the make-whole amount and default interest totaled $387 million.

Rather than deciding the issue in the Plan confirmation process, the parties agreed to "kick the can down the road" via a stipulation whereby the Plan would be confirmed, and Ultra Petroleum agreed to reserve $400 million in case the creditors ultimately prevailed.

The Bankruptcy Code provides that a class of claims is not impaired if "the plan [of reorganization] ... leaves unaltered the legal, equitable, and contractual rights to which such claim … entitles the holder." 11 U.S.C. § 1124(1). The Code also provides that a court should disallow a claim "to the extent that [it seeks] unmatured interest." 11 U.S.C. § 502(b)(2). The bankruptcy court held that unimpairment "requires that [creditors] receive all that they are entitled to under state law."

Fifth Circuit Decision

In a direct appeal, the Fifth Circuit reversed and ruled that impairment requires that *the plan itself* must do the altering (for a claim to be impaired) as opposed to rights being altered by other provisions of the Bankruptcy Code. The U.S. Court of Appeals for the Third Circuit is the only other circuit court to address this issue, and the Fifth Circuit agreed with their ruling in *In re PPI Enterprises (U.S.), Inc.*, 324 F.3d 197(3d Cir. 2003). In *PPI*, a landlord creditor argued that its claim was impaired, even though the Plan called for full payment of its claim, as reduced by the statutory cap of Section 502(b)(6) that limits a landlord's claim for rejection damages. The Third Circuit had held the PPI plan merely reflected the Bankruptcy Code's disallowance of a portion of the landlord's claim and this limitation by itself was not impairment even if the landlord could have collected more outside of bankruptcy.

The Fifth Circuit remanded on the issues of whether the make-whole amount and default interest were allowable under the Bankruptcy Code. The court held that the only question regarding recovering the make-whole amount "is whether the pre-Code solvent-debtor exception survives the enactment of § 502(b)(2)." The court also directed the bankruptcy court to address whether the creditors had an equitable entitlement to such interest, citing *In re Energy Future Holdings Corp.*, 540 B.R. 109, 124 (Bankr. D. Del. 2015).

The creditors filed a petition for *en banc* review by the entire Fifth Circuit which might provide additional rulings in the not too distant future.

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