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Private Credit & Special Situations

WHAT IS IT?

The Fifth Circuit "Fake-Whole": Assessing Make-Whole Enforceability in the Wake of *Ultra*

Summary

In a much-anticipated decision issued on October 14, 2022, the Fifth Circuit Court of Appeals ("Fifth Circuit"), held in *Ultra Petroleum* that the make-whole premium at issue constituted the economic equivalent of "unmatured interest"[1] and was therefore "disallowed" under Section 502(b)(2) of the Bankruptcy Code, a reversal of the U.S. Bankruptcy Court for the Southern District of Texas ("Bankruptcy Court")'s holding with respect to such issue. However, the Fifth Circuit recognized a limited exception, concluding that solely because the debtor was solvent the make-whole premium remained payable notwithstanding such disallowance. Given the rarity of solvent-debtor cases, the Fifth Circuit's ruling that the make-whole premium would otherwise be disallowed could have a significant impact on the financial markets (including the Private Credit Market) and reduce allowance of make-whole claims in bankruptcy cases in the Fifth Circuit.[2] The effect of the ruling is binding only within the Fifth Circuit (consisting of Louisiana, Mississippi, and Texas) and divergent from the Delaware bankruptcy court's analysis on make-whole premiums in the Third Circuit. The ruling, a three-judge panel decision, may – as with the Fifth Circuit's ruling on the topic three years ago (see our prior article discussing this Fifth Circuit decision) - be taken up *en banc* by the entire Fifth Circuit and reconsidered or, possibly, appealed to the Supreme Court.[3] For the avoidance of doubt, the ruling discussed would not impact the enforceability of make-wholes outside of the bankruptcy context.

[1] Unmatured interest under Section 502(b)(2) is any interest on principal that will accrue after the petition date.
[2] The Court also allowed post-petition interest to accrue on the make-whole premium – often referred to as a double recovery.
[3] The debtor in *Ultra* will have until October 28, 2022 to request an *en banc* hearing.

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Background

At confirmation of its chapter 11 plan, the debtor argued that its plan treated all creditors as unimpaired by paying their claims in full in cash despite the plan not paying noteholders the make-whole premium provided for in the applicable notes.[4] The noteholders objected and argued that in order for the noteholders' claims to be deemed unimpaired the make-whole premium and post-petition interest must be paid on the terms provided for in the notes (including interest accruing at the default rate). The Bankruptcy Court found that the make-whole constituted neither "unmatured interest" nor its "economic equivalent" for the purpose of Section 502(b)(2) and, therefore, the failure to pay such amount left the noteholders impaired under the plan. The debtor appealed directly to the Fifth Circuit, which reversed the Bankruptcy Court on the issue of impairment, but left the issue of whether the disputed claims were disallowed (as unmatured interest) for the Bankruptcy Court to decide (see our prior article referenced above). On October 26, 2020, on remand from the Fifth Circuit to consider whether make-whole premiums constitute "unmatured interest," the Bankruptcy Court found in favor of the noteholders and ruled that payment of the contractually-required make-whole premium was required as the make-whole premium did not constitute unmatured interest nor the economic equivalent thereof and, therefore, must be paid by the debtor to leave noteholders unimpaired under the chapter 11 plan.[5] The debtor appealed, and in its October 14, 2022 ruling, the Fifth Circuit reversed the Bankruptcy Court's finding that the make-whole did not constitute unmatured interest but affirmed its judgment that the debtor was obligated to nevertheless pay the make-whole (on account of the solvent-debtor exception).[6]

The Court's Reasoning

Section 502(b)(2) of the Bankruptcy Code disallows claims for "unmatured interest." Case law in the Fifth Circuit has interpreted this provision to also disallow claims that constitute the "economic equivalent of unmatured interest."[7] Writing for the majority of the panel, Judge Elrod found in *Ultra* that "make-whole amounts, like the one at issue here, are expressly designed to liquidate fixed-rate lenders' damages flowing from debtor default while market interest rates are lower than their contractual rates," and therefore are the definition of unmatured interest.[8]

[4] Under Section 1124(1) of the Bankruptcy Code, "a class of claims or interests is impaired under a plan unless, with respect to each claim or interest of such class, the plan [] leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest."

[5] *See In re Ultra Petroleum Corp.*, 624 B.R. 178,191-195 (Bankr. S.D. Tex. 2020).

[6] The "solvent debtor exception" is an equitable exception rooted in bankruptcy common law that applies when a debtor's assets exceed its liabilities; it suspends the general rule in bankruptcy that post-petition interest is not required to be paid to the debtors' creditors.

[7] *See e.g. In re Pengo Indus., Inc.*, 962 F.2d 543, 546 (5th Cir. 1992).

[8] The noteholders' instrument defines the Make-Whole Amount as "the excess, if any, of the Discounted Value of the Remaining Scheduled Payments with respect to the Called Principal of such fixed rate Note over the amount of such Called Principal." The "Remaining Scheduled Payments" are all interest and principal payments on the loan through maturity. The Remaining Scheduled Payments are summed and discounted to their present value using a discount factor 50 bps over the yield to maturity of Treasury securities comparable in risk profile to the notes. The "Called Principal" is then subtracted from the present value of the Remaining Payments and the make whole is any resulting positive number.

Indeed, Judge Elrod noted that "[i]n our circuit, we evaluate whether a claim is disallowed under Section 502(b)(2) based on whether the claim is for the 'economic equivalent of unmatured interest' — not simply whether the claim is itself for 'unmatured interest.'"

The make-whole premium at issue in *Ultra* was calculated in a manner common in today's lending markets, i.e., based on the amount of future interest payments on the outstanding principal under the loan at the time of the triggering default as discounted to present value. The Fifth Circuit rejected arguments characterizing the make-whole premium as distinct from unmatured interest because a contingent premium is not consideration for the "use or forbearance of another's money accruing over time," but instead liquidated damages payable to compensate the noteholders for the costs of finding and consummating a comparable transaction. The Fifth Circuit focused on whether the make-whole amount compensated for the replacement transaction costs and the loss of future interest. Indeed, a key component of its finding was that the make-whole's calculation was tied to unmatured interest. To illustrate the point, the Fifth Circuit hypothesized a "Fake-Whole Amount" of (∑ [all unmatured interest payments] + $1.00) × 1, and concluded that it was "exactly the economic equivalent of unmatured interest." (internal quotations omitted).

As is common, the *Ultra* make-whole premium was calculated based on the amount of future interest payments on the outstanding principal under the loan at the time of the triggering default as discounted to present value. The Fifth Circuit panel rejected the noteholders' arguments characterizing the contingent make-whole premium as distinct from unmatured interest because it is not consideration for the "use or forbearance of another's money accruing over time," but instead liquidated damages payable to compensate the noteholders for the costs of finding and consummating a comparable transaction.

The Fifth Circuit's analysis focused heavily on the structure of the premium, particularly that the make-whole's "key ingredient" was its calculation of future unearned interest, and a narrow reading of the Fifth Circuit's decision could mean that premiums that are untethered to the loan's amortization or interest payment schedule fall outside the scope of the Fifth Circuit's definition of "economic equivalent of unmatured interest." Although it is possible that fees fixed as multiples of invested capital ("MOIC"), fixed percentage call premiums, or exit fees may fair better under the Fifth Circuit's analysis for lack of a specific tie to interest calculations, the Fifth Circuit's ruling offers no clear comfort in this regard. Moreover, only time will tell whether motivated parties try to argue that this ruling should be applied to disallow such fees or other similar economic features. Market participants may also wish to consider whether other structural differences, such as characterizing the premium based on replacement transaction costs could further distinguish a make-whole premium from the Fifth Circuit's holding.

A broader reading of the Fifth Circuit's holding could see the "economic equivalent of unmatured interest" definition capture fees that are fixed (without reference to interest calculations) or fees based on a MOIC if a bankruptcy court finds that the premium could include unmatured interest or serve the purpose of being an economical equivalent thereof (i.e., a "Fake-Whole").

The Fifth Circuit's statement that even liquidated damages can be recharacterized as unmatured interest "masquerading as principal" is an approving nod to interpreting Section 502(b)(2) to disallow all or portions of fees payable upon acceleration or prepayment in bankruptcy. Advancing this view further, the Fifth Circuit observed that the make-whole "compensates Creditors for the future use of their money, albeit use that [unless the make-whole is triggered] will never actually occur", which in the majority's view, is just another way of describing unmatured interest. The dissenter on the panel, Judge Oldham, did not present a more favorable view on make-whole allowance under Section 502(b)(2) but rather criticized the majority that it did not go far enough and urged the panel to extend the "economic equivalent of unmatured interest" exclusion to solvent debtor cases such as *Ultra* because Section 502(b)(2) does not recognize the solvent debtor exception.

Two potential practical consequences of the *Ultra* decision may be that: 1) creditors might be motivated to accelerate prior to the debtor filing for bankruptcy so that the make-whole would be included in their claim as of the petition date which may reduce the risk of their make-whole premium being disallowed as unmatured interest, and 2) debtors may be meaningfully motivated to file for bankruptcy before its creditors can accelerate the loan in order to preserve the unmatured nature of the make-whole and commence such filing in the Fifth Circuit if such venue is available.[9] How the foregoing risk, among others, resulting from the *Ultra* decision are priced into credit markets (including the Private Credit Market) remains to be seen.[10]

Conclusion

If construed broadly within the Fifth Circuit and ultimately affirmed on appeal, the decision in *Ultra* will impact the viability of make-whole premium formulations in bankruptcy that are commonplace call protections in term loans, notes, and similarly structured credits. If interpreted narrowly, the Fifth Circuit's holding will still impact the viability in bankruptcy of call protections tethered to the calculation of future interest payments discounted to present value but could exclude differently structured or fixed fees payable upon the same or similar triggers as call protections. Regardless of where the breadth of interpretation ultimately falls, the Fifth Circuit's ruling will undoubtedly be the subject of much analysis, legal negotiation, structuring discussions, and litigation in the future.

[9] Under 28 U.S.C. § 1408, a debtor may commence a chapter 11 case in any district (i) in which the domicile (i.e., place of incorporation), residence, principal place of business, or principal assets of the debtor have been located for the 180 days prior to filing or (ii) in which the debtor's affiliate, general partner, or partnership has a pending case. In certain situations, the debtor has first filed a remote subsidiary that qualified for a favored jurisdiction and then bootstrapped the filing of all of the other affiliates in that favored jurisdiction.

[10] Note that courts have held that, notwithstanding Section 502(b)(2), an oversecured creditor may be entitled to payment on its make-whole claim under Section 506(b) of the Bankruptcy Code, which permits an oversecured creditor to recover post-petition interest, fees, costs and charges accrued during the pendency of the bankruptcy case to the extent of the collateral value remaining after payment of its prepetition claim. However, based on the Fifth Circuit's reasoning in this latest decision and in a prior decision in the *Ultra* the bankruptcy cases, *In re Ultra Petroleum Corp.*, 943 F.3d 758 (5th Cir. 2019), the Fifth Circuit would likely hold that a make-whole claim is not payable under Section 506(b) because payment of the make-whole would constitute the equivalent of payment of interest for the period commencing after the debtor's repayment of the secured debt (which is typically at emergence) through the stated maturity date of such debt, while Section 506(b) only requires payment during the pending of the bankruptcy case while the secured debt is outstanding.