Bankruptcy Law

# ‘Make-Whole’ Payments Face Potential Game-Changer in Bankruptcy

By James Nani

Deep Dive

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- Opinion could increase Texas’ popularity as bankruptcy venue

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**‘Make-Whole’ Payments Face Potential Game-Changer in Bankruptcy**

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1. ‘Make-whole’ ruling may create problems for some creditors
2. Opinion could increase Texas’ popularity as bankruptcy venue

A recent Fifth Circuit decision has put certain lenders on notice that a popular method of collecting lump sum, interest-like payments won’t help them if their borrower is an insolvent company going through bankruptcy.

In a long-awaited decision last month, the US Court of Appeals for the Fifth Circuit found that “make-whole” payments that lenders often put into debt contracts can be disallowed as a claim in bankruptcy. The ruling calls into question the enforceability of any make-whole provision—a common tool for lenders to ensure they don’t lose out on interest payments—in bankruptcy. Junior creditors may now have to rethink how they construct those protections in loan documents.

In its Oct. 14 decision, the divided Fifth Circuit held that oil and gas company Ultra Petroleum Corp. and its affiliates must pay its unsecured noteholders $387 million. Ultra Petroleum’s case was an exception to normal bankruptcy law, the court found, because it went from insolvent to solvent as natural gas prices increased after it filed its bankruptcy in 2016.

While the Fifth Circuit’s ruling on solvent debtors was a big win for Ultra’s unsecured creditors, it appears to be a boon for corporate debtors in the long run because it held that such make-whole payments constitute unmatured interest that isn’t allowed to be collected under bankruptcy law. Ultra emerged from bankruptcy in 2020.

“The Ultra decision has the potential to be a game changer and puts all investors holding unsecured debt on notice that claims for payment of a make-whole amount arising on or after a bankruptcy filing might be disallowed entirely,” said Adam L. Shpeen, a partner at Davis Polk & Wardwell LLP.

**Make-Wholes**

Make-whole provisions in debt contracts can be structured in various ways, but they’re generally a lump sum or fee payment incurred if a borrower pays the debt off early. The amount owed is calculated to give creditors the present value of interest payments they would have received if the borrower had continued paying down the debt over time.

The Fifth Circuit found that make-whole amounts in Ultra’s contracts were “nothing more” than the economic equivalent of a lender’s interest that hasn’t matured, but in today’s dollars.

Because they’re equivalent, the court found that those claims aren’t allowed under Section 502(b)(2) of the US bankruptcy code, which stops interest from accruing as of the date a debtor files for bankruptcy. While the creditors were still required to be paid because Ultra was solvent, the ruling means that if a debtor isn’t solvent, such make-whole claims can be rejected under the bankruptcy code.

In Ultra’s case, $201 million of the $387 million is the make-whole payment that must be paid to unsecured creditors.

Because of how large make-whole payments can be, and how common such provisions are in high-yield, fixed-rate debt contracts, the Fifth Circuit’s ruling is “incredibly significant,” said Theresa A. Foudy, a restructuring partner at Morrison & Foerster LLP.

With its ruling, the Fifth Circuit, which covers Louisiana, Mississippi and Texas, will become one of the hardest places for unsecured creditors to enforce make-whole payments, said restructuring partner Charles Persons of Sidley Austin LLP. That may help accelerate an ongoing trend of making Texas one of the most popular venues to file large Chapter 11 bankruptcies, he said.

“Debtors looking to challenge creditors’ entitlement to make-whole premiums are probably going to be more likely to file in the Fifth Circuit now,” Foudy said.

**‘Cat and Mouse’**

The Second and Third circuits, where most large, complex Chapter 11 cases are handled, have both previously opined on make-whole payments. But those circuits, which ruled in the bankruptcy cases of Energy Future Holdings Corp. and Momentive Performance Materials Inc., focused on the specific circumstances of their respective cases, Foudy said.

The Fifth Circuit in Ultra is the first appellate-level case to directly address the specific statutory issue for make-wholes, Foudy said.

Finance lawyers have been playing “cat and mouse” for years to try and refine their make-whole payment language to fit the Second and Third circuit rulings, Persons said. The Fifth Circuit got to the heart of the issue.

“The Fifth Circuit sort of cuts through the language in the document and basically said if it looks like an unmatured interest, and it smells like an unmatured interest then it’s an unmatured interest no matter how you draft it,” Persons said.

The Fifth Circuit itself has previously flip-flopped on the make-whole issue. In 2019, the court said it was “persuaded” that make-whole amounts may be disallowed claims in bankruptcy, but it withdrew the opinion later that year.

**Looking Ahead**

If other courts adopt the Fifth Circuit’s reasoning, the impact could be far-reaching, affecting scores of high-yield debt instruments that contain make-whole provisions, Shpeen said.

It’s unclear what impact, if any, the ruling may have on scrutiny of make-whole claims that arise under secured debt documents, Shpeen said. But the decision is likely to tee up the question over whether there should be different treatment in bankruptcy of make-whole amounts for unsecured versus secured creditors.

Additionally, appeals aren’t over. The Fifth Circuit was divided in its ruling, with Judge Andrew S. Oldham focusing his dissent on the solvent debtor issue. However, he agreed with the majority that make-whole amounts are “unmatured interest in disguise.”

Ultra on Friday sought review from the entire Fifth Circuit on the solvent-debtor exception portion of the opinion.

While Ultra’s unsecured creditors may have won the day, those in other bankruptcies likely won’t have the same luck, because solvent debtors in large Chapter 11 cases aren’t that common. Recent cases of large solvent debtor corporations, such as Hertz Corp.and PG&E Corp., have tended to be anomalies.

“Make-wholes are in every loan document,” Persons said. “The solvent debtor thing happens once in a blue moon.”

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