

Houston Bankruptcy Court Splits With Third Circuit on “Statutory Impairment”

Ultra court clarifies the requirements for classifying a creditor as “unimpaired” under a plan of reorganization.

Key Points:

- Texas bankruptcy court splits from Third Circuit in finding that a creditor must receive everything it is entitled to under non-bankruptcy law in order for the creditor to be “unimpaired.”
- The decision does not require that unsecured creditors receive post-petition interest but provides that they will be “impaired” if they do not

In a recent opinion, the Bankruptcy Court for the Southern District of Texas, Houston Division (the Court), held that for a creditor to be “unimpaired” under section 1124(1) of the Bankruptcy Code, the creditor must receive everything to which it is contractually entitled, including post-petition interest, even if some portion of that claim would be disallowed under a statutory provision in the Bankruptcy Code. The decision marked a split from cases in the Third Circuit, where the impairment inquiry and the doctrine of “statutory impairment” has focused on the satisfaction of claims as allowed. As a result, the Third Circuit has found that unsecured creditors can be unimpaired even if they have not received the full amount of their state law claims.

Background

The confirmed plan of reorganization (the Plan) of Ultra Petroleum Corp., *et al.*, (the Debtors) provided that the claims of certain unsecured noteholders (the Noteholders) would be paid at whatever amount was necessary to make the Noteholders unimpaired. The Court thus faced the question: What would the Noteholders need to receive in order to be unimpaired? The dispute centered on two elements of the Noteholders’ claim, which asserted that — under the contractual provisions of the Noteholders’ indenture — the Noteholders were entitled to both a make-whole and to post-petition interest, calculated at the default rate, on both the principal amount of the notes and on the make-whole. The Debtors did not dispute the Noteholders’ analysis of the indenture; instead, the Debtors objected to the Noteholders’ asserted entitlement to a make-whole premium and post-petition interest at the contractual default rate. The Debtors argued that the make-whole amount was an unenforceable liquidated damages provision under New York law, and that both the make-whole and the contractual post-petition interest represented unmatured interest, which section 502(b)(2) of the Bankruptcy Code expressly disallows.

Before focusing on impairment, Judge Marvin Isgur addressed the amounts to which the Noteholders were contractually entitled, finding that the contractual make-whole premium was valid under New York

state law and became due upon the filing of the bankruptcy petition,¹ and that default interest at the contractual rate was also valid under New York state law. Judge Isgur then turned to whether the Noteholders were entitled to payment in full of the make-whole premium and contractual default interest in order to be unimpaired.

Bankruptcy Code Sections Addressing Impairment and Post-Petition Interest

Section 502(b)(2) of the Bankruptcy Code disallows claims for unmatured interest, including post-petition interest, on unsecured debt. Courts in many jurisdictions, however, have found an exception to this general rule when the bankrupt debtor is solvent.² Courts looking for a statutory basis for this exception have generally cited the “best interests of creditors” test of section 1129(a)(7). That test requires an “impaired” creditor that has not affirmatively accepted a proposed plan of reorganization to receive under the plan at least as much as the creditor would receive in a hypothetical liquidation of the debtor under chapter 7 of the Bankruptcy Code. In a chapter 7 liquidation, if a debtor is solvent and thus all unsecured claims are paid in full, section 726(a)(5) of the Bankruptcy Code provides for the payment of post-petition interest to unsecured creditors “at the legal rate.” While the meaning of “the legal rate” remains a subject of ongoing debate, many courts have found that the legal rate is the federal judgment rate.³

Notably, however, section 1129(a)(7) provides that the “best interests” test only applies to claims that are impaired. Thus, this statutory analysis begs the question: what is an unsecured creditor entitled to when a debtor seeks to treat the creditor as unimpaired?

Prior to its repeal in 1994, section 1124(3) of the Bankruptcy Code provided that a claim was unimpaired if the holder received “cash equal to ... the allowed amount of such claim.” Thus, because section 502(b)(2) disallows claims for post-petition interest, a creditor could be paid “the allowed amount” of its claim (excluding post-petition interest) and be left unimpaired under section 1124(3).⁴

As a result, prior to the repeal of section 1124(3), solvent debtors could avoid paying post-petition interest to unimpaired unsecured creditors by paying their allowed claims in full in cash. A solvent debtor thus could avoid paying any post-petition interest to unsecured creditors by treating them as unimpaired, with the benefit of that reduced payment providing what was viewed as a windfall to equity. Congress decided that such a result was inequitable, and, in 1994, amended section 1124 by deleting section 1124(3). Following the repeal of section 1124(3), courts assessing whether a creditor is impaired generally look to section 1124(1) of the Bankruptcy Code, which provides that a claim is impaired unless the plan of reorganization “leaves unaltered the legal, equitable, and contractual rights to which such claim ... entitles the holder of such claim.”⁵

The Third Circuit’s Impairment Standard Under *PPI* Leads to Confusion Regarding Post-Petition Interest

In *In re PPI Enterprises (U.S.), Inc.*, 324 F.3d 197, 206-07 (3d Cir. 2003) (*PPI*), the Third Circuit addressed whether a landlord creditor whose allowed claim was capped by section 502(b)(6) of the Bankruptcy Code was impaired and thus entitled to vote on a proposed plan of reorganization that paid the capped claim in full. The Third Circuit noted that the Bankruptcy Code — rather than the plan of reorganization — provided for the disallowance of a portion of the landlord’s claim, and found that the landlord was unimpaired. The court held that the “legal ... rights” of the landlord under section 1124(1) of the Bankruptcy Code had to take into account any applicable law that affected the landlord’s claim, including specific statutory provisions of the Bankruptcy Code. Drawing a distinction between statutory impairment and plan impairment, the Third Circuit found that because the plan provided for payment of the claim in the full amount allowed by the Bankruptcy Code, the landlord was unimpaired.

Interestingly, in its discussion of the history of section 1124, the Third Circuit acknowledged in *PPI* that section 1124(3) had been repealed in order to allow unsecured creditors to receive post-petition interest from solvent debtors. The Third Circuit failed to reconcile how disallowance of post-petition interest under section 502(b)(2) differed in its statutory impairment analysis from disallowance of rent under section 502(b)(6). After all, the entire purpose of the repeal of section 1124(3) was to prevent debtors from getting around paying post-petition interest on unsecured claims by treating the claims as unimpaired. The Delaware bankruptcy court faced that same conundrum in *In re Energy Futures Holdings Corp.*, 540 B.R. 109, 113-14 (Bankr. D. Del. 2015) (*EFH*). In that decision, the bankruptcy court, bound by *PPI* as controlling precedent, found that the Third Circuit's reasoning, when applied to claims for post-petition interest, led to the opposite result from what Congress seemingly intended. Because the disallowance of unmatured interest (including post-petition interest) under section 502(b)(2) is statutory impairment akin to section 502(b)(6)'s cap on landlord claims, the Delaware bankruptcy court found in *EFH* that the proposed plan of reorganization did not have to provide for the payment of post-petition interest in order for unsecured creditors to be unimpaired.

The Delaware bankruptcy court acknowledged that this reasoning could result in impaired creditors receiving better treatment than unimpaired creditors due to the Bankruptcy Code's protections for impaired creditors including the "fair and equitable" test of section 1129(b)(2) and the best interests of creditors test of section 1129(a)(7). Nonetheless, the bankruptcy court in *EFH* was bound by the Third Circuit's *PPI* decision, and found that post-petition interest was not required in order for the creditors to be unimpaired. In an attempt to avoid this seemingly inequitable result, however, the Delaware bankruptcy court suggested that, because section 1124(1) requires that unimpaired creditors' "equitable ... rights" be unaltered, a court could require a solvent debtor to pay post-petition interest to an unimpaired creditor on the basis of equitable principles. The court then left that particular issue for future analysis.

Houston Bankruptcy Court Shifts Impairment Inquiry From Allowance to Discharge

Judge Isgur faced the same issue that had arisen in *EFH*: to be unimpaired, must an unsecured creditor receive payment of post-petition interest? Explicitly rejecting the reasoning of *PPI*, Judge Isgur found in *Ultra* that section 1124(1) required that unimpaired creditors receive all of their non-bankruptcy rights. Suggesting that the repeal of section 1124(3) had eliminated the allowed claim standard for impairment, the Court found that, for the purposes of section 1124(1), the focus should instead lie on the discharge granted by section 1141(d) of the Bankruptcy Code. Section 1141(d) provides that the extent of the discharge is governed by the terms of the confirmed plan of reorganization, and the Court noted that the Plan provided that the Debtors' liability on the make-whole premium and post-petition interest were to be discharged. Given that discharge, the Court found that the Noteholders could not be unimpaired under section 1124(1) unless the Noteholders were actually paid the amount to which they were entitled under state law.

Like the Delaware bankruptcy court in *EFH*, Judge Isgur also noted that the Bankruptcy Code sections requiring the payment of post-petition interest at the legal rate are not applicable to unimpaired creditors, and that the Noteholders were thus entitled to post-petition interest at the contractual rate.⁶

Impact

The Court's decision clarifies that if a creditor's claim is discharged under a plan of reorganization, then the creditor is impaired unless it receives everything to which it is entitled under non-bankruptcy law. The Delaware bankruptcy court's *EFH* decision showed the contradictions resulting from the statutory impairment analysis set forth by the Third Circuit in *PPI*, and Judge Isgur, not bound by *PPI*, set forth in *Ultra* a clearer and more logical concept of impairment. Whether or not other courts will adopt this expansive approach remains to be seen.

Importantly, the Court's ruling does not require solvent debtors to pay post-petition interest to unsecured creditors; rather, the ruling merely provides that if unsecured creditors are contractually entitled to receive post-petition interest and the proposed plan does not provide for such interest to be paid, then the creditors are impaired and are thereby entitled to the Bankruptcy Code's protections for impaired creditors.

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Endnotes

- ¹ The language from the relevant indenture quoted by the Court was explicit that the make-whole amount was due upon any default as well as any pre-payment, and thus the issues litigated in recent high profile cases as to whether the bankruptcy did or did not trigger the make-whole were not relevant. See, e.g., *Delaware Trust Co. v. Energy Future Intermediate Holding Co. LLC (In re Energy Future Holdings Corp.)*, 842 F.3d 247 (3d Cir. 2016); *U.S. Bank N.A. v. Wilmington Savings Fund Society, FSB (In re MPM Silicones, LLC)*, 531 B.R. 321 (S.D.N.Y. 2015).
- ² See, e.g., *In re Washington Mut., Inc.*, 461 B.R. 200, 241 (Bankr. D. Del. 2011) (“There is an exception to the general rule [that unsecured creditors are not entitled to recover post-petition interest], however, when the debtor is solvent.”).
- ³ See, e.g., *In re Washington Mut., Inc.*, 461 B.R. at 241; *In re Energy Futures Holdings Corp.*, 540 B.R. 109, 113-14 (Bankr. D. Del. 2015).
- ⁴ *In re New Valley Corp.*, 168 B.R. 73 (Bankr. D.N.J. 1994).
- ⁵ Section 1124(2), which was not implicated in the *Ultra* decision, provides that a creditor can be rendered unimpaired by the reinstatement of its claim.
- ⁶ Based on the opinion, the Debtors apparently did not argue that any contractual interest should be non-default. At the same time, the opinion's conclusion on measuring post-petition interest states only that the Noteholders are entitled to post-petition interest at “their contractual rate” without specifying whether that is default or non-default.