UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

In re:	)	Chapter 11
	)	
ULTRA PETROLEUM CORP., *et al.*	)	Case No. 16-32202 (MI)
	)	(Jointly Administered)
	)	
Debtors.	)	
	)	

OPCO NOTEHOLDERS' POST-HEARING BRIEF

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INTRODUCTION

The OpCo Noteholders submit this post-argument brief in further support of their previous filings on the post-petition interest and Make-Whole Amount issues, addressing four points raised during the May 16, 2017 oral argument:[1]

I. Section 1124(1) of the Bankruptcy Code directs that an unimpaired creditor receive its rights under applicable law, undiminished by the limitations of section 502 of the Bankruptcy Code. Here, the undiminished rights include the Make-Whole Amount and contractual post-petition interest.

II. Because a settled rule under the Bankruptcy Act was undisturbed by the enactment of the Bankruptcy Code, that rule—that a solvent debtor must honor its contracts—continues in force today.

III. As a matter of applicable New York law, the Make-Whole and default interest provisions are not penalties, and must be enforced.

IV. If section 726(a)(5) supplied the interest rate for post-petition interest, that rate would be the rate provided for by contract, not the federal judgment rate.

ARGUMENT

I. IMPAIRMENT

Seeking to distinguish "plan impairment" from what they call "statutory impairment," the Debtors argue that the claim of an unimpaired creditor is subject to the limitations of section 502. But as the OpCo Noteholders pointed out at oral argument, the distinction between *plan* impairment and *statutory* impairment is a fallacy,[2] for section 502 is not self-activating. Standing alone, it does not "alter"—that is, *extinguish or discharge*—creditor rights. It is indeed chapter 11 *plans* that alter creditor rights—whether by making effective the limitations of section 502, or by providing that a class shall receive a reduced distribution, or by both, it is *plans* that alter

[1] The OpCo Noteholders are listed on **Schedules 1-3** to the OpCo Noteholder Claims Response. *Objection of OpCo Noteholders to Confirmation of Chapter 11 Plan* [Dkt. No. 1269] (the "Confirmation Objection"); *Joint Response of OpCo Noteholders to Debtors' Claims Objection, and Reply to Arguments Concerning Post-Petition Interest and Fees* [Dkt. No. 1390] (the "OpCo Noteholder Claims Response"). Capitalized terms used in this brief, and not separately defined, are defined in *Debtors' Second Amended Joint Chapter 11 Plan of Reorganization* [Dkt. No. 1105-1] (the "Plan").

[2] Hard cases make bad law, as the saying goes. The theory of "statutory impairment," being different from "plan impairment" appears to have been developed by Judge Leif Clark, in a case in which the court was faced with what appears to have been an irritating problem: the objection of a short-seller to the imposition of subordination under section 510(b). *In re Am. Solar King*, 90 B.R. 808, 821-22 (Bankr. W.D. Tex. 1988).

rights. The "confirmation of a plan . . . discharges the debtor from any debt that arose before the date of such confirmation. . . ." 11 U.S.C. § 1141(d)(1)(A). Here, the Debtors' *Plan* establishes the rights of the Class 4 creditors, and, absent relief from this Court, will forever change those rights.

The Debtors do not contradict the fundamental statutory architecture. Section 101(5) defines a "claim" in a title 11 case as a collection of rights established by applicable law.[3] Here, "applicable" law is the state law that gives rise to the Class 4 creditors' contract claims. *Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co.*, 549 U.S. 443, 451 (2007). Section 502 contains a set of rules for a claim's "allowance." Among them are limitations on certain claim components that, while perfectly valid under applicable law, are not "allowed claims." *See, e.g.*, 11 U.S.C. §§ 502(b)(2) (disallowing claims for unmatured interest), 502(b)(6) (capping landlord claims).

Congress was quite aware of the distinction between a "claim" and an "allowed claim." In 1994, it repealed the only subsection of section 1124 that referred to claims allowance. Former subsection (3) provided that a creditor was unimpaired if:

> on the effective date of the plan, the holder of such claim or interest receives, on account of such claim or interest, cash equal to— (A) with respect to a claim, the ***allowed amount*** of such claim.

11 U.S.C. § 1124(3) (repealed) (emphasis added); *Solow v. PPI Enters. (U.S.), Inc. (In re PPI Enters. (U.S.), Inc.)*, 324 F.3d 197, 205 (3d Cir. 2003) (quoting former section 1124(3)). A court had interpreted this subsection to allow a solvent debtor to *exclude* post-petition interest from an unimpaired creditor's treatment, *In re New Valley Corp.*, 168 B.R. 73 (Bankr. D.N.J. 1994), a result Congress thought "unfair:"

> In . . . *New Valley Corp.* . . . unsecured creditors were denied the right to receive post-petition interest on their allowed claims even though the debtor was liquidation and reorganization solvent. . . . In order to preclude this unfair result in the future, the Committee finds it appropriate to delete section 1124(3) from the Bankruptcy

[3] 11 U.S.C. § 101(5).

> Code. As a result of this change, if a plan proposed to pay a class of claims in cash in the full allowed amount of the claims, the class would be impaired, entitling creditors to vote for or against the plan of reorganization.

H.R. Rep. No. 103-835, at 47-48 (1994), *as reprinted in* 1994 U.S.C.C.A.N. 3340, 3356-57, 1994 WL 562232 (emphasis added). Following the repeal of subsection (3), the statutory reference point for the "legal, equitable and contractual rights" that must be "unaltered" for a claim to be unimpaired has simply been the "claim" itself, as established by non-bankruptcy law. Regardless of the petition date, an unimpaired creditor's contractual rights, including rights to interest, must accrue—at the default rate if that is what the contract specifies—through the date upon which all amounts owing are actually paid.

Other sections of the Bankruptcy Code also show that Congress distinguished between "claims" and "allowed claims" intentionally. Section 1126(a), which provides the baseline voting rule, refers to *allowed* claims. "The holder of a claim or interest *allowed under section 502* may accept or reject a plan." 11 U.S.C. § 1126(a) (emphasis added). This makes sense. The holder of an allowed claim may see its legal, equitable and contractual rights limited in bankruptcy by section 502—but that holder has the considerable power of the ballot. The rule is different for unimpaired creditors. Section 1126(f) provides for deemed acceptance of a plan by an unimpaired class "and each holder of a claim . . . of such class," *and makes no reference to "allowed" claims.* 11 U.S.C. § 1126(f). An impaired holder votes its *allowed claim*, and by doing so may influence the process. An unimpaired holder has no voice because its bundle of rights under non-bankruptcy law is unchanged. *See In re Texas Rangers Baseball Partners*, 434 B.R. 393, 406-407 (Bankr. N.D. Tex. 2010) ("[I]f a creditor receives under a plan everything to which the creditor would be entitled in a judgment entered immediately following the plan's effective date, the creditor is receiving treatment that, as required by section 1124(1), honors all the creditor's 'legal, equitable and contractual rights.' For the typical unsecured creditor, those rights equate to payment of the debt owed with interest as allowed by law.").

The Debtors' Supplemental Brief[4] contains extended discussion of section 1141(d), *see id*. at 4-9. To what end is puzzling. The Debtors do not address the basic problem for their "statutory impairment" argument—that section 1141(d) provides that *plans* alter claims, which means that when Congress, in section 1124(1) refers to alteration by the "plan," then a section 502 limitation made effective by confirmation of a plan is precisely what Congress meant. After a long voyage, the Debtors seem to arrive at the destination that section 1141(d) indeed results in discharge. Why they travel there is a mystery, for the Plan in this case declares that Class 4 is unimpaired, and it is a matter of record that the Class 4 creditors were denied a vote. That can only mean that the Class 4 creditors are entitled to "unimpairment" as the law defines it—and as we have previously shown, that means that their claims, not their "allowed" claims, must be fully paid.

In short, the reference to "plan" in section 1124 is explained by the facts that: (1) impairment applies in OpCo's Plan and generally to "class[es] of claims or interests," and "classes" exist only under Chapter 11 plans, (2) the unimpairment of Class 4 deprived that class of the right to reject the Plan by vote, *see* 11 U.S.C. §§ 1124, 1126, 1129(a)(8), and (3) it is OpCo's Plan that, absent relief from this Court, would conclusively alter the rights of the Class 4 creditors.[5] The case falls squarely within section 1124(1), and denial of the Make-Whole Amount or default interest under the theory that either violates section 502(b)(2) would be error.

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[4] *See Supplemental Brief in Support of Debtors' Objection to Asserted Make-Whole Entitlement, Default Rate Post-petition Interest, and Other Related Fees and Expenses Asserted Under the OpCo Funded Debt Claims* [Dkt. No. 1478] at 8.

[5] For example, on dismissal of a chapter 11 case, even if the "allowed claim" of a landlord has been capped under section 502(b)(6), the limitations of allowance will not carry over into a state court. The landlord will revert to its rights under state law. *See* 11 U.S.C. § 349; *cf.* 11 U.S.C. § 103(a) ("[C]hapters 1, 3, and 5 of this title apply in a case under chapter 7, 11, 12, or 13 of this title[.]"); *In re Blendheim*, 803 F.3d 477, 487 (9th Cir. 2015) ("[I]mportantly, upon dismissal or conversion of a case, a debtor loses any benefits promised in exchange for the successful completion of the plan . . . . The Code treats any lien voided under a Chapter 13 plan as reinstated upon dismissal or conversion, restoring to creditors their state law rights of foreclosure on the debtor's property. . . . [Section] 349 provides that any lien stripped under § 506(d) will be reinstated upon dismissal of the case . . . . In effect, conversion or dismissal returns to the creditor all the property rights he held at the commencement of the Chapter 13 proceeding and renders him free to exercise any nonbankruptcy collection remedies available to him.") (citations omitted).

II. SOLVENCY

No express provision of the Bankruptcy Code requires that a solvent debtor honor its contracts. Yet the settled rule is that it must do so. The path to the rule begins in the Bankruptcy Act.

Under the Bankruptcy Act, a solvent debtor was obliged to honor its contracts, including, specifically, by paying all interest on amounts due under those contracts. *Johnson v. Norris*, 190 F. 459, 466 (5th Cir. 1911) ("The bankrupts should pay their debts in full, principal and interest to the time of payment, whenever the assets of their estates are sufficient."); *Ruskin v. Griffiths*, 269 F.2d 827, 832 (2d Cir. 1959) (stockholders of a solvent debtor "cannot complain that they are treated inequitably when their interest is cut down by the payment of a sum to which the debenture holders are clearly entitled by the express provisions of the trust indenture"). The Seventh Circuit agreed in *In re Chicago, Milwaukee, St. Paul & Pac. R.R. Co.*, 791 F.2d 524, 530 (7th Cir. 1986) (applying Bankruptcy Act) ("[W]hen the debtor is solvent, the judicial task is to give each creditor the measure of his contractual claim, no more and no less."), as did the First Circuit, *Debentureholders Protective Comm. of Cont'l Inv. Corp. v. Cont'l Inv. Corp.*, 679 F.2d 264, 269 (1st Cir. 1982) (applying Bankruptcy Act) ("Where the debtor is solvent, the bankruptcy rule is that where there is a contractual provision, valid under state law, providing for interest on unpaid instalments of interest, the bankruptcy court will enforce the contractual provision with respect to both instalments due before and instalments due after the petition was filed.").

In 1978, the Bankruptcy Act was supplanted with the Bankruptcy Code. But the rule is that Act precedents continue to control absent an express Bankruptcy Code section or Code legislative history to the contrary. *Dewsnup v. Timm*, 502 U.S. 410, 419 (1992). As the Fifth Circuit put it in *In re Laymon*, "[t]he Supreme Court 'has been reluctant to accept arguments that would interpret the Code, however vague the particular language under consideration might be, to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history." 958 F.2d 72, 74 (5th Cir. 1992) (citation omitted). In *Laymon*, finding silence in the Code, the Court of Appeals looked to precedents under the Act to analyze whether the contract should supply the interest rate which secured creditors were entitled to receive under section 506(b). *Id.* at 75.

The rule that a solvent debtor must honor its contracts was not abrogated by any express text of the Bankruptcy Code, nor by any legislative history of the Code. Thus Bankruptcy Act precedent remains valid. This explains why so many cases interpreting the Code have held that a solvent debtor must honor its contracts. *See, e.g., UPS Capital Bus. Credit v. Gencarelli (In re Gencarelli)*, 501 F.3d 1, 7 (1st Cir. 2007) ("[W]here there is a contractual provision, valid under state law, . . . the bankruptcy court will enforce the contractual provision.") (citation omitted); *Official Comm. of Unsecured Creditors v. Dow Corning Corp. (In re Dow Corning Corp.)*, 456 F.3d 668, 679 (6th Cir. 2006) ("[I]n solvent debtor cases, rather than considering equitable principles, courts have generally confined themselves to determining and enforcing whatever pre-petition rights a given creditor has against the debtor."); *In re MPM Silicones*, 2014 WL 4436335, at *17 (S.D.N.Y. Sept. 9, 2014) (noting solvent debtor exception to section 502(b)(2)); *In re Chemtura Corp.*, 439 B.R. 561, 605 (Bankr. S.D.N.Y. 2010) ("[I]n a solvent debtor case, 'it is the role of the bankruptcy court to enforce the creditors' contractual rights.'") (citation omitted); *see In re Mirant Corp.*, 327 B.R. 262, 270-71 (Bankr. N.D. Tex. 2005) (request to recharacterize lease obligations of solvent company denied because debtor was solvent); *In re Schoeneberg*, 156 B.R. 963, 970 (Bankr. W.D. Tex. 1993) ("Where a debtor is solvent it is undisputed that unsecured creditors are entitled to interest on their claims.").

The solvent-debtor rule is acknowledged not simply by bankruptcy courts, but by the Debtors themselves, for the Plan proposes to pay post-petition interest, albeit at a *de minimis* rate. This is not a chapter 7 case, and so section 726 of the Bankruptcy Code does not apply. Indeed it cannot apply, for it describes how "property of the estate shall be distributed," and here, none of the property of the estate is being distributed. It all vests in the reorganized debtor. *See Plan* at 27; *see also* 11 U.S.C. § 1141(b). Section 1129(a)(7) incorporates section 726, but by its terms it applies only to impaired classes. So, under what theory did the Debtors concede that any interest was due to Class 4 at all? It can only be that they, too, recognize that the Bankruptcy Act rule continues to have force. The solvent-debtor rule remains in force, because the Code has not abrogated it.

III. BOTH THE MAKE-WHOLE AMOUNT AND DEFAULT INTEREST ON OBLIGATIONS UNPAID WHEN DUE ARE VALID UNDER NEW YORK LAW

The solvent-debtor cases and the text of section 1124 take the Court to the same point of embarkation. The only question presented by the current dispute is whether a New York court would rule that the Make-Whole Amount, and default interest on sums not paid when due, are valid claims under New York law. At oral argument, the Court placed a narrower focus on that question, asking whether, as a matter of New York law, the combination of the Make-Whole and default interest is enforceable, or whether some portion would be rejected as a penalty on the theory that it constitutes "double-counting." *See* Tr. of Hearing on May 16, 2017 at 28:6-9; *id.* at 28:10-21; *id.* at 29:17-24.

As the Make-Whole and default interest provisions are remedies for breach of a New York contract,[6] this Court is constrained to apply the rule of decision that a New York court would apply. *See, e.g., United Merchs. & Mfgs., Inc. v. Equitable Life*, 674 F.2d 134, 136 n.3, 141 (2d. Cir. 1982) (applying New York law as stipulated in the parties' loan agreements and finding "[w]hether a contract clause which nominally prescribes liquidated damages is in fact an unenforceable penalty provision is a question of state law"); Tr. of Hearing at 12:24-13:1, *In re GMX Res., Inc.*, No. 13-11456-SAH (Bankr. W.D. Okla. Aug. 29, 2013), Dkt. No. 687 ("*GMX* Tr.") (same). Here the question of New York law is quite narrow. It is not whether the Make-Whole provision, standing alone, is unenforceable as a penalty, but whether the contractual obligation to pay default interest, by allegedly "double-counting" a portion of the Make-Whole, renders the default interest itself unenforceable as a penalty.

A. Standing Alone, the Make-Whole Is Enforceable.

The Debtors have never contended that, *standing alone*, the Make-Whole provision

[6] The parties chose New York law to govern their agreement, *see* MNPA § 22.7, and they agree that it controls.

would be unenforceable as a penalty. *See Reply in Support of Debtors' Objection to Asserted Make-Whole Entitlement, Default Rate Postpetition Interest, and Other Related Fees and Expenses Asserted under the OpCo Funded Debt Claims* [Dkt. No. 1414] at 8 ("The problem under New York law . . . is not the Make-Whole Amount itself, but that the Noteholders seek the Make-Whole Amount plus postpetition interest."). Their implicit concession was sensible, for there is no question that in New York, just as is in Texas, the provision *is* an enforceable liquidated damages measure. *JMD Holding Corp. v. Cong. Fin. Corp.*, 828 N.E.2d 604, 609 (N.Y. 2005) ("early termination" fee enforceable under New York law as a liquidated damages clause); *Katzenstein v. VIII SV5556 Lender, LLC (In re St. Vincent's Catholic Med. Ctrs. of N.Y.)*, 440 B.R. 587, 594 (Bankr. S.D.N.Y. 2010) (recognizing yield maintenance premiums as enforceable liquidated damages provisions under New York law); *Parker Plaza West Partners v. UNUM Pension & Ins. Co*., 941 F.2d 349, 356 (5th Cir. 1991) (prepayment provision valid as liquidated damages clause under Texas law).

In New York, and among courts construing and applying New York law, this point is broadly settled. *See United Merchs. & Mfgs.*, 674 F.2d at 143-44 (holding pre-payment charge was an enforceable claim for liquidated damages); *Walter E. Heller & Co. v. Am. Flyers Airline Corp.*, 459 F.2d 896, 900 (2d Cir. 1972) (holding liquidated damages amount in loan contract was reasonable); *Wilmington Sav. Soc'y FSB v. Cash Am. Int'l, Inc.*, 2016 WL 5092594, at *5 (S.D.N.Y. Sep. 19, 2016) (enforcing make-whole) (citing cases); *GMX* Tr. at 14:1-4 (upholding a make-whole provision as an enforceable liquidated damages clause under New York law); *In re School Specialty, Inc.*, 2013 WL 1838513, at *8 (Bankr. D. Del. Apr. 22, 2013) (finding prepayment provision construed as liquidated damages provision was not plainly disproportionate to a lender's loss); *In re Vanderveer Estates Holdings, Inc*., 283 B.R. 122, 130 (Bankr. E.D.N.Y. 2002) (upholding yield maintenance premium as enforceable claim for liquidated damages); *Fin. Ctr. Assocs. of E. Meadow, L.P. v. TNE Funding Corp. (In re Fin. Ctr. Assocs. of E. Meadow, L.P.)*, 140 B.R. 829, 836 (Bankr. E.D.N.Y. 1992) (enforcing prepayment charge as an enforceable liquidated damages provision). When determining the validity of a make-whole or liquidated damages clause, New York courts consider the reasonableness of the amount on the face of the clause without reference to other operative portions of the contract. *See Vanderveer*, 283 B.R. at 130-31, 134 (analyzing and upholding yield maintenance premium without reference to default interest clause, which also was enforceable).

The Make-Whole formula—which references the U.S. Treasury rate plus .50% ("T + 50")—has been approved as an appropriate liquidated damages clause by many courts applying New York law. *See id.* (upholding formula "based on prevailing Treasury Bond yield at or about the time of prepayment"); *School Specialty*, 2013 WL 1838513, at *1 (same); *Anchor Resolution Corp. v. State St. Bank & Tr. Co. of Am. (In re Anchor Resolution Corp.)*, 221 B.R. 330, 341 (Bankr. D. Del. 1998) (make-whole claim based on Treasury rate plus 0.50% upheld); *GMX* Tr. at 19:10-20:15 (same).

A make-whole provision need not merely estimate the impact of market interest fluctuations to be allowable. Courts consider other elements of the term lender's potential or consequential damages, including the cost and expense of securing a substitute borrower. *See United Merchs. & Mfrs.*, 674 F.2d at 142 (acknowledging cost and expense of procuring substitute borrower as one of many factors in determining reasonableness of liquidated damages); *Walter E. Heller & Co.*, 459 F.2d at 899 (holding that liquidated damages amount was reasonable in part because lender "was faced with the cost and expense of procuring substitute borrower or borrowers and the attendant delay in lending the sums to be lent to [original borrowers]") (internal quotation marks omitted); *Fin. Ctr. Assocs. of E. Meadow*, 140 B.R. at 836 (citing "the cost and expenses of procuring a substitute borrower and the attendant risk and delay[.]") (citation omitted).

In short, the Court raised questions about the intrinsic fairness of the Make-Whole formula, but the Debtors have never contended that the formula, standing alone, would be unenforceable, and courts have widely held that it *is* enforceable.

The formula accounts for the nature of the private placement market place. Interest rates on issued private placement notes vary as a function of two components—the yield on treasury securities of comparable maturity and the "spread" over that yield. The spread is a function (primarily) of the creditworthiness of the issuer and the maturity of the notes. Thus, in bidding for private placement notes, investors quote a spread over the applicable treasury rate. It is common for spreads on investment-grade senior notes to range from under 100 basis points (*i.e.*, one percentage point) to over 200 basis points. Usually the spread is less than 300 basis points, unless there is an unusual market situation, such as the aftermath of the financial crisis.

The Make-Whole Amount is calculated by reference to the applicable treasury rate at a point in time and a spread of 50 basis points ("T + 50"). In essence, as discussed in the hearing, this means that a lender receiving a make-whole amount and the related principal has to reinvest the sum of the two at T + 50 (or higher) in order to be "made whole." Among the lender's risks are that, contractual rights notwithstanding, time will elapse between the calculation of the make-whole amount and payment of the amounts due, and again between payment and then ultimate reinvestment. The longer that delay, the greater the lender's risk. Yields on treasury securities of comparable maturities may rise or fall over time. So too do spreads. The result is that the re-investment rate may be much lower (or higher) than it was when the make-whole amount was calculated.

It is not simply that the interest market-place is dynamic; the field for replacement lending is constrained.[7] No large, liquid market exists for private placement notes, as it does for public bonds. The universe of potential issuers for any institutional investor is constrained by:

(1) the number and type of issuers in the market issuing private placement (as opposed to public) notes at the time the investor must reinvest;

(2) reserve requirements imposed by the National Association of Insurance Commissioners for different types and risk categories of investments; and

(3) the investor's own criteria, including required covenant protections and deal structure, required minimum returns, geographic and industry concentration limitations and general risk tolerance.

[7] By way of example, in 2016 there were approximately 27,759 corporate and government public bond issuances. In contrast, in that same period, there were only approximately 1,218 private placement issuances. Thomson Reuters Eikon, https://www.thomsonreuters.com/en/products-services/financial/trading-platforms/thomson-reuters-eikon.html (last visited June 11, 2017) (search for all private issuances of bonds from January 1 to December 31, 2016).

Given these constraints, a lender cannot simply cover its loss by buying public bonds on a secondary market. It will be able to reinvest only in a new private issue, which may be difficult to find, and the lender will almost certainly be earning less than T + 50 on funds held in cash equivalents pending reinvestment. The Make-Whole Amount is fixed as of the acceleration date, but time will elapse between that date and a lender's receipt of funds, and again until reinvestment, and throughout that time, treasury rates may rise or fall and spreads come in. The 50-basis-point spread is a hedge against those risks—and a hedge to which the sophisticated parties agreed.

To illustrate, suppose that upon the issuance of 10-year private placement notes, the yield for a 10-year treasury security is 3.5%, and the spread for the issuer is 175 basis points. The coupon will be 5.25%. Suppose then that the notes are accelerated upon a default two years after issuance, at a time when the yield on an eight-year treasury security is 4%. To be made whole, the make-whole formula would require the lenders to instantly receive and reinvest the principal and the make-whole amount at 4.5%. If there is a delay of a year or more between the date of calculation of the make-whole amount and the date of payment, as in this case, rates and spreads may change. If treasury rates for a 7-year security are 3% when the investor finally is paid principal and make-whole amount, and if spreads have come in to 125 basis points for an issuer comparable to the (pre-default) issuer, the investor will not be made whole by re-investment at T + 50 (which would be 3.5%) or even by an investment in that comparable issuer, since that yield will be 4.25%, not the 4.5% that is needed.

All of these risks were assessed, negotiated, and liquidated by sophisticated parties. *AXA Inv. Managers v. Endeavor Capital Mgmt. LLC*, 890 F. Supp. 2d 373, 388 (S.D.N.Y. 2012) ("New York courts also give due consideration to whether the parties were sophisticated and represented by counsel, the contract was negotiated at arms-length between parties of equal bargaining power, and . . . that [the liquidated damages provision] was freely contracted to.") (internal quotation marks omitted); *see School Specialty, Inc.*, 2013 WL 1838513, at *3 ("New York courts have cautioned against interfering with parties' agreements."). There is no dispute that the Make-Whole provision resulted from full and fair negotiation by duly informed, represented, and sophisticated parties. *See Fin. Ctr. Assocs. of E. Meadow, L.P.*, 140 B.R. at 837 (where "the magnitude of the loan transaction and quality and quantity of the loan documents" is great, it "leave[s] little doubt that . . . we have an arms-length transaction between adequately represented sophisticated businessmen"). As the decisions above have shown, the bargain between the OpCo Noteholders and OpCo must be enforced.

B. The Obligation to Pay Default Interest Is Not Unenforceable as "Double-Counting."

The Debtor argues that the addition of default interest during the post-petition period creates a "double-counting," which generates a penalty. Thus the real "penalty" question is whether, given that the trigger for the Make-Whole obligation was an acceleration, rather than a pre-prepayment, the *addition* of the default interest is unenforceable as "double-counting?"

At least two bankruptcy courts—one of them sitting in Brooklyn—have expressly considered the issue and held that interest may be had on a make-whole amount even where such make-whole is calculated based on a discounted yield loss formula. *In re Kimbrell Realty/Jeth Court, LLC*, 483 B.R. 679, 692 (Bankr. C.D. Ill. 2012) ("Although the period of default interest partially overlaps with the discount period of the prepayment premium, that does not mean that the amounts are double compensation for the same loss."); *Vanderveer Estates*, 283 B.R. at 134 ("The debtor argues that [the lender] is not entitled to both default interest and a yield maintenance premium under [section] 506(b), because these are duplicative charges. This is not correct."). These decisions are correct. Non-bankruptcy courts applying New York law, including the Second Circuit, also have endorsed this reasoning. *See Chesapeake Energy Corp. v. Bank of New York Mellon Tr. Co., N.A.*, 837 F.3d 146, 152 (2d Cir. 2016) (affirming a district court decision which awarded damages based on a make-whole formula, with interest); *NML Capital v. Republic of Argentina*, 952 N.E.2d 482, 494 (N.Y. App. Ct. 2011) (answering certified question from Second Circuit by holding bondholders entitled to prejudgment interest on unpaid interest-only payments and rejecting contention that "imposition of prejudgment interest on the unpaid interest payments permit[ted] the bondholders to recover interest twice on the same principal").

As the parties challenging enforcement of a contract, the Debtors bore the burden to prove those courts wrong; specifically, to overcome the presumption that the liquidated damages clause is effective. *See Wechsler v. Hunt Health Sys., Ltd.*, 330 F. Supp. 2d 383, 413 (S.D.N.Y. 2004) ("The party challenging the liquidated damages provision bears the burden of proving that the provision constitutes a penalty."); *see also JMD Holding Corp.*, 828 N.E.2d at 609-10 (stating that "we have cautioned generally against interfering with parties' agreements" and citing cases for an emerging presumption in favor of finding liquidated damages clauses enforceable). The burden is significant: "[A] liquidated damages provision is not to be interfered with 'absent some persuasive justification.'" *GFI Brokers, LLC v. Santana*, 2009 WL 2482130, at *2 (S.D.N.Y. Aug. 13, 2009) (citation omitted). "Absent some element of fraud, exploitive overreaching or unconscionable conduct," the contract should be enforced. *JMD Holding Corp.*, 828 N.E. 2d at 609 (citation omitted).

To meet that burden, the Debtors have to show that the payment of default interest as well as the Make-Whole Amount makes the combination "conspicuously disproportionate." *Id.* The showing cannot be made here because the Make-Whole Amount and interest are different remedies that serve different purposes. The first is an agreed measure of damages. The second is a remedy for failure to pay principal, pre-petition interest and the Make-Whole Amount when due. As explained at the hearing, had the Debtors performed, the Class 4 creditors would have had, in hand, the Make-Whole Amount, the principal, and pre-petition interest, and would then—over a year ago—have sought to put that money to work through relending. The Debtors never explained how, if contractual default interest were disallowed, that loss would be compensated—as indeed it must be, in a solvent-debtor, unimpaired-class case. Because the Class 4 creditors did not have the principal, pre-petition interest, or the Make-Whole Amount in hand when due, default interest is required for each sum on the lapse of time between the petition date and its payment.

C. If, *Arguendo*, Default Interest "Double-Counted" a Portion of the Make-Whole Amount, Only Partial Disallowance of the Default Interest Would Be Justified.

Even if one ignores the above precedent and assumes, *arguendo*, that the default interest piece "double-counts" a component of the Make-Whole Amount, then the "double-counting" could *only* exist as to amounts of default interest that addressed the same time period and were calculated from the same underlying amounts. Said differently, there could *not* be double-counting of at least three components of the default interest amount. First, the overdue interest on principal and pre-petition interest in the amount of T + 50 would not be double-counting given that the Make-Whole formula discounts future payments at a factor of T + 50. Second, the default interest margin of 2% would be not double-counting because the Make-Whole Amount is not calculated using the default interest rate of the Note, but rather the base rate which does not include the 2% default margin.[8] Third, default interest on the full Make-Whole Amount would not constitute double-counting because the Debtors' delay in paying the Make-Whole when due is not part of the Make-Whole formula. To strike the *entire* amount of the default interest would eliminate the parties' bargained-for liquidation of relending damages and leave the OpCo Noteholders uncompensated for the separate harm of the Debtors' delayed payment.

There is authority in New York for such "blue penciling" of the default interest clause. For example, when faced with contractual provisions that are unduly burdensome, courts applying New York law will enforce them to the extent reasonable and necessary to protect the benefitted party from damage. *See Coolidge Co. v. Mokrynski*, 472 F. Supp. 459, 463 (S.D.N.Y. 1979) (holding that covenant not to compete "may reasonably be enforced to the extent necessary" after narrowing its unreasonable temporal scope). In addition, New York courts enjoy considerable discretion with respect to the determination of interest to be allowed on an award of damages. *See, e.g., Rhodes v. Davis*, 628 F. App'x 787, 793 (2d Cir. 2015) (remanding to dis-

[8] *See Disclosure Statement for Debtors' Second Amended Joint Chapter 11 Plan of Reorganization* [Dkt. No. 1106] at 33 (listing various rates).

trict court applying New York Law "to determine, in the exercise of its discretion, whether to award prejudgment interest and if so at what rate").

This discretion empowers the Court to alter the amount of the default interest if any portion of it represents impermissible double-counting that amounts to a penalty. Default interest at a rate of T + 50 and the 2% the default margin is reasonable and necessary to compensate the OpCo Noteholders for the Debtors' delay in paying the principal and unpaid pre-petition interest, a separate and distinct harm and amount from the Make-Whole. Additionally, allowing the default interest at the full rate on the overdue Make-Whole is reasonable and necessary to compensate the OpCo Noteholders for the Debtors' delay in paying the Make-Whole Amount. If the Court rejects the precedent discussed in sections III.A and III.B, *supra*, then the logic of double-counting would at most justify the disallowance of the default interest amount which allegedly could be duplicative, and *not* of (1) default interest on overdue principal and pre-petition interest at the rate of T + 50; (2) default interest at the 2% default margin on overdue principal and pre-petition interest; and (3) the full default interest on the overdue Make-Whole Amount itself.[9]

D. Should the Court Find the Entirety of the Default Interest Clause Unenforceable for Double-Counting, the MNPA Dictates that the Default Interest Clause Be Severed, Leaving Intact the Make-Whole.

If the Court rejects the precedent discussed in Sections III.A and III.B above and finds that the default interest clause gives rise to a penalty by double-counting, and also declines to exercise its discretion to modify the amount of default interest due as set out in III.C above, then the remedy is not to disallow both the Make-Whole and the default interest, but rather to follow the severability clause in the MNPA to disallow only the default interest and leave the Make-Whole intact. As unwarranted as the OpCo Noteholders believe this result would be, the MNPA

[9] Should the Court resolve the case as described in this Section, the OpCo Noteholders believe that there can be no dispute on the mathematics of the remaining portions of default interest due because the parties' earlier briefing shows that the Debtors agree on the calculated amounts that are at issue in this case. *Memorandum in Support of Debtors' Objection to Asserted Make-Whole Entitlement, Default Rate Post-Petition Interest, and Other Related Fees and Expenses Asserted Under the OpCo Funded Debt Claims* [Dkt. No. 1215] at 4-5; OpCo Noteholder Claims Response at 4-6. If, however, the Debtors dispute the OpCo Noteholders' calculations, then the parties should be allowed to submit additional briefing on these issues.

provides that any portion of the agreement that is adjudicated unenforceable may be severed without affecting the enforceability of the rest of the agreement. *See* MNPA § 22.4.

Courts sever unenforceable contractual provisions while enforcing the rest of the contract, especially when the unenforceable provision is for a form of remedy. *See Beletsis v. Credit Suisse First Bos. Corp.*, 2002 WL 2031610, at *6 (S.D.N.Y. Sept. 4, 2002) ("Even assuming that the attorney fee clause is unlawful, it can easily be severed allowing the rest of the EDR Policy to remain in full force and effect."); *Kidder, Peabody & Co., Inc. v. IAG Int'l Acceptance Grp. N.V.*, 28 F. Supp. 2d 126, 139 (S.D.N.Y. 1998) (subsequent affirmances omitted) ("When a contract contains both lawful and unlawful objectives, New York courts often enforce legal components of an agreement where the 'illegal aspects are incidental to the legal aspects and are not the main objective of the agreement.'") (quoting *Artache v. Goldin*, 519 N.Y.S.2d 702, 705 (N.Y. App. Div. 2d Dep't 1987)); 15 Grace McLane Giesel, *Corbin on Contracts* § 89.10 at 659 (2003) ("Modern courts continue to view [remedial] provisions, to the extent they are unenforceable, as easily separable from the rest of the contract so that the troublesome provision is excised and the remaining contract stands fully enforceable.").

This rule applies in the context of liquidated damages clauses. Where a defendant argues that an otherwise valid liquidated damages provision is transformed into an unenforceable penalty by an agreement's inclusion of other, duplicative remedies, "the appropriate response is to invalidate the impermissible provisions, not to artificially deem the liquidated damages clause a 'penalty.'" *See CIT Grp./Equip. Financing, Inc. v. Shapiro*, 2013 WL 1285269, at *7 n.5 (S.D.N.Y. Mar. 29, 2013); *see also Sun v. Mercedes Benz Credit Corp.*, 562 S.E.2d 714, 719 (Ga. App. 2002) (severing section of liquidated damages clause requiring payment of one extra month's lease payment in addition to all future lease payments while enforcing balance of the clause).

To sum up, no "double-counting" theory is powerful enough to overcome New York's strong presumption that the contract terms should be enforced. Default interest is fair compensation for a solvent debtor's failure to pay sums when those sums were due. But if the Court disagrees with settled law and holds that the entire amount of default interest constitutes an unenforceable penalty, then the parties' agreement in the MNPA that such a provision must be severed from the rest should be enforced, leaving the Make-Whole in place.

IV. SECTION 726(A)(5)

The OpCo Noteholders have shown that 11 U.S.C. § 726(a)(5) does not apply to the treatment of unimpaired creditors under a confirmed plan in a chapter 11 case. *See* Sections I & II, *supra*. To their earlier briefing on this point, they add a few observations about the text of the statute.

If section 726(a)(5) had any bearing on this case, it would not import the rate calculated under 28 U.S.C. § 1961. Congress might have specified the "federal judgment rate," or cross-referenced section 1961 itself, had that been its intent. But Congress intended, and therefore wrote, something very different. By using the phrase, "at the legal rate," Congress intended to import, for each of the four subsections of section 726(a) that precedes subsection (a)(5), the interest rate that the law would apply to a particular claim under one of those sections.

A few examples will illustrate. Section 726(a) governs a chapter 7 trustee's distribution of estate property. It contains a waterfall of priorities. The first, in subsection (a)(1), comprises claims payable under 11 U.S.C. § 507—*i.e.*, priority claims. Among priority claims are allowed claims for domestic support obligations, *see id.* § 507(a)(1), and claims for unpaid federal income taxes. *See id.* § 507(a)(8). The second priority in the waterfall, subsection (a)(2), is for timely-filed general unsecured claims.

A different "legal rate" of interest applies to *each* of these types of claim. Most states prescribe interest rates for overdue support obligations. *See, e.g.*, Tex. Fin. Code Ann. § 304.002. Congress enacted a special interest rate for unpaid federal income taxes. 26 U.S.C. § 6621. In many states, including Texas, the law prescribes different interest rates for general unsecured claims arising under tort and contract theories. *Compare* Tex. Fin. Code Ann. § 304.002 (18% interest rate payable on contract claims), *with* Tex. Fin. Code Ann. § 304.103 *and* Tex. Fin.

Code Ann. § 304.003(c)(2)-(3) (5% or 15% rates payable on tort claims depending on prime rates as published by Board of Governors). In short, applicable state and federal law prescribes various rates for the different kinds of unsecured claims to which the first four subsections of section 726(a) refer.

Section 726(a)(5) calls, in the fifth priority, for the distribution of estate property in respect of interest "on any claim paid under paragraph (1), (2), (3), or (4)" at "the legal rate." It is hard to conceive of statutory words that would more plainly have directed the Court to whatever rate applicable law confers on each different claim. The cross reference is not to "all of the foregoing," nor even to "claims." It is to each singular "claim." The "legal rate" thus applies separately to each specific "claim," and will, as shown, depend on what that claim was. Here, where New York law governs, the operative interest rate is the rate supplied by contract. *NYCTL 1998–2 Tr. v. Wagner*, 876 N.Y.S.2d 522, 523 (N.Y. App. Div. 2009) ("[W]hen a contract provides for interest to be paid at a specified rate until the principal is paid, the contract rate of interest, rather than the legal rate . . . governs until payment of the principal or until the contract is merged in a judgment.") (citation and internal quotation marks omitted); *see, e.g.*, *NML Capital*, 952 N.E.2d at 491 ("The parties to a loan agreement . . . may, for example, agree that if principal is not repaid on the maturity date, a default rate of interest will apply thereafter.").

A ruling that section 726(a)(5) means the federal judgment rate, and applies to the chapter 11 case of a solvent debtor, would lead to strange results. Suppose solvent debtor Smith does not pay his federal income taxes when due. During the life of his chapter 11 case, the default interest on Smith's unpaid tax liability to the government would accrue, according to the Debtors, only at the federal judgment rate, and not at the specific rate prescribed by Congress for Smith's default. So too would the solvent deadbeat dad and the tortfeasor find safe harbors from Texas law, for so long as he could seek cover in bankruptcy court.

The federal judgment rate is an odd measure to contemplate in any event. It applies to "any money judgment in a civil case recovered in a district court." 28 U.S.C. § 1961. The commencement of a Title 11 case is precisely opposite to the entry of a judgment. On the filing of the case, a creditor is stayed; it can take no action to enforce his claim. The judgment creditor can go immediately to a sheriff and enforce.

In short, *In re Schoeneberg* had it right. *See* 156 B.R. 963, 972 (Bankr. W.D. Tex. 1993) (adopting contract rate). Should this Court have any occasion to consider "the legal rate" for any claim under Class 4, that rate is set by contract.

CONCLUSION

The Make-Whole Amount should be allowed. Default interest should be allowed and calculated to accrue on each of the principal and the Make-Whole Amount, in each case running from the petition date to the date of payment.

Respectfully submitted,

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