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# Economic Outlook

## The Times Have Changed

***By Patrick J. O'Keefe***

**WHAT'S INSIDE**

FEATURE ARTICLE

# Treatment of Make Whole Provisions in Chapter 11 Cases

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Recent chapter 11 cases have spawned several disputes over the allowance of claims arising from make-whole provisions in credit agreements. In some instances, the stakes have been high. Enforceability of these provisions results in enhanced recoveries for noteholders and lenders at the expense of other creditors. While recent opinions teach us that the specific language of the underlying agreements determines the outcome of these disputes, the opinions also provide a helpful outline of issues that will determine enforceability.

## Make Whole Provisions

Unless the loan documents provide otherwise, in many jurisdictions a commercial lender has the right to refuse a borrower's early repayment of its loan. *See e g Arthur v Burkich*, 520 N.Y.S. 2d 638 (N.Y. App. Div. 1987) (applying the so-called "perfect tender in time" rule). In the loan documents, a lender may waive this right, so long as the borrower's repayment includes a make whole premium. The make whole premium, a form of prepayment penalty, is designed to compensate the lender for the lost opportunity to earn the interest that would have accrued during the full term of the loan. During a period of low interest rates, make whole premiums are important to lenders who might otherwise suffer damages representing the difference between interest payments under the loan documents and the lower market rate of interest at the time of the prepayment.

## Enforceability Under State Law

The determination of the allowance of a claim for a make whole premium first requires an inquiry into whether the make whole provision may be enforced under state law. Courts have characterized make whole premiums as prepayment penalties and have looked to state law relating to the latter to identify the criteria to determine enforceability. *See In re School Specialty, Inc., et al* 2013 WL 1838513 (Bankr. D. Del. April 22, 2013)(*citing United Merchs. & Mfrs. v. Equitable Life Assurance Soc'y of the U.S. (In re United Merchs. & Mfrs.* , 674 F.2d 134, 141 (2d Cir. 1982)(looking to New York law to determine whether a liquidated damages clause was unenforceable as a penalty)). In *School Specialty*, for example, the court applied the traditional criteria to determine enforceability under state law: (1) whether, at the time of the agreement, actual damages were difficult to determine; and (2) whether the amount of the make whole premium is "plainly disproportionate" to the lender's actual damages. *Id.* at *2 (citations omitted).

## Enforceability Under the Bankruptcy Code

A review of state law does not end the inquiry. 11 U.S.C. § 502(b)(3) provides that a bankruptcy court shall not allow a claim for "unmatured interest" presents a potential hurdle to recovery. Further, while 11 U.S.C. § 506(b) provides that an oversecured creditor may have an allowed claim for "interest," that claim may include "fees, costs, or charges" only to the extent that they are "reasonable." *Id.*

## *The School Specialty* Decision

In *School Specialty*, the court entered an interim debtor in possession financing order (the "Interim DIP Order") under which the debtors stipulated that they were indebted to their lender, Bayside Finance LLC ("Bayside") in the aggregate principal amount of $95,024,001.06. This principal amount included an "Early Payment Fee" (*i e* , a make whole premium) of about $24 million. An official committee of unsecured creditors filed a motion seeking disallowance of the make whole premium.

Bayside's loan had an initial maturity date of October 31, 2014 (the "Initial Maturity Date"). However, if the debtors were able to refinance certain debentures, the maturity date would be extended to December 31, 2015 (the "Conditional Maturity Date"). In January 2013, the debtors and Bayside entered into a forbearance agreement under which debtors acknowledged a covenant default, acceleration of the loan and liability for the make whole premium. The premium was calculated by discounting future interest payments through the Conditional maturity date and the date on which the loan balance was accelerated.

With regard to the state law analysis, the committee focused on the second prong under New York law (*i e* , whether the amount of the make whole premium was "plainly disproportionate"). The committee argued that, to the extent that the premium was calculated based upon the Conditional Maturity date, and not the initial maturity date, Bayside was receiving a "grossly disproportionate" premium based upon a calculation that ignored "market place" formulas.

The court rejected the committee's arguments. The court found that: (1) the premium was calculated to provide to Bayside its "bargained for yield"; and (2) the premium was the product of "arms-length negotiations between sophisticated parties." Under New York law, these findings led to the conclusion that the premium was not disproportionate. Notably, the court rejected the argument that the premium should be calculated based on the Initial Maturity Date rather than the Conditional Maturity Date,

finding however unlikely a refinancing and an extension of the maturity date might be, at the time of the loan, Bayside was still obligated to keep funds available until the Conditional Maturity Date and was justified in using that date to calculate the premium.

Noting, but not deciding, the issue of whether Section 506(b)(6)'s reasonableness requirement applies to amounts calculated prepetition (*i e*, as in the context to the debtor's prepetition forbearance agreement with Bayside), the court determined that, in any event, the premium was not "plainly disproportionate" and was therefore reasonable.

Finally, the court determined whether Bayside's claim for the make whole premium should be disallowed under Section 502(b)(3) as a claim for unmatured interest. In *In re Trico Marine Servs Inc*, 450 B.R. 474 (Bankr. D. Del. 2011), Judge Shannon had adopted the majority view that that prepayment charges do not represent unmatured interest because they become fully mature, by contract, prior to the maturity date of the underlying loan. Judge Carey adopted this holding.

## The Momentive Performance Materials Decision

In contrast to *School Specialty*, the parties in *In re MPM Silicones LLC*, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014) ("Momentive"), disputed whether a make whole premium was due under the terms of the loan documents. The dispute arose in the context of plan confirmation. The indenture trustees for holders of approximately $1.1 billion in First Lien Notes and of $250 million in so-called 1.5 Lien Notes objected to the debtors' plan, which did not provide for payment of make whole premiums under the indentures. Payment of the premium would increase distributions to the noteholders in an amount exceeding $200 million.

Judge Drain noted the general application of the "perfect tender in time" rule under New York law and the exception to that rule where a lender agrees that a borrower may prepay a loan under certain conditions, including the condition that the borrower pay a make whole premium. Under New York law, however, a lender forfeits its rights to such a premium where the lender accelerates the payment of the debt, unless (1) the borrower purposefully defaults to trigger acceleration; or (2) the agreement expressly provides for payment of the premium upon the lender's acceleration. *Id.* at *13.

In *Momentive*, the agreements provided for acceleration upon the borrowers filing for bankruptcy. However, the agreements did not expressly provide for payment of a make whole premium in the event of such an acceleration. Although the noteholders had bargained for prepayment upon a bankruptcy filing, they had failed to obtain an obligation to include in the prepayment a make whole premium. *Id.* Stated differently, upon acceleration, the notes became fully mature. Prepayment can only occur prior to maturity and the loan documents did not provide otherwise.

Judge Gerber, in *In re Chemtura Corp*, 439 B.R. 561 (Bankr. S.D.N.Y. 2010), had earlier reviewed the enforceabilty of a make whole premium in the context of approving a settlement embodied in a plan of reorganization pursuant to Fed. R. Bankr. P. 9019. The plan provided for payment to certain noteholders, which included a portion of a make whole premium. In *Chemtura*, the court noted that the documents provided for a make whole premium in the event that the debt was prepaid prior to the "maturity date." The maturity date was June 1, 2016. The language of the documents supported the noteholders, whom Judge Gerber characterized as having the better argument as to enforceability.

In *Momentive*, the noteholders urged Judge Drain to follow Judge Gerber. However, Judge Drain declined to do so, noting that the award of a make whole premium rises or falls on the language of the underlying agreements. "[U]nless the parties have *clearly and specifically* provided for payment of a make-whole . . . notwithstanding the acceleration or advancement of the original maturity of the notes, a make-whole will not be owed." *Id.* at *14, (*citing U.S. Bank National Association v. Southside House*, 2012 U.S. Dist. LEXIS 10824, at *2 (E.D.N.Y. January 30, 2012)) (emphasis added).

The noteholders identified other language in the indenture providing for "prepayment premiums" in the event of certain defaults. However, Judge Drain found that these references were vague and ambiguous and fell far short of the "clear and specific" standard set forth in the *Southside House* decision.

Finally, the noteholders argued that they were entitled to a claim for damages arising from the debtors' breach of the "perfect tender in time" rule. Judge Drain, however, characterized such damages as "unmatured interest" which are disallowed under 11 U.S.C. § 503(b)(2).

## Conclusion

It would be superficial to conclude that the District of Delaware is friendly to make whole premiums while the Southern District of New York is hostile. As *School Specialty* and *Momentive* demonstrate, the enforceability of make whole provisions initially depends initially on the wording of the underlying agreements. In *School Specialty*, the parties did not dispute that the make whole provision had been triggered. The court, however, had to decide whether the provision was enforceable under state law and the bankruptcy code. In *Momentive*, by contrast, the agreements were not "clear and specific." Therefore, no make-whole obligation was triggered. The court only looked at the bankruptcy code in considering breach of contract as an alternate theory of recovery.

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