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A COLLECTION OF COMMENTARIES ON THE CRITICAL LEGAL ISSUES IN THE YEAR AHEAD

Enforcement of Make-Whole Provisions in Bankruptcy: The Importance of Careful Drafting

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Indentures typically contain provisions that offer protection to bondholders and borrowers in the event of early repayment of or, in some instances, default on the loan. This includes make-whole provisions, which traditionally have compensated bondholders for the loss of future interest payments in situations where, because of declining market interest rates, the borrower voluntarily prepays its debt obligations. Make-whole provisions therefore can be best understood as lender-side protections that allow for prepayment in exchange for a sum to compensate the lender for the loss of its bargained-for investment yield. Without such protections, bondholders would suffer damages to their investment yield if forced to reinvest the prepaid funds.

While bondholders have relied on make-whole provisions in voluntary redemption contexts for years, their right to recover their investment in default situations has been the cause of frequent litigation. As borrowers seek Chapter 11 protection to refinance their debt at lower interest rates, bondholders have faced serious obstacles to recovering their make-whole payments. Similarly, borrowers have found themselves on the losing end in litigation, as courts have ordered them to execute the make-whole provisions in their loan agreements. Three 2013 decisions have reinforced the importance of clear contractual language that protects bondholders and borrowers should Chapter 11 cast a shadow over the trust indenture.

Voluntary Redemption Versus Acceleration of Debt

Indentures often draw a distinction between a borrower's voluntary early redemption and acceleration of principal because of a borrower's default, either by a missed payment or automatically upon the borrower's filing of a bankruptcy petition. In the latter case, a make-whole premium may not be due if the default operates to accelerate the maturity date for the entire amount of the debt because the bondholders are forcing early repayment (as opposed to the borrower electing early repayment prior to the maturity date).

However, the issue becomes less clear where, after acceleration caused by a bankruptcy default, the borrower elects to repay the loan early to refinance its debt at lower interest rates. In these circumstances, bondholders and borrowers have fought intensely over the scope of the make-whole protection. In earlier litigation involving the US Airways, Solutia and Calpine reorganizations, the courts held that automatic acceleration of debt under a bankruptcy provision, also known as an *ipso facto* clause, negates any right to a make-whole premium because, absent clear contractual language to the contrary, automatic acceleration would result in the acceleration of the maturity date, and any repayment that follows would necessarily occur after the maturity date.

The 2013 cases — *School Specialty*, *GMX Resources* and *AMR Corp.* (in connection with American Airlines) — have taken the issue a step further, stressing that the key to whether bondholders may recover their bargained-for make-whole premium is whether the contractual language in the governing agreements clearly provides for payment of the make-whole premiums upon acceleration — even an automatic acceleration under Chapter 11 — or only in the event of a voluntary early redemption.

Clear Contractual Language

Specific Provisions. In *School Specialty* and *GMX Resources*, the bankruptcy courts found that the governing agreements specifically provided for payment of the make-whole premium, even in the event of a bankruptcy default and acceleration. In both cases, the governing agreements provided for a make-whole premium if the loan was prepaid or accelerated before the stated maturity dates.[1] In contrast, in *AMR*, the U.S. Court of Appeals for the Second Circuit affirmed the bankruptcy court's finding that the clear contractual language of the relevant indentures provided that the voluntary bankruptcy filing acted to automatically accelerate the debt to maturity.[2] The relevant indentures expressly stated that no make-whole payment was due upon automatic acceleration.[3]

Rejected Arguments. In each of these cases, the courts also rejected attempts by the challenging parties to overcome the clear and unambiguous terms of the governing agreements.

In both *School Specialty* and *GMX Resources*, the courts found that the make-whole provisions provided for liquidated damages that were enforceable as a matter of state law, and rejected the arguments that the make-whole payments were "unmatured interest,"[4] for which claims are not allowed under the U.S. Bankruptcy Code. In both *School Specialty* and *GMX Resources*, the objecting parties also argued that the make-whole amount was a penalty or plainly disproportionate to the claimants' loss and, accordingly, the make-whole provisions were not enforceable under state law and therefore not allowed under the Bankruptcy Code. The courts in both cases rejected the arguments that the make-whole amounts were penalties.[5] Additionally, in both cases the courts dismissed the argument that the make-whole payment was not reasonable under Section 506(b) of the Bankruptcy Code, which only allows a secured creditor to recover, in addition to the amount of its secured claim, "reasonable" fees, costs and charges provided for under the governing agreement or applicable state law.[6] Indeed, the *School Specialty* court found that because the make-whole payment was not a penalty, it did not need to pass muster under the "reasonableness" test.[7]

In *AMR*, the Second Circuit dismissed the indenture trustee's various policy and statutory arguments. First, the Second Circuit rejected the trustee's arguments that only the indenture trustee could trigger acceleration and affirmed the bankruptcy court's conclusion that any attempt by the indenture trustee to waive the event of default and decelerate the debt, if indeed the contract provided for such a remedy, would be a violation of the automatic stay (from which they were not entitled to relief).[8] (In bankruptcy, the automatic stay protects the debtor from the collection efforts and potential "race to the courthouse" of its creditors, which could result in the loss of going

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[1] *See* Transcript of Proceedings at 26, 31, *In re GMX Resources Inc.*, No. 13-11456 (Bankr. W.D. Okla. Aug. 27, 2013); *In re Sch. Specialty Inc.*, No. 13-10125 (KJC) 2013 WL 1838513, at *1 and *6 (Bankr. D. Del. April 22, 2013).

[2] *In re AMR Corp.*, 730 F.3d 88, 99 (2d Cir. 2013).

[3] *Id.*

[4] *See* Transcript of Proceedings at 26, *In re GMX Resources Inc.; In re Sch. Specialty Inc.*, 2013 WL 1838513, at *1 and *6.

[5] *See* Transcript of Proceedings at 18-21, *In re GMX Resources Inc.; In re Sch. Specialty Inc.*, 2013 WL 1838513, at *3-5.

[6] *See* Transcript of Proceedings at 29, *In re GMX Resources Inc.; In re Sch. Specialty Inc.*, 2013 WL 1838513, at *4.

[7] *In re Sch. Specialty Inc.*, 2013 WL 1838513, at *4.

[8] *In re AMR Corp.*, 730 F.3d 88 at 100-01, 102.

concern value of the debtor's estate.) Second, the Second Circuit rejected the trustees' attempt to characterize repayment as "voluntary" under the governing agreement; under the provisions of the agreement, a "voluntary" prepayment would require the payment of the make-whole amount.[9] Although American Airlines sought to refinance its obligations at more favorable rates, it only did so after its obligations had been automatically accelerated to maturity. Finally, the Second Circuit held that *ipso facto* clauses are not invalid *per se*, as the prohibition of *ipso facto* clauses under the Bankruptcy Code applies to executory contracts — contracts under which performance by both sides remains outstanding — and the contract at issue in this case was not executory.[10]

Implications

These decisions serve as an important reminder regarding the drafting of clear and unambiguous terms. Moreover, these decisions highlight the contractual language parties may want to use in future indentures to either avoid or ensure imposition of a make-whole payment.

Borrowers that expect to avoid make-whole payments upon the voluntary filing of a bankruptcy petition may seek clear contractual language providing that no make-whole premium is due if the obligations are repaid following a voluntary bankruptcy filing irrespective of an acceleration under an *ipso facto* clause.

> "Indenture parties no longer can rely solely on statutory and policy arguments to determine whether a make-whole payment is due."

On the other hand, bondholders that seek to protect themselves against voluntary debt refinancings in Chapter 11, particularly in a declining interest rate environment, may seek clear contractual language requiring payment of a make-whole premium, even after an event of default that operates to automatically accelerate the debt.

Regardless of the path bondholders and borrowers choose, the *School Specialty*, *GMX Resources* and *AMR* cases have sent a message: All indenture parties no longer can rely solely on statutory and policy arguments to determine whether a make-whole payment is due, but should carefully draft these provisions to specify the situations in which lenders are entitled to their bargained-for investment yield in the form of a make-whole payment.

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[9] *Id.* at 103.

[10] *Id.* at 106. In *AMR*, the indenture trustee also argued that Section 1110 of the Bankruptcy Code mandated payment of the make-whole amount. Section 1110 maintains the automatic stay as against a party with a security interest in aircraft equipment, if the aircraft lessee agrees to perform "all obligations" under the governing agreement. American elected to perform under the governing agreement in order to continue using and operating the aircraft that secured the bondholders' debt. The Second Circuit rejected the indenture trustee's argument, finding that Section 1110 only required American to cure nonbankruptcy defaults. *Id.* at 110-111.