Recent Developments in the Enforceability of Make-Whole Premiums in the Second Circuit

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In March 2019, Judge Stuart M. Bernstein of the U.S. Bankruptcy Court for the Southern District of New York ruled that lenders using clear and unambiguous language in their loan agreements may be entitled to prepayment premiums that they would have otherwise forfeited in a borrower's bankruptcy. In *In re 1141 Realty Owner LLC*, Judge Bernstein acknowledged the general rule set forth in the U.S. Court of Appeals for the Second Circuit's decisions in *In re AMR Corp.* and *In re MPM Silicones, L.L.C.* (*Momentive*) that when a lender accelerates a loan following a debtor's default, the lender forfeits the right to a prepayment premium because the acceleration advances the maturity date, and therefore the debt cannot be prepaid. However, the court enforced the mortgage lender's claim for a prepayment premium despite its pre-petition acceleration of the loan, ruling that parties can, and in this case did, contract around this general rule by requiring payment of the make-whole premium in connection with any post-default payment.

The *1141 Realty* decision provides guidance for debtors and lenders on the enforceability of prepayment premiums if the borrower files for bankruptcy protection in the Second Circuit.

Make-Whole Premiums and the Legal Landscape in the Second Circuit

Debt instruments often include provisions providing for prepayment premiums, also known as make-whole premiums, yield-maintenance premiums or redemption premiums. These types of provisions are designed to compensate the lender for its anticipated interest-rate yield if the borrower elects to repay its debt in advance of the maturity date. Put simply, the provisions protect the lender's expected return on its investment. Although prepayment premiums are generally enforceable outside bankruptcy, courts have reached conflicting decisions on their enforceability in Chapter 11.

In 2013, in *AMR*, the Second Circuit relied on the express language of the indentures in holding that the debtor's voluntary bankruptcy filing triggered a default which automatically accelerated the notes but did not require payment of the make-whole amount. Following the bankruptcy filing, the debtors sought to repay certain pre-petition notes excluding the make-whole amount. The indentures defined a voluntary bankruptcy filing as an event of default and, in such event, provided for the automatic acceleration of the unpaid principal amount of the notes, including interest and other amounts due, but excluding the make-whole amount. In an attempt to refute the plain language of the indentures, the noteholders argued that (1) the trustee never elected to accelerate the debt, (2) even if acceleration took place, the lender could rescind acceleration, which would require payment of the make-whole amount in connection with the debtor's proposed refinancing, and (3) regardless of whether the debt was accelerated upon the bankruptcy filing, the debtor's proposed refinancing was a voluntary redemption requiring payment of the make-whole amount.

The Second Circuit rejected each of the lender's arguments, holding that payment of the make-whole was not required because the indentures provided for the automatic acceleration of the notes excluding the make-whole amount upon the debtor's voluntary bankruptcy filing. Importantly, the Second Circuit found that the automatic acceleration of AMR's debt changed the maturity date from some point in the future to the date of the debtor's default (*i.e.*, the date of the bankruptcy filing). Therefore, AMR's attempt to repay the debt following the bankruptcy filing was not a voluntary prepayment but rather a post-maturity payment that did not trigger the make-whole amount.

The Second Circuit revisited the enforceability of make-whole premiums in its 2017 decision in *Momentive*. The indentures governing Momentive's senior-lien notes contained optional redemption clauses providing for the payment of a make-whole

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premium if Momentive were to redeem the notes at its option prior to October 15, 2015, which was five years prior to the maturity date. When Momentive issued replacement notes under its Chapter 11 plan in October 2014, the senior-lien noteholders argued that they were entitled to payment of the make-whole premium because Momentive had redeemed the notes at its option prior to October 15, 2015. Similar to *AMR*, the indentures in *Momentive* provided for the automatic acceleration of the notes upon a bankruptcy filing. Relying on its prior holding in *AMR*, the Second Circuit held that any payment on the accelerated notes following the bankruptcy filing was a post-maturity payment, not a redemption. The Second Circuit also noted that, even assuming Momentive's issuance of the replacement notes was a redemption, the make-whole was only payable upon optional prepayment of the debt and would not have been at Momentive's option as required to trigger the make-whole premium, because the repayment obligation arose automatically from the acceleration provisions in the indenture.[1] Nevertheless, the court left open whether a properly drafted make-whole provision would be enforceable in bankruptcy.

1141 Realty Decision

1141 Realty Owner LLC owns the Flatiron Hotel in New York City. In 2015, 1141 Realty borrowed $25 million secured by a mortgage on the hotel property. In 2017, 1141 Realty defaulted under the loan by failing to maintain a valid liquor license. The lender declared a default and elected to accelerate the debt pre-petition. 1141 Realty subsequently filed for bankruptcy, and the lender filed a claim for approximately $32 million, including approximately $3.1 million allocated to a yield-maintenance premium, *i.e.*, a make-whole premium. Relying on the Second Circuit's decisions in *AMR* and *Momentive*, 1141 Realty argued that the yield-maintenance premium was unenforceable as a matter of New York law because the lender had accelerated the debt.

The loan agreement in 1141 Realty provided that any payment made after an event of default "shall be deemed a voluntary prepayment" that violated the loan agreement's prohibition against prepayments, triggering payment of the yield-maintenance premium. The yield-maintenance provision did not mention acceleration of the debt.

Judge Bernstein acknowledged the general rule in the Second Circuit that a lender that accelerates a loan following a default forfeits the right to a prepayment premium because the acceleration advances the maturity date, and therefore, the loan cannot be prepaid. However, Judge Bernstein noted that there are two exceptions to this general rule. First, if a clear and unambiguous provision requires payment of the prepayment premium even after the default and acceleration, the provision will be analyzed as a liquidated damages provision. Second, if the borrower intentionally defaults in order to accelerate the debt and evade payment of the prepayment premium, the prepayment premium will be enforced.

Judge Bernstein found that the parties in 1141 Realty had contracted around the general rule by providing that any payment following an event of default would trigger payment of the yield-maintenance premium. Judge Bernstein distinguished the Second Circuit's decisions in *AMR* and *Momentive* based on differences in the relevant loan agreements in those cases: (1) in *AMR*, the relevant provision explicitly stated that no make-whole premium was due in the event of an automatic acceleration, and (2) in *Momentive*, the relevant provision required payment of the make-whole premium in the event of an optional redemption, which the Second Circuit concluded had not occurred because the acceleration of the debt upon the bankruptcy filing made payment mandatory and not optional. Notably, Judge Bernstein rejected the debtors' arguments that (1) a lender forfeits a prepayment premium as a matter of law by accelerating the debt, and (2) a make-whole provision must expressly require payment of the premium after acceleration. Rather, Judge Bernstein found that the "parties can provide for their rights with any language that plainly conveys their intent."

Takeaways

The *1141 Realty* decision provides guidance on the enforceability of make-whole premiums in the Second Circuit. Under Judge Bernstein's ruling, a make-whole provision is more likely to be enforced if the underlying debt documents explicitly provide that the premium is payable even after acceleration or, alternatively, render acceleration irrelevant, and as the parties did in *1141 Realty*, require payment of the premium in connection with any post-default payment.

However, there are important distinctions between AMR and Momentive, on the one hand, and *1141 Realty*, on the other, which may limit the reach of Judge Bernstein's decision. First, the lender in *1141 Realty* had accelerated the debt pre-petition, whereas in *AMR* and *Momentive* the debt was automatically accelerated upon the debtor's bankruptcy filing. Second, in *1141 Realty*, the make-whole provision was payable in connection with any post-default payment, therefore rendering acceleration irrelevant. In contrast, in *AMR* and *Momentive*, the automatic acceleration of the debt upon the debtor's bankruptcy filing was key to the analysis of the make-whole provision.

[1] By contrast, in *In re Energy Future Holdings Corp.*, the U.S. Court of Appeals for the Third Circuit held that the debtor's noteholders were entitled to an optional redemption premium, *i.e.*, a make-whole, when the debtor chose to refinance its notes in bankruptcy, notwithstanding the automatic acceleration of the notes upon the debtor's bankruptcy filing.