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Problems in the Code

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Enforceability of Make-Whole Premiums in Chapter 11

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In recent years, the enforceability of "make-whole" premiums in bankruptcy has been heavily litigated because of the value that is often at stake and the ambiguity governing the enforceability of such provisions in chapter 11. The varied rulings on this issue could influence a debtor's decision on where to file for chapter 11 protection, or a distressed investor's lending decision. The variations among case decisions can be resolved by making simple changes to the Bankruptcy Code.

Background

A "make-whole" premium is a loan provision to compensate a lender if a borrower repays the debt before maturity for the loss of the lender's anticipated yield, also called "yield maintenance," "redemption" and "prepayment" premiums. If a loan is made at 5 percent interest and rates fall, the borrower might be able to refinance more cheaply, and the repaid lender will lose yield for the remainder of the loan term. For a large-bond issue, the amounts involved could be substantial. To calculate the premium, future cash flows are generally discounted using a present-value calculation based on Treasury bond yields.[2]

Unless the debt instrument provides otherwise, a debt may only be repaid at maturity (the "perfect tender in time" rule), which protects the lender's right to the income stream for which it bargained. Make-whole premiums thus modify this rule.[3] While make-whole premiums are generally enforceable under applicable state law outside of bankruptcy, courts have rendered conflicting decisions on their enforceability in chapter 11.

Second Circuit Focuses on Contractual Language

Many of the leading cases on the enforceability of make-whole provisions in chapter 11 proceedings have come from courts in the Second Circuit. In particular, the 2013 decision in *AMR* and subsequent cases upholding it have emphasized the importance of carefully drafting loan documents, and concluded that in the absence of clear and unambiguous language to the contrary, a make-whole premium is only payable prior to maturity, and therefore not payable following a default and acceleration that advances the maturity date to the date of the bankruptcy filing.

AMR

In *In re AMR Corp.*, the Second Circuit considered whether a make-whole premium was enforceable in chapter 11 proceedings. In the bankruptcy court, American Airlines (AMR) had sought and obtained post-petition financing, and it received court approval to use that financing to pay off existing secured debt. The pre-petition lender argued that it was also owed the make-whole amount. Critically, the indenture provided that no make-whole premium would be payable as a consequence of, or in connection with, an event of default (including a bankruptcy filing) or an acceleration. Further, acceleration was automatic upon certain events of default, including a bankruptcy filing.[4]

Although the pre-petition lender advanced various arguments, they all failed in the face of the indenture's plain language. For example, the lender proposed waiving the default and decelerating the debt, but the court concluded that this would violate the automatic stay. The lender also argued that the acceleration clauses were unenforceable *ipso facto* clauses. However, the court explained that while *ipso facto*

1 This work represents the views of the authors, and the statements made herein are not those of their firm or its clients.
2 *See, e.g., In re AMR Corp.*, 730 F.3d 88, 94 (2d Cir. 2013).
3 *In re 1141 Realty Owner LLC*, 598 B.R. 534, 540-41 (Bankr. S.D.N.Y. 2019).
4 730 F.3d at 92-95.

clauses are in many situations unenforceable under the Bankruptcy Code, they are not categorically prohibited. In this case, the indentures were not executory contracts and therefore did not implicate the Code's prohibition against *ipso facto* clauses. Finally, although the indenture provided that voluntary (but not mandatory) redemptions required a make-whole payment, the court concluded that repayment of the debt was not a voluntary prepayment for purposes of the indenture; rather, it was a post-maturity payment, following acceleration.[5]

Momentive

In 2017, the Second Circuit revisited make-whole payments in *In re MPM Silicones LLC* (*Momentive*). The indentures governing Momentive's senior-lien notes contained optional redemption clauses, providing for the payment of a make-whole premium if Momentive were to redeem the notes at its option prior to October 2015. In October 2014, pursuant to its reorganization plan, Momentive issued replacement notes to its senior-lien noteholders, who argued that they were entitled to payment of the make-whole amount.[6]

The court concluded that under the indentures, the make-whole was due only in the case of an optional redemption, not following an acceleration due to bankruptcy. Following *AMR*, the court concluded that the replacement notes were not an optional redemption prior to maturity. Rather, automatic acceleration reset the maturity date upon the bankruptcy filing, meaning that there was no prepayment and that redemption was not optional. The court refused to distinguish between "prepayment" and "redemption," noting that redemption refers to repayment at or before maturity.[7]

1141 Realty

In 2019, the U.S. Bankruptcy Court for the Southern District of New York in *In re 1141 Realty Owner LLC* upheld a make-whole provision, albeit under facts easily distinguishable from *AMR* and *Momentive*.[8] When the debtor, the owner of New York's Flatiron Hotel, defaulted on its mortgage loan, the trustee for the commercial mortgage-backed securities accelerated the debt and demanded immediate repayment. The loan agreement provided that if, following an event of default, payment of all or any part of the debt is tendered by the borrower or otherwise recovered by the lender, such tender or recovery shall be deemed a voluntary prepayment and the borrower shall pay the yield-maintenance default premium (*i.e.*, the "make-whole").[9]

The court observed that, per *AMR*, generally a lender that accelerates a loan following a default forfeits a prepayment premium because acceleration advances the maturity date, making the loan unable to be prepaid. However, the court explained that courts recognize two exceptions: (1) if a contract clause clearly and unambiguously requires a prepayment premium even after default and acceleration, the clause will be analyzed as a liquidated damages clause; and (2) if the borrower intentionally defaults to trigger acceleration and evades the prepayment premium, the lender can enforce the prepayment premium. The court found the contract to be clear and unambiguous, therefore it analyzed the prepayment premium as a liquidated-damages amount. Ultimately, the court concluded that the premium was enforceable because actual damages were difficult to determine, and the amount of the premium was not plainly disproportionate to the possible loss.[10]

Third Circuit Also Looks to Contractual Language, but Distinguishes Between Prepayment and Redemption

Like courts in the Second Circuit, the Third Circuit in *In re Energy Future Holdings Corp.* (*EFH*) emphasized the importance of interpreting a contract, including a make-whole provision, in accordance with the parties' intent. However, its analysis otherwise differed from that used by courts in the Second Circuit. The Third Circuit considered what happens when an indenture accelerates debt upon bankruptcy. If a debtor then opts to redeem the debt, does the redemption premium fall away? The *EFH* court concluded that the premium does not.[11]

Prebankruptcy, an affiliate of EFH had issued secured notes. The indentures provided that the borrower could, at its option, redeem the notes prior to certain fixed dates if it paid a make-whole premium. As with the aforementioned cases, the indentures provided for automatic acceleration upon the filing of bankruptcy. The borrower sought to refinance the notes at lower interest rates, first filing for bankruptcy in order to avoid paying the premium. After filing, the indenture trustees filed adversary proceedings in opposition, seeking payment of the premium.[12]

For purposes of its analysis, the circuit court asked three questions: (1) Did a redemption occur; (2) was it optional; and (3) if "yes" to both, did the optional redemption occur before the fixed dates mentioned above?[13] The circuit court distinguished *AMR* on the facts and concluded that, although *Black's Law Dictionary* defines "redemption" as usually referring to repurchase before maturity,[14] and acceleration advances maturity, New York case law interprets redemption to include both pre- and post-maturity repayments of debt. Thus, the Third Circuit disagreed with the *Momentive* bankruptcy court (a decision that was later affirmed by the Second Circuit).[15]

The court then evaluated whether the repayment was optional. Looking at the facts, the court found that the chapter 11 filing was voluntary, as was the debtor's plan for repaying rather than reinstating the debt. Furthermore, the repayment clearly occurred during the period for which the redemption premium applied. The court concluded that the make-whole premium was payable.[16]

Fifth Circuit Raises Additional Concerns

In 2019, the Fifth Circuit contributed to the debate over make-whole enforcement with its decision in *In re Ultra*

5 *Id.* at 95-96, 98-100, 102-03, 105-07. An *ipso facto* ("by the fact itself") clause is a contract clause that specifies the consequences of a party's bankruptcy. *Black's Law Dictionary* 992 (11th ed. 2019); *accord*, 730 F.3d at 91 n.1, 105-06. Under § 365, *ipso facto* clauses are generally unenforceable for executory contracts, which are generally defined as contracts on which performance on both sides remains due to some extent. *Id.*

6 874 F.3d 787, 801-02 (2d Cir. 2017).

7 *Id.* at 802-04; *accord*, *Black's Law Dictionary* 1530.

8 598 B.R. at 537, 543 (Bernstein, J.).

9 *Id.* at 537-39.

10 *Id.* at 541-42.

11 842 F.3d 247, 250-51, 254 (3d Cir. 2016); *accord*, 874 F.3d at 795.

12 842 F.3d at 251-52.

13 *Id.* at 254.

14 *Black's Law Dictionary* 1390 (9th ed. 2009).

15 842 F.3d at 254-58; *cf.*, 874 F.3d at 803 (declining to follow *EFH*).

16 842 F.3d at 255-56, 261.

Petroleum Corp.,[17] the facts of which were atypical. The debtors filed for bankruptcy, then over the course of the proceedings became solvent due to a rise in crude oil prices. The debtors proposed a reorganization plan that purported to pay unsecured noteholders in full but excluded a make-whole payment. The noteholders objected, arguing that exclusion of the make-whole payment rendered them impaired.[18]

The circuit court focused on § 502(b)(2) of the Bankruptcy Code and remanded the case to the bankruptcy court to evaluate whether the make-whole premium constituted "unmatured interest" disallowed by § 502(b)(2). If so, the Code itself, not the reorganization plan, would prohibit a make-whole payment. The circuit court also remanded to the bankruptcy court to consider whether a "solvent-debtor exception" applied that would countermand § 502(b)(2).[19] The solvent-debtor exception is a pre-Code principle, and whether it survived enactment of the Code is disputable.[20] If enforceable, the principle might entitle creditors of a solvent debtor to all amounts owed under their contracts.[21]

On remand, Hon. **Marvin Isgur** determined that the Code requires a solvent debtor to pay a make-whole and post-petition interest before distributing value to shareholders.[22] He distinguished a make-whole payment from unmatured interest disallowed by § 502(b)(2), as the former is liquidated damages and the latter is compensation over time for borrowing money. He also concluded that the solvent-debtor exception had not been "silently" repealed by the Code's adoption. Because of the solvent-debtor exception, in addition to payment of the make-whole, unsecured creditors were entitled to post-petition interest at their contractual default rates (not at the federal judgment rate).[23] The reorganized debtors appealed Judge Isgur's opinion and judgment, and the appeal is currently pending in the Fifth Circuit.

Key Takeaways

While it remains to be seen how *Ultra Petroleum* will ultimately be resolved, it seems to be on track to generate two significant appellate decisions that could influence other courts for years to come. In the meantime, we can make a few generalizations about the court opinions discussed herein.

Judges analyzing make-whole provisions always consider carefully the specific language of the debt documents and seek to uphold the original agreement made by the parties. Accordingly, careful drafting is paramount. For example, if drafters want a make-whole premium to be payable in any scenario, they should consider including language that explicitly provides that the premium is payable as part of any repurchase, or in any case that the debt has become due, prior to the original maturity date, including upon any event of default (including bankruptcy), whether or not constituting a prepayment and whether or not the debt has been accelerated.

If contract language is not explicit, courts in the Second Circuit generally have found that prepayment premiums that are conditioned on prepayment are not payable if a loan has accelerated and therefore is being *repaid* but not *prepaid*. In contrast, the Third Circuit has concluded that "redemption" but not "prepayment" premiums generally are left intact by default and acceleration. Key issues remain unsettled in the Fifth Circuit, but we can expect a determination as to whether make-whole amounts are either impermissible "unmatured interest" or unenforceable liquidated damages. For now, Judge Isgur has found neither to be the case.

Also, parties should choose governing law consciously. All of the cases discussed herein appeared in federal court and considered New York state contract law, but a different choice of laws could lead to different results.

Possible Statutory or Judicial Clarification

Presently a split exists between the Second and Third Circuits over whether "redemption" is distinct from "prepayment."[24] In addition, it is unsettled whether make-whole payments are unmatured interest prohibited by § 502(b)(2).[25] Congress or the U.S. Supreme Court could resolve the latter issue. For example, Congress could amend § 502(b)(2) to say, depending on the preferred policy, that "the court ... shall allow such claim ... except to the extent that ... such claim is for unmatured interest, *which shall (or shall not) include any make-whole, yield maintenance, redemption, prepayment, or similar premium*."[26]

In addition, in cases where a creditor is oversecured, § 506(b) provides that an oversecured creditor is entitled to interest and reasonable fees, costs and charges provided by contract or by state law. Depending on how it revises § 502(b)(2), Congress could also amend § 506(b) to clarify that "any reasonable fees, costs, or charges *(including (or excluding) any reasonable make-whole, yield maintenance, redemption, prepayment, or similar premium)*" are allowable. abi

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17 The court initially rendered judgment in January 2019, 913 F.3d 533 (5th Cir. 2019), but upon a petition for rehearing, the original opinion was withdrawn and a new one substituted in November 2019, 943 F.3d 758 (5th Cir. 2019).

18 *Id.* at 760-62.

19 *Id.* at 761-66.

20 Under the solvent-debtor exception, "creditors may recover post-petition interest when the debtor turns out to be solvent," as opposed to the "age-old rule in bankruptcy, adopted from the English system ... that interest on claims stops accruing when the bankruptcy petition is filed." *In re Fesco Plastics Corp.*, 996 F.2d 152, 155 (7th Cir. 1993) (citing *United States v. Ron Pair Enters. Inc.*, 489 U.S. 235, 246 (1989)). In *Ron Pair*, the Supreme Court acknowledged this "pre-Code rule" but left ambiguous whether the replacement of the Bankruptcy Act by the Bankruptcy Code in 1978 had done away with it. 489 U.S. at 246. In *Ultra Petroleum*, the debtors argued that the exception no longer existed, and the circuit court remanded to the bankruptcy court to consider the argument. 943 F.3d at 765-66.

21 *Id.* at 761-66.

22 Amended Memorandum Opinion, No. 16-32202 (Bankr. S.D. Tex. Oct. 27, 2020), ECF No. 1874 (correcting typographic errors), amending Memorandum Opinion, No. 16-32202, 2020 WL 6276712 (Bankr. S.D. Tex. Oct. 26, 2020), ECF. No. 1872.

23 Amended Memorandum Opinion, No. 16-32202, *slip op.* at 27 n.3 (Bankr. S.D. Tex. Oct. 27, 2020), ECF No. 1874 ("Because the Make-Whole Amount is allowed under § 502 of the Bankruptcy Code, the Court does not decide whether the solvent-debtor exception also permits recovery of the Make-Whole Amount.").

24 This is fundamentally a dispute over New York state law and could be resolved by the state legislature amending the New York Debtor and Creditor Law. Alternatively, a federal circuit court or the Supreme Court could certify a state law question to the New York Court of Appeals. N.Y. Comp. Codes R. & Regs. tit. 22, § 500.27.

25 Rather than unmatured interest, some courts have analyzed make-wholes as liquidated damages. *Compare* 943 F.3d at 762 *with* 598 B.R. at 541-42. However, the two approaches are not necessarily mutually exclusive. *Compare In re Doctors Hosp. of Hyde Park Inc.*, 508 B.R. 697, 705-06 (Bankr. N.D. Ill. 2014) (holding that make-whole was both liquidated damages clause and unmatured interest), *with In re Ultra Petroleum Corp.*, Amended Memorandum Opinion, No. 16-32202, *slip op.* at 9-10, 22-23 (Bankr. S.D. Tex. Oct. 27, 2020), ECF No. 1874 (disagreeing with *Doctors Hospital* and holding that make-whole at issue was liquidated damages and not unmatured interest). Even if make-wholes are "damages" rather than "interest" for purposes of state law, clarification would be helpful from either Congress or the Supreme Court on whether the payments are disallowed "unmatured interest" for purposes of § 502(b)(2). *Accord, id., slip op.* at 8-9 ("[I]t is the Bankruptcy Code, not New York law, [that] determines the scope of amounts disallowed as unmatured interest. However, because the Bankruptcy Code leaves unmatured interest undefined ... reference to state law is appropriate.").

26 The new language is italicized.