Westlaw Today
powered by Reuters

Recent Delaware bankruptcy rulings address whether a plan of reorganization can deny a 'make-whole' payment without impairing lenders' claims

By Ron E. Meisler, Esq., Carl T. Tullson, Esq., Jennifer Madden, Esq., and Justin Larsen, Esq., Skadden, Arps, Slate, Meagher & Flom LLP*

FEBRUARY 8, 2022

Takeaways

- "Make-wholes" — one-off payments required if debt is prepaid or, in certain cases, otherwise accelerated — have generated litigation, with debtors contending they can continue to pay lenders under the debt's original terms without the lenders' consent and without paying the make-whole.
- Lenders often resist attempts by debtors to reinstate debt without payment of the "make-whole," arguing their claims are "impaired" for purposes of the debtor's reorganization plan if they do not receive the payment.
- In one case, a Delaware bankruptcy court recently sided with a debtor, citing Bankruptcy Code sections that allow reinstatement despite acceleration clauses and prohibit penalties for filing bankruptcy.
- In another Delaware bankruptcy case, claims for make-whole premiums survived the debtors' motion to dismiss based on the specific redemption language of the governing debt documents.
- Drafting make-whole provisions carefully to avoid uncertain outcomes is increasingly critical.

A recent bankruptcy ruling may have material implications for the enforceability of make-whole premiums in Chapter 11 cases.

In *In re Mallinckrodt plc*, the U.S. Bankruptcy Court for the District of Delaware held on November 5, 2021, that the debtors did not have to pay a "make-whole" premium in order to reinstate secured first-lien claims as unimpaired under a plan of reorganization.

This ruling is the latest development in the rapidly evolving case law of make-wholes — lump-sum payments called for in some loan agreements that are triggered when debt is prepaid, or a borrower goes into bankruptcy (which results in acceleration of the debt claim). The decision may have lasting implications for creditor recoveries, debtors' plans of reorganization and negotiations of debt documents.

Mallinckrodt files, then offers to pay noteholders everything except the make-whole

Mallinckrodt Pharmaceuticals has faced enterprise-threatening litigation, including a dispute with the Centers for Medicare and Medicaid Services and over 3,000 lawsuits related to the production and sale of opioids. To date, the company has spent over $100 million defending these lawsuits. Its cash reserves faced additional pressure in April 2020 when approximately $495 million in unsecured notes came due.

"Make-wholes" ... have generated litigation, with debtors contending they can continue to pay lenders under the debt's original terms without the lenders' consent and without paying the make-whole.

To manage its cash flow, Mallinckrodt, through two affiliates, arranged a private debt exchange that month, issuing more than $495 million in new notes with higher yields and longer maturities, secured by a first lien on substantially all of the company's assets. The new notes paid 10% and matured in 2025. They included a make-whole provision, referred to in the governing indentures as the "Applicable Premium."

The indenture provided that Mallinckrodt pay the noteholders the "Applicable Premium" in the event that the notes were accelerated, which would occur if the company voluntarily filed for bankruptcy prior to April 15, 2022. On October 12, 2020, Mallinckrodt and its affiliates filed a petition for Chapter 11 protection.

On September 29, 2021, the debtors proposed a reorganization plan that would reinstate the first-lien notes but not pay the make-whole. The noteholders would continue to receive payments at the original rate, with the same maturity and security.

In short, the debtors intended to pay as though they had never filed for bankruptcy. The debtors maintained that the noteholders could not vote against the plan, because the proposed treatment left them unimpaired by the plan.

Does nonpayment of a make-whole constitute impairment?

The Bankruptcy Code sets out conditions that must be met before a reorganization plan may treat a claim as unimpaired. In particular, the Code requires that (a) subject to a few exceptions, the debtor cures any default giving rise to accelerated payment, and (b) the plan does not otherwise alter the legal, equitable or contractual rights of the creditor. Among the defaults that do not need to be cured are those triggered by the debtor filing for bankruptcy.

Drafting make-whole provisions carefully to avoid uncertain outcomes is increasingly critical.

Mallinckrodt argued that the noteholders could be treated as unimpaired under its reorganization plan because (a) under the Bankruptcy Code, the make-whole did not need to be cured given that it was triggered only by the company's petition for Chapter 11, and (b) the plan did not otherwise alter the legal, equitable or contractual rights of the noteholders, who would have "the same claims, against the same companies, with the same priority position, and the same terms."

An ad hoc group of first-lien noteholders disagreed. They objected to the proposed plan, arguing that they could not be treated as unimpaired without payment of the make-whole. They maintained that the statute only applied to the curing of defaults that have accelerated a debt. Because neither the make-whole provision nor the debtors' failure to pay it accelerated a debt, the cited statute was irrelevant, the noteholders contended.

Additionally, the noteholders argued that their legal and contractual rights were altered by the debtors' plan because, once Mallinckrodt filed for bankruptcy, they obtained an unavoidable contractual right to the make-whole payment. In other words, once the debtors entered Chapter 11, they owed a new charge under the governing contract: the premium, which on the first-lien notes amounted to approximately $94 million.

On November 5, 2021, the Bankruptcy Court overruled the creditor group's objection, holding that payment of interest and principal pursuant to the original indenture — but not of the make-whole — was sufficient to treat the noteholders as unimpaired.

First, the court noted that the Bankruptcy Code permits a debtor to reinstate an obligation even if there is a contractual provision requiring an acceleration of any claim or interest after a default. The court went on to disagree with the noteholders' characterization of the make-whole as a "new charge." Instead, it found that it amounted to an acceleration of a claim and was precisely the type of provision that the Bankruptcy Code permitted a debtor to de-accelerate.

Moreover, because the Debtors proposed to fully meet the original terms of the notes, the make-whole amounted to a bankruptcy penalty, the court found. But reinstatement allows a debtor to "roll back the clock to the time before the default existed," the court explained. In this case, that meant prior to Mallinckrodt filing for bankruptcy. Because the make-whole was only triggered by the filing, reinstatement meant that Mallinckrodt did not owe the make-whole.

Outcomes have varied in make-whole disputes

Mallinckrodt is not the only case to take up the enforceability of make-whole clauses, but outcomes have differed with the circumstances and varying loan agreement terms.

In 2016, the borrowers in *In re Energy Future Holdings Corp.* argued that they could refinance secured debt without triggering a make-whole under an "optional redemption" provision in the governing documents. They contended that payment of a debt after maturity is not a "redemption," and the maturity date had been accelerated upon the debtors' bankruptcy.

The U.S. Court of Appeals for the Third Circuit disagreed, siding with the lenders. The Third Circuit reasoned that a redemption may occur before or after a note's maturity, and it held that the redemption was "voluntary" because the debtors redeemed the notes over the noteholders' objections. Because the refinancing was an "optional redemption," the Third Circuit concluded that the indenture required the debtors to pay the make-whole.

In In re Mallinckrodt plc *… the debtors did not have to pay a "make-whole" premium in order to reinstate secured first-lien claims as unimpaired under a plan of reorganization.*

However, in a 2017 case involving similar facts and arguments, *In re MPM Silicones LLC* (*Momentive*), the U.S. Court of Appeals for the Second Circuit held that the make-whole was not payable. The court reasoned that payment on a debt that is automatically accelerated due to the debtor's bankruptcy filing is not an "optional redemption," because "redemption" refers to payments made prior to maturity, and this one was made after (the automatic acceleration clause changed the maturity date to the petition date). The Second Circuit went on to explain that even if this payment were a redemption, it was not "optional" because operation of the automatic acceleration clause made it mandatory.

On December 22, 2021, the U.S. Bankruptcy Court for the District of Delaware issued another ruling regarding the enforceability of make-whole provisions. The court, in *In re Hertz Corp.*, granted in part the debtors' motion to dismiss a complaint filed on behalf of holders of two series of senior unsecured notes for recovery of allegedly due make-whole premiums.[1]

Under the previously confirmed plan, the debtors would pay all of the principal owed on the series of notes but would not account for any make-whole payments. As in *Mallinckrodt*, the *Hertz* plan denied the payment of make-wholes while treating the claims as unimpaired.

However, a key distinction between the *Mallinckrodt* plan and the *Hertz* plan is that the noteholders in *Hertz* would receive payment of the principal in full, in cash on the plan's effective date as opposed to *Mallinckrodt*'s plan, which reinstated the debt. The noteholders in each case challenged such treatment, arguing that their claims could not be treated as unimpaired without payment of the make-whole.

In determining whether to dismiss the noteholders' make-whole claim, the court focused on the specific redemption language in each of the governing debt documents. The relevant provision for one group of notes provided for a make-whole if the debtors redeemed the notes "prior to maturity" (a date accelerated to the petition date upon a filing for bankruptcy), whereas the provision for another set of notes stated that a make-whole would be due if the debtors redeemed the notes "[a]t any time prior to [the specified date]."

Moreover, for purposes of the make-whole provisions, the debtors' plan to pay the noteholders in cash, rather than reinstate the debt, constituted a voluntary redemption of the notes.

The court dismissed claims regarding the former notes but not the latter. Regarding the former notes, the court agreed with the debtors' argument that use of the undefined term "maturity" in the make-whole provision must refer to the common meaning of maturity because the indentures used a defined term, "Stated Maturity," to reference the original due date.

Accordingly, although the notes were redeemed prior to the original maturity date, they were nevertheless not redeemed "prior to maturity," because the maturity date had been accelerated by the debtors' Chapter 11 petition, the court explained. As for the other group of notes, the court denied the debtors' motion to dismiss because under the express terms of the redemption provision, the noteholders had stated a plausible claim that the make-whole was triggered by a redemption "prior to [the specified date]," a date that was not modified upon the debtors' bankruptcy filing.

A case now pending in the U.S. Court of Appeals for the Fifth Circuit, *In re Ultra Petroleum Corp.*, could provide further guidance as to the enforceability of make-whole premiums in the context of unsecured debt. The *Ultra* debtors proposed a reorganization that purports to leave all unsecured claims unimpaired.

Under the plan, noteholders would receive a payment in cash for all allowed claims, from which the debtors excluded any make-whole. Some unsecured creditors contend that their claims were impaired because the debtors did not pay a make-whole triggered by the bankruptcy filing. Oral arguments were heard on October 4, 2021.

Conclusion

The decisions in *Mallinckrodt* and *Hertz* exemplify the importance of careful drafting of make-whole provisions, and companies in bankruptcy or weighing a filing should consider whether and how to reinstate or otherwise treat claims involving these terms to ensure they are properly classified as "unimpaired" under a reorganization plan.

Notes

[1] The noteholders' claim for postpetition interest and the court's analysis of the "solvent debtor exception" are beyond the scope of this article but will likely be the focus of a follow-up article after the Fifth Circuit rules in *Ultra*. The court's discussion regarding the payment of postpetition interest (and the distinction between code impairment and plan impairment) so as to render the claims unimpaired is also beyond the scope of this article.

About the authors




(L-R) **Ron E. Meisler** is a corporate restructuring partner in **Skadden, Arps, Slate, Meagher & Flom LLP**'s Chicago office. He represents companies experiencing financial difficulties, purchasers of and investors in distressed companies, and lenders to and creditors of troubled companies and creditors' committees in connection with all stages of complex restructurings throughout the U.S., Europe, Asia and South America. **Carl T. Tullson** is a corporate restructuring partner in the Wilmington, Delaware, office. He represents clients in complex debt restructurings, troubled company mergers and acquisitions, and financing transactions. **Jennifer Madden** is a corporate restructuring associate in the Palo Alto, California, office. **Justin Larsen** is a corporate restructuring law clerk in the Wilmington office. This article was originally published Jan. 19, 2022, on the firm's website. Republished with permission.

This article was published on Westlaw Today on February 8, 2022.