

Caution: Make-Whole Provisions Are Taken At Face Value

Law360, New York (November 14, 2013, 6:29 PM ET) -- Two recent decisions have shown that courts will rely heavily on the plain meaning of contract language when considering the enforceability of make-whole provisions.

On Sept. 12, 2013, the United States Court of Appeals for the Second Circuit's decision in the American Airlines bankruptcy case held that, under the language of the loan indenture at issue, secured noteholders did not have the right to collect a make-whole premium in connection with the post-petition refinancing of their debt where the borrower's voluntary petition for bankruptcy automatically accelerated the debt and the indenture provided that the make-whole amount was payable in connection with a prepayment but not following acceleration.

In contrast, the April 22, 2013, School Specialty decision by the United States Bankruptcy Court for the District of Delaware upheld a 37 percent make-whole premium where the loan documents explicitly provided that the premium would be due following acceleration of the debt.

The decisions, each of which interpreted make-whole provisions in loan documents governed by New York law, underscore the importance of carefully drafting credit documents and explicitly providing for the payment of make-whole premiums upon acceleration, particularly given that many bankruptcy courts will look for reasons not to enforce such provisions in order to augment the assets available for other creditors.

In many loan agreements and indentures, the borrower is allowed to repay or refinance its outstanding debt prior to maturity only if the borrower pays a certain amount to compensate the lender or noteholder for the loss of future interest payments. Such amounts are generally referred to as make-whole premiums or prepayment fees.

In bond deals, make-whole premiums often are calculated based on the future stream of interest payments between the date on which the principal is prepaid and the maturity date. Such premiums are structured to protect the noteholder's right to receive the yield that it bargained for at the time that it made the investment. In contrast, standard loan agreements often provide for a prepayment fee that is calculated based on a percentage of the amount being prepaid, with this percentage being reduced over time. Such fees typically do not approximate the loss to the lender as a result of the prepayment.

In general, make-whole provisions are enforceable outside of bankruptcy. In bankruptcy, however, the enforceability of such provisions is less certain. Some courts have characterized make-whole premiums as unmatured interest (i.e., interest that was not earned as of the petition date) that cannot be

recovered under Section 502(b)(2) of the Bankruptcy Code. Most courts, however, have found make-whole provisions enforceable if:

- The premium has been triggered under the terms of the contract;
- The make-whole provision is a valid liquidated damages provision under state law; and
- The premium satisfies the reasonableness standard under Section 506(b) of the Bankruptcy Code.

The American Airlines and the School Specialty cases, in particular, show that bankruptcy courts will uphold make-whole provisions that are valid under state law, but only if it is clear under the terms of the contract that such provisions have been triggered.

The American Airlines Case

In the underlying case, the debtors sought to obtain post-petition secured financing that would be used, in part, to repay certain existing prepetition notes secured by aircraft. The debtors had filed for bankruptcy protection on Nov. 29, 2011, at which point approximately \$206 million of principal remained outstanding under the indenture. American's bankruptcy filing automatically triggered the default provisions under the indenture. During the case, American made regularly scheduled payments of principal and interest due under the indenture pursuant to Section 1110(a) of the Bankruptcy Code, which allowed it to maintain the use of the aircraft.

The indenture, which was governed by New York law, provided that a make-whole payment would be due in the event of a voluntary prepayment of the notes but not in the event of a mandatory prepayment of the notes. The indenture further provided that "[n]o Make-Whole Amount shall be payable on the [notes] as a consequence of or in connection with an Event of Default or the acceleration of the [notes]."

The indenture also called for automatic acceleration of the notes upon the debtors filing a voluntary petition for bankruptcy, providing that "then and in every such case the unpaid principal amount of the [notes] then outstanding, together with accrued but unpaid interest thereon and all other amounts due thereunder (but for the avoidance of doubt, without Make-Whole Amount), shall immediately and without further act become due and payable ..."

In connection with their motion to obtain post-petition financing, the debtors requested authorization to use the new financing to repay the indebtedness owed to the prepetition noteholder without payment of the make-whole amount. The noteholder filed objections to the debtors' motion, arguing, among other things, that:

- The debtors were "voluntarily" redeeming the notes with the post-petition financing, and therefore the make-whole amount was due under the terms of the indenture;
- If the debt was accelerated as a result of the bankruptcy default, the noteholder should be allowed to waive the default; and

- Filing for bankruptcy did not automatically accelerate the debt and any clauses that so dictated were unenforceable ipso facto clauses.

The bankruptcy court overruled the noteholder's objections, and the noteholder appealed directly to the Second Circuit.

On appeal, the Second Circuit agreed with the bankruptcy court that the debtors' voluntary petition for bankruptcy triggered the automatic acceleration of the debt and that, under the terms of the indenture, no make-whole payment was due. In reaching its decision, the Second Circuit relied on the plain meaning of the indenture.

The Second Circuit rejected the noteholder's argument that the debtors were voluntarily redeeming the notes with the proceeds of the post-petition financing, finding that the debtors' proposed payment was a post-maturity date repayment of the automatically accelerated debt, rather than a prepayment, and that a make-whole payment was not due in such circumstances under the terms of the indenture.

The Second Circuit also rejected the noteholder's argument that the noteholder could waive or rescind the event of default. In particular, the Second Circuit agreed with the bankruptcy court that any attempt to rescind the event of default would be an attempt to modify the contractual right of the estate to repay its accelerated debt without the make-whole amount. As such, the noteholder's attempt to rescind the event of default was subject to the automatic stay.

The Second Circuit also rejected the noteholder's argument that the default and automatic acceleration provisions in the indenture were unenforceable ipso facto provisions. Because the indenture was not an executory contract — i.e., a contract on which performance remains due to some extent on both sides — the Second Circuit ruled that the provisions of Section 365(e)(1) of the Bankruptcy Code, which provide that ipso facto clauses in executory contracts are unenforceable, were not applicable.

The School Specialty Case

On May 22, 2012, School Specialty Inc. and certain of its affiliates entered into a credit agreement providing for a term loan in the aggregate principal amount of \$70 million. The credit agreement, which was governed by New York law, provided that the borrowers would be required to pay an early payment fee upon either prepayment or acceleration of the term loan prior to the maturity date (which could be extended if certain conditions were met).

The amount of the early payment fee changed depending on when the early payment occurred. For example, if the debt was prepaid or accelerated within the first 18 months of the original closing, a make-whole payment would be due in an amount equal to the discounted future stream of interest payments between the date on which the principal was prepaid or accelerated and Dec. 15, 2015 (i.e., the extended maturity date of the term loan).

Approximately eight months after entering into the term loan, the borrowers defaulted on their debt. The borrowers subsequently entered into a forbearance agreement with the lender which provided for the acceleration of the term loan, making all outstanding principal, interest and the make-whole payment due and payable. Subsequently, on Jan. 28, 2013, School Specialty Inc. and certain of its affiliates filed for bankruptcy protection under Chapter 11 of the Bankruptcy Code with the United States Bankruptcy Court for the District of Delaware.

Shortly after the commencement of the bankruptcy case, the bankruptcy court approved the debtor-in-possession financing requested by the debtors in their first-day motions. Pursuant to the interim DIP financing order entered by the bankruptcy court, the debtors stipulated that they were liable to the lender under the credit agreement for an aggregate principal amount of approximately \$95 million, including a \$23.7 million make-whole payment. The creditors' committee filed a motion to disallow the make-whole payment, arguing, among other things, that the make-whole payment:

- Was disproportionate to the lender's probable loss;
- Was unreasonable in light of the requirements of a secured claim under § 506(b) of the Bankruptcy Code; and
- Constituted a claim for unmatured interest which should be disallowed under § 502(b)(2) of the Bankruptcy Code.

The court rejected each of the claims of the creditors' committee in turn, thereby enforcing the language in the credit agreement which expressly provided for the payment of the make-whole premium following the acceleration of the debt.

In its analysis, the court concluded that the make-whole payment was not disproportionate to the lenders' probable loss because, *inter alia*, it was based on a calculation of the lender's targeted return to its investors, i.e., its "bargained-for yield," and the credit agreement was the result of an arms-length transaction.

The court also concluded, in part based on its finding of enforceability under New York law, that the make-whole payment satisfied the reasonableness standard set forth in Section 506(b) of the Bankruptcy Code. Lastly, the court rejected the creditors' claim that the payment constituted unmatured interest under § 502(b)(2), opting to follow the majority of cases that concluded a make-whole payment was "akin to a claim for liquidated damages."

The Implications of American Airlines and School Specialty

The decisions in *American Airlines* and *School Specialty* affirm that, when considering the enforceability of make-whole provisions in contracts governed by New York law, courts will rely heavily on the plain meaning of the language in the contract. Careful drafting of such provisions is of the utmost importance.

Secured creditors should carefully review their financing agreements to make sure these agreements explicitly provide that the make-whole premium will be due upon acceleration, including the acceleration of the debt due to a bankruptcy filing, in order to make sure that they get the benefit for which they bargained. In addition, secured creditors should ensure that, unlike in *American Airlines*, there are no exceptions to the payment of the make-whole amount. Such measures will make it more likely that a bankruptcy court will subsequently enforce the make-whole provision over the objection of the unsecured creditors committee or a subordinated creditor.

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