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Make-Whole Provisions Continue to Cause Controversy

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Editor's Note: The following post comes to us from Michael Friedman, Partner in the Banking Group and in the Litigation, Bankruptcy and Restructuring Group at Chapman and Cutler LLP, and is based on a Chapman publication by Mr. Friedman and Craig M. Price.

Given today's low interest rate environment, the enforceability of make-whole provisions has been the subject of intense litigation as debtors seek to redeem and refinance debt entered into during periods of higher interest rates, and investors seek to maintain their contractual rates of return. This trend has come to the forefront most recently in two separate cases, one filed in Delaware and the other in New York. In *Energy Future Holdings*, the first-lien and second-lien indenture trustees have each initiated separate adversary proceedings in Delaware bankruptcy court claiming the power company's plan to redeem and refinance its outstanding debt entitles the respective holders to hundreds of millions of dollars in make-whole payments.[1] Conversely, In *MPM Silicones, LLC*, it is the debtors that have sought a declaratory judgment from the New York bankruptcy court that, on account of an automatic acceleration upon the bankruptcy filing, no make-whole payment is required to be paid.[2] Given the frequency which make-whole disputes have arisen and the enormous sums at stake, it is important for all investors to understand the various arguments for and against payment of a make-whole premium, and the specific issues to look for when analyzing debt containing make-whole provisions. Despite the various legal arguments that exist, the single most important factor will always be the specific language of the applicable credit agreement or indenture.

Make-Wholes Generally

Credit documents often contain express make-whole provisions to offer yield protection to investors in the event of a repayment of a loan prior to the agreed upon maturity. Such provisions allow parties to agree in advance on a measure of damages for such prepayment. Lenders use

[1] *In re Energy Future Holdings Corp.*, Adversary Proceeding No 14-50363 (with respect to the first-lien notes) and Adversary Proceeding No 14-50405 (with respect to the second-lien notes). In an attempt to resolve the make-whole issues, debtors have previously proposed a tender offer to repurchase both the first-lien and second-lien notes.

[2] *In re MPM Silicones, LLC*, Adversary Proceeding No. 14-08227.

make-wholes to lock in a guaranteed rate of return on their investment at the time they agree to provide the financing. Borrowers typically benefit from such provisions by obtaining lower interest rates or fees than they would otherwise absent such protections.

Make-Whole Arguments

For the most part, disputes regarding the enforceability of a make-whole provision center around the following arguments: (i) does the contractual language of the relevant credit agreement provide for payment of the make-whole; and, if so, (ii) has a bankruptcy filing or other default accelerated the debt, causing it to be already due and payable, thereby negating the requirement to pay a make-whole payment.[3] Other lesser arguments that may be raised include: (i) whether the make-whole represents an unenforceable penalty under applicable state law, (ii) does the make-whole represent a claim for unenforceable unmatured interest under § 502(b)(2) of the Bankruptcy Code, (iii) whether the make-whole represents a secured or unsecured claim, and (iv) whether the make-whole amount is unreasonable.

Does the Relevant Agreement Include a Make-Whole?

Because make-whole provisions are creatures of contract and not of law, to be effective (and to provide for a secured claim), these provisions must be contained in the applicable loan documents. In determining whether a proposed debt repayment triggers a make-whole claim, courts first consider whether the lender is entitled to a make-whole claim under the relevant contract as a matter of state law. Whether a make-whole is due depends principally on the plain language contained in the applicable bond indenture or credit agreement.[4] Courts also look to such language to determine the amount of any make-whole payment.

Does the Indenture Provide for Payment Following an Acceleration?

While make-whole amounts are typically triggered by an early repayment prior to maturity, most credit documents provide that the outstanding debt automatically accelerates and thereby becomes immediately due and payable upon a bankruptcy filing. Make-whole clauses may be held ineffective following an automatic acceleration, as certain courts have held that there cannot be any "prepayment" following a debt's deemed maturity upon acceleration.[5] Numerous courts

[3] See, e.g., *In re Sch. Specialty, Inc*., 2013 WL 1838513 at *4 (Bankr. D. Del. Apr. 22, 2013).

[4] See, e.g., *In re Calpine Corp*., 2010 WL 3835200, at *4 (S.D.N.Y. Sept. 15, 2010) (lenders not entitled to make-whole because the plain language of the debt instruments did not provide for the payment following an acceleration); *In re Solutia, Inc*., 379 B.R. 473, 485 n.7 (Bankr. S.D.N.Y. 2007) (court refused to "read into agreements between sophisticated parties provisions that are not there," and held that no make-whole amount was due).

[5] *See In re LHD Realty Corp*., 726 F.2d 327, 330-331 (7th Cir. 1984) ("acceleration, by definition, advances the maturity date of the debt so that payment thereafter is not prepayment but instead is payment made after maturity."); *In re Premier Entm't Biloxi LLC*, 445 B.R. 582, 625-27 (Bankr. S.D. Miss. 2010) (noteholders had no contractual right to prepayment premium where indenture provided for automatic acceleration of notes upon default arising from debtors'

have, however, held that a make-whole is still payable provided that the applicable credit agreement provides for such payment following an acceleration. In two recent cases, *In re School Specialty, Inc*[6] and *In re GMX Resources, Inc*.,[7] the bankruptcy courts found that the governing agreements specifically provided for payment of the make-whole premium notwithstanding a bankruptcy-related acceleration. In contrast, in *In re AMR Corp*., the bankruptcy court, which was later affirmed by the U.S. Court of Appeals for the Second Circuit, found the contractual language of the relevant indentures provided that no make-whole payment was due following an automatic acceleration.[8]

Whether an acceleration has occurred and its effect on the make-whole is at the center of both the *Energy Future Holdings* and *MPM Silicones* disputes. With respect to the *Energy Future Holdings* first-lien notes, the indenture trustee has alleged that the applicable indenture contains no carve-out from payment of the make-whole upon an acceleration. Furthermore, the first-lien indenture trustee alleges that any acceleration can be rescinded by the holders. In its complaint, the *Energy Future Holdings* second-lien trustee has asserted that: (i) the debt was not accelerated, and (ii) if such debt was accelerated, the underlying credit agreements provide for payment of all principal, interest and "premium, if any" notwithstanding acceleration. In *MPM Silicones*, debtors' complaint alleges that no optional redemption can occur as the bankruptcy filing immediately accelerated the notes, accelerating the maturity date and making the outstanding amounts immediately due and payable. The *MPM Silicones* trustee has asserted a counterclaim seeking payment of the make-whole, alleging that payment is required pursuant to the indenture notwithstanding the acceleration. Whether such amounts are due and owing in these three cases will therefore depend in each instance on the judge's interpretation of the applicable contractual language, and specifically, whether an acceleration has occurred and, if so, whether the applicable indentures provide for payment of the make-wholes despite such acceleration.[9] Such contract language will also determine, among other things, the applicable rate of interest, whether default interest is due and what fees and expenses must be paid by the debtors.

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bankruptcy filing rendering the notes mature at time of their repayment as part of consummation of debtors' confirmed chapter 11 plan).

[6] *In re Sch. Specialty, Inc*., 2013 WL 1838513 at *4 (Bankr. D. Del. Apr. 22, 2013).

[7] In *In re GMX Resources, Inc.*, No. 13-11456 (Bankr. W.D. Ok. filed Apr. 1, 2013), the bankruptcy court found the first-lien lenders' claim properly included a make-whole premium of approximately $66 million and represented a legitimate liquidated damage provision, not unmatured interest subject to disallowance under section 502(b)(2) of the Bankruptcy Code, and Bankruptcy Code section 506(b)'s reasonableness standard did not apply.

[8] *In re AMR Corp*., 485 B.R. 279, 294 (Bankr. S.D.N.Y. 2013); *In re AMR Corp.*, 730 F.3d 88, 103 (2d Cir. 2013).

[9] See *In re AE Hotel Venture*, 321 B.R. 209, 219 (Bankr. N.D. Ill. 2005) ("Because the loan documents here expressly provide for a prepayment premium even when the debt is accelerated" the premium was approved).

Other Considerations

There are a number of other arguments debtors may attempt to use to negate a make-whole provision. These include claiming that such payments are for "unmatured interest," which is not allowed under the U.S. Bankruptcy Code, or by arguing that the make-whole amount was a penalty or plainly disproportionate to the claimants' loss. These arguments are of limited merit as make-whole provisions have typically been held to be valid liquidated damage provisions enforceable as a matter of state law.[10] Similarly, courts have typically dismissed arguments that the make-whole payment was not reasonable under § 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. In fact, in *School Specialty*, the amount of the make-whole premium represented 37 percent of the loan principal.[11] In that instance, the court held that because the make-whole provision was a valid liquidated damages clause, no "reasonableness" examination under § 506 was required, but that even if the make-whole premium had to pass a "reasonable" test, the court would have approved it.[12]

Is the Claim Secured?

Whether a claim is deemed a secured claim is determined initially under § 506(b) of the Bankruptcy Code which provides that a claim may be secured so long as it "is secured by property the value of which … is greater than the amount of such claim…." Thus, a secured claim can only exist up to the value of the collateral. It is important to note that to the extent that a lender's claim, including the make-whole, exceeds the collateral's value, any such amounts over the collateral's value will be an unsecured claim.

Can the Acceleration be Waived?

In *Energy Future Holdings*, the first-lien trustee alleges that even if the debt was accelerated, such acceleration can be rescinded by the holders. Creditors have previously attempted to argue that they are entitled to waive such contractual acceleration occurring following a bankruptcy filing. However, courts have generally held any such waiver to be an action to exercise control over the property of the estate and a violation of the automatic stay[13].

[10] See *In re Trico Marine Servs., Inc.*, Case No. 10-12653 (Bankr. D. Del.) (BLS) (Opinion dated April 15, 2011) (the Delaware bankruptcy judge held: "The substantial majority of courts considering this issue have concluded that make-whole … obligations are in the nature of liquidated damages rather than unmatured interest …").

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

[12] *Id*. at *5.

[13] See *In re Solutia*, 379 B.R. at 484; In re AMR Corp., 730 F.3d at 103 (Second Circuit affirmed bankruptcy court's conclusion that any attempt by the indenture trustee to waive the event of default and decelerate the debt would be a violation of the automatic stay).

What to look for in Make-Whole Provisions

- As in any contract provision, when examining a make-whole provision, parties should seek clear and unambiguous terms specifying the situations in which lenders are entitled to their bargained-for make-whole payment.
- Loan agreements should provide that a make-whole amount is due regardless of any acceleration or action taken by lender to protect its rights.
- The manner of calculating the make-whole should be based upon actual damages accruing to the lender (many make-whole calculations are based upon the present value of the difference between the agreed interest rate and an interest rate based on LIBOR or Treasury Notes or Bonds, though other formulations are possible).
- Loan agreements should expressly state that the make-whole is a liquidated damages provision, not a claim for unmatured interest or a penalty, and that the make-whole amount represents a reasonable forecast of the damages caused by prepayment.
- To ensure that a secured claim exists, the make-whole amount should be included within definition of secured collateral and in all lien instruments.
- Another important issue is whether the provision at issue is a make-whole or a no-call provision. This issue is significant. Unlike make-wholes that allow for pre-payment upon the payment of a fee, “no-call” provisions specifically prohibit the borrower from prepaying the loan before maturity or before a specified date. While almost all bankruptcy courts hold that no-call provisions are not enforceable in bankruptcy, thereby allowing debtors to pay-off amounts prior to their maturity, courts are generally split over whether a debtor’s repayment during a no-call period gives rise to a claim for damages. An important consideration, however, is that due to § 506(b), no secured claim for a no-call breach will exist unless the credit agreement specifically provides the measure of damages for such a breach.