

MAKE-WHOLE CLAIMS AND BANKRUPTCY POLICY

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Loan agreements and bond indentures frequently contain “make-whole” or “yield maintenance” provisions that are designed to give the lender or bond investor the benefit of its interest rate bargain in the event that the obligor repays its debt obligation prior to maturity. Generally, although formula and calculation methodologies vary, upon a prepayment the obligor will be required to pay an additional amount that is calculated to be the interest rate differential between the loan or bond contract rate and the interest rate at which the prepaid funds can be reinvested through maturity. The hypothetical reinvestment rate typically references treasury yields along a curve plus a margin, with a present-value discount. When interest rates have fallen between the time the debt was incurred and the prepayment, the formula often will produce a positive number and the obligor will be required to pay a make-whole claim.

In a bankruptcy of the obligor, a claim for a make-whole payment may be very significant, especially today, when interest rates have fallen to historic lows and may stay at these levels for an extended time. The effect of significant make-whole claims is to dilute the recovery to other creditors; indeed, unsecured creditors that are not entitled to receive a make-whole payment could be viewed as effectively subsidizing a lender or bond investor’s contractual make-whole right.

In this article, we will discuss the state of the law regarding the enforceability in bankruptcy proceedings of make-whole provisions, as well as policy considerations that suggest the beneficiaries of make-wholes may be unfairly enriched at the expense of oth-

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er creditors. We will begin by focusing on two recent high-profile bankruptcy decisions by the United States Bankruptcy Courts for the Southern District of New York and the District of Delaware, respectively, that have garnered considerable interest from insolvency practitioners and the lending community. The decisions in *American Airlines*¹ and *School Specialty*² each address the enforceability in bankruptcy of “make-whole” payments, and stand generally for the proposition that courts in these key bankruptcy jurisdictions will honor the strict terms of a make-whole negotiated in good faith between a debtor and its lenders to the extent that such provision is enforceable under applicable state law.³ The decisions appear to be in line with both the majority of precedential cases from these districts and others. We will then consider these decisions in light of fundamental policy goals of the bankruptcy code, and policy choices that have been made by Congress to achieve those goals.

I. Make-Whole Provisions in Bankruptcy

Historically, bankruptcy courts have split on whether to allow the payment of make-whole amounts to lenders. A minority of courts has likened the payment of make-whole amounts to the payment of unmatured interest, something that is expressly forbidden by the bankruptcy code.^{4 5} Another line of cases relied on the ability to award post-petition reasonable “charges” to oversecured creditors in approving the payment of make-whole amounts in the limited circumstances where make-wholes arise under oversecured

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¹ U.S. Bank Trust Nat’l Assoc. v. American Airlines Inc. (*In re* AMR Corporation), 485 B.R. 279 (Bankr. S.D.N.Y. 2013).

² *In re* Sch. Specialty, Inc., No. 13-10125 (KJC), 2013 WL 1838513 (Bankr. D. Del. April 22, 2013).

³ See *In re* AMR Corporation at 288; *In re* Sch. Specialty at 15. See also Transcript of Oral Decision on Confirmation of Debtors’ Joint Chapter Plan of Reorganization for Momentive Performance Materials Inc. & its Affiliated Debtors at 44, *In re* MPM Silicones, L.L.C., No. 14-2503-rdd (Bankr. S.D.N.Y. Aug. 26, 2014) (relying on the *American Airlines* decision in connection with an analysis of the disallowance of make-whole premiums under New York law).

⁴ See, e.g., *In re* Ridgewood Apartments of DeKalb Cnty., Ltd., 174 B.R. 712, 720 (Bankr. S.D. Ohio 1994) (“[B]ecause the . . . claim is for interest which is not yet due at the time the bankruptcy was filed . . . it would not be allowed to an undersecured creditor”); *In re* Doctors Hosp. of Hyde Park, Inc., 508 B.R. 697, 708 (Bankr. D. Ill. 2014) (finding that “[t]he Yield Maintenance Premium represents unmatured interest”)

⁵ 11 U.S.C. § 502(b)(2) (2012).

creditors' debt instruments, but only to the extent that the court determined the amount of the make-whole payment to be reasonable.⁶

The majority trend, however, has been to permit the payment of make-whole amounts so long as the relevant make-whole provision is enforceable under applicable state law, in some cases regardless of whether the lender is oversecured.⁷ This line of cases holds that prepayment charges are not in the nature of unmatured interest since they fully mature in accordance with the terms of the contract.⁸ Courts adhering to this line of reasoning examine the loan agreement or indenture at issue to determine whether any applicable prepayment premium has become payable in accordance with its terms, and if so, analyze whether such premium is permissible under applicable state law. Recently, the courts in *American Airlines* and *School Specialty* each took this approach in their review of the enforceability of a debtor's make-whole obligations and reached different conclusions based on the facts in each case.

In *American Airlines*, the debtor sought to enter into a postpetition financing arrangement and use the proceeds, in part, to prepay certain of its prepetition debt which carried a significantly higher interest rate.⁹ The trustee for the prepetition debt that was proposed to be prepaid objected, arguing that the debtor could not prepay its obligations without also paying a make-whole amount provided for in the prepetition indenture.¹⁰ The *American Airlines* court analyzed the prepetition indenture, and found that the filing of a voluntary bankruptcy proceeding constituted an event of default that automatically accelerated the maturity of the debt.¹¹ The indenture also specifically provided that no

⁶ See, e.g., 11 U.S.C. § 506(b) (2012) ("To the extent that an allowed secured claim is secured by property the value of which . . . is greater than the amount of such claim, there shall be allowed to the holder of such claim . . . any reasonable fees, costs, or charges provided for under the agreement . . ."); *Premier Entm't Biloxi LLC v. U.S. Bank Nat'l Assoc.* (*In re Premier Entm't Biloxi LLC*), 445 B.R. 582, 618 (Bankr. S.D. Miss. 2010) ("In general, a prepayment premium is encompassed under the term 'charges.'").

⁷ Section 502(b)(1) of the bankruptcy code forbids the payment of any claim to the extent that "such claim is unenforceable against the debtor and property of the debtor under . . . applicable law." 11 U.S.C. § 502 (2012); *Cf. In re Trico Marine Services, Inc.*, 450 B.R. 474, 481 (Bankr. D. Del. 2011) (finding that an unsecured creditor held an allowed claim for a make-whole payment).

⁸ E.g., *In re Outdoor Sports Headquarters, Inc.*, 161 B.R. 414, 424 (Bankr. S.D. Ohio 1993) ("Prepayment amounts, although often computed as being interest that would have been received through the life of a loan, do not constitute unmatured interest because they fully mature pursuant to the provisions of the contract."); *In re Trico Marine Services, Inc.*, 450 B.R. at 481.

⁹ *U.S. Bank Trust Nat'l Assoc. v. American Airlines Inc.* (*In re AMR Corporation*), 485 B.R. 279, 283-84 (Bankr. S.D.N.Y. 2013).

¹⁰ *Id.*

¹¹ *Id.* at 289.

make-whole payment was due upon such an acceleration.¹² As a result, the court found that under the plain language of the indenture, no make-whole payment was due the debtor's bondholders in connection with its prepayment of the prepetition debt.¹³

In contrast, the decision in *School Specialty* upheld a lender's entitlement to payment of a significant make-whole amount.¹⁴ In that case, the debtor entered into a prepetition credit agreement that provided for an "early payment fee" upon either prepayment or acceleration of the loan.¹⁵ Prior to the petition date, the debtor and its lenders entered into a forbearance agreement that acknowledged an event of default and the acceleration of the debt, and, consequently, fixed the lenders' right to receive the early payment fee.¹⁶ The debtor's official committee of unsecured creditors challenged the early payment fee, not under the terms of the contract but rather under applicable state law.¹⁷ The *School Specialty* court determined that under New York law (as with the law in many jurisdictions), "early termination fees are analyzed under the standards applicable to liquidated damages."¹⁸

Under New York state law, contractual liquidated damages provisions are enforceable if, as of the time the parties entered into their agreement, actual potential damages were difficult to determine and the amount of the liquidated damages were not "plainly disproportionate" to potential losses.¹⁹ The *School Specialty* unsecured creditors' committee argued that the prepayment calculation, which resulted in a prepayment fee equal to 37% of the principal balance of the loan, failed this test because it provided for a fee that was "grossly disproportionate" to the lenders' expected loss.²⁰ Upon examination, however, the *School Specialty* court determined that the prepayment fee calculation was reasonable at the time the parties negotiated the loan in good faith, and could not be invalidated simply because it ultimately resulted in a significant prepayment fee.²¹

¹² *Id.* at 289-90.

¹³ *Id.* at 298.

¹⁴ *In re Sch. Specialty, Inc.*, No. 13-10125 (KJC), 2013 WL 1838513, at *5 (Bankr. D. Del. April 22, 2013).

¹⁵ *Id.* at *1.

¹⁶ *Id.* at *2.

¹⁷ *Id.* at *1.

¹⁸ *Id.* at *2.

¹⁹ *Id.*

²⁰ *Id.* at *3, *4 n.7.

²¹ *Id.* at *4.

II. Tension Between Enforcement of Make-Whole Provisions and Bankruptcy Policies

Bankruptcy laws are intended to address numerous public policy considerations that, at times, are in tension with one another. Most fundamentally, bankruptcy is intended to provide a debtor with a fresh economic start, and to provide recoveries for similarly situated creditors fairly *vis a vis* one another.²² In addition, the bankruptcy code applies applicable non-bankruptcy law in determining creditor rights, except where exceptions are required to further the policy goals of a fresh start and creditor equality.²³

In limited circumstances, Congress has determined that certain recoveries by creditors that are otherwise permissible under applicable non-bankruptcy law should be disallowed or capped in bankruptcy. A prime example is claims for damages filed by lessors of non-residential real property where the debtor has rejected the lease.²⁴ Long-term commercial leases that are rejected by a debtor could give rise to very significant claims for damages. The bankruptcy code caps the amount of such claims to further the goal of equitable recoveries by all creditors.²⁵ Courts have observed that such claims may be “disproportionate in amount to any actual damage suffered, particularly in the event of a subsequent rise in rental values.”²⁶ That observation is true as far as it goes, but landlords also may be forced to cover a debtor’s default during a period when real estate demands significantly lower rents than the debtor’s lease rate. In such a scenario, and as a result of the policy decisions reflected in the bankruptcy code, the landlord may not look to the bankruptcy court or the market for full, or even *pro rata*, compensation for its losses.

In other contexts, claimants are required to mitigate damages. For example, suppliers who are party to a contract with a debtor are entitled to assert a claim for damages

²² See *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934) (“[o]ne of the primary purposes of the Bankruptcy Act is to ‘relieve the honest debtor from the weight of oppressive indebtedness, and permit him to start afresh’”) (quoting *Williams v. U.S. Fid. & Guar. Co.*, 236 U.S. 549, 554-555 (1915)); *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215, 219 (1941) (“the theme of the Bankruptcy Act is equality of distribution”).

²³ See *Board of Trade of City of Chicago v. Johnson*, 264 U.S. 1, 10 (1924) (“Congress derives its power to enact a bankrupt law from the federal Constitution and the construction of it is a federal question. Of course, where the Bankrupt Law deals with property rights which are regulated by state law, the federal courts in bankruptcy will follow the state courts; but when the language of Congress indicates a policy requiring a broader construction of the statute than the state decisions would give it, federal courts cannot be concluded by them”) (quoting *Bd. of Trade v. Weston*, 243 F. 332 (7th Cir. 1917)).

²⁴ This is not the only example, though. For instance, an employee’s claim for damages arising from the termination of an employment contract is also capped by the bankruptcy code. 11 U.S.C. § 502(b)(7) (2012).

²⁵ 11 U.S.C. § 502(b)(6) (2012).

²⁶ *Oldden v. Tonto Realty Corp.*, 143 F.2d 916, 920 (2d Cir. 1944).

that are measured by application of non-bankruptcy law if the debtor rejects the contract. Under applicable law, a non-breaching contract counterparty is entitled to damages, which includes consequential damages or lost profits. The non-breaching party, however, is required to make a good faith effort to mitigate its damages. A supplier of product to the debtor, for example, is required to make a good faith effort to find another buyer for its product and a purchaser of goods from the debtor is required to make good faith efforts to find a replacement source for those goods.²⁷

Courts that have found make-whole provisions enforceable in bankruptcy have not required the financial creditor with a make-whole right to mitigate damages by re-investing the proceeds of a prepayment, if possible, to reduce the formulaic make-whole amount. Rather, courts that have upheld make-whole payments have turned to the liquidated damages doctrine to determine whether the formulaic claim amount is permissible under non-bankruptcy law.

III. Conclusion

Following the decisions in *American Airlines* and *School Specialty*, it is clear that financial creditors with a contractual make-whole entitlement have an opportunity to assert a claim in bankruptcy proceedings designed to make such creditors whole; and in certain circumstances may also receive a windfall.²⁸ Their make-whole claim is not subject to a statutory cap, like lessors of non-residential real property, and there is no requirement to mitigate damages, as there is for most other creditors. Although the payment of make-whole amounts clearly may be enforced under applicable state law in many instances, there appears to be tension between a claim in bankruptcy for such a payment and public policies underlying the bankruptcy code, including maximizing recoveries and the fair treatment of all creditors.

²⁷ *E.g.*, *In re Orion Refining Corp.*, 445 B.R. 312, 315 (D. Del. 2011) (upholding a Bankruptcy Court decision that a creditor failed to mitigate damages as required by applicable state law).

²⁸ As noted, generally, make-whole formulas are tied to Treasury yields along an applicable curve. Of course, an investment in Treasuries is typically considered “risk-free,” while the obligor’s credit profile likely involved some degree of risk at the time the loan was made or bond was issued. Financial creditors with a make-whole right, therefore, may recover the lion’s share of their anticipated yield, and redeploy that make-whole amount as well as recovered principal in investments with significantly greater yield than Treasuries.