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Overcoming Hurdles in the Enforceability of Make-Whole Provisions

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There have been recent conflicting decisions in U.S. district courts of New York, Delaware, and others states regarding to the enforceability of make-whole provisions in bankruptcy. The ambiguity created by the courts' decisions has caused uncertainty for all parties involved in these kinds of loan documents. This comment is an analysis of the enforceability of make-whole provisions in the context of bankruptcy in light of the recent decisions. In order for a make-whole or a no-call provision to be upheld, a number of hurdles must be cleared. The provisions must be valid under both state law and bankruptcy law. Make-whole provisions are generally enforceable outside of bankruptcy under state law to the extent that they are not true penalties under a liquidated damages analysis. Once bankruptcy comes into play, the provisions must withstand a number of hurdles. In order to be enforceable in bankruptcy, a make-whole provision must be a valid liquidated damages claim under state law, it must be provided for and triggered under the contractual agreement, and it must not be tantamount to unmatured interest.

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INTRODUCTION

One of the main goals of the Bankruptcy Code is to balance the interest of creditors, both secured and unsecured, and debtors in an equitable manner.[1] These competing interests in bankruptcy often put secured creditors in a detrimental position because the bankruptcy court is trying to reach an equitable distribution for all.[2] One of the ways a secured creditor's position can be impacted negatively is by the disallowance of defeasance fees.[3] In instances where disallowance occurs, value is being reallocated from secured creditors and given to unsecured creditors.

Bond indentures and credit agreements often have provisions that limit the ability of a debtor to repay its debt before maturity. One type of provision, termed a no-call, does not allow for prepayment of a loan,[4] while other types of provisions permit prepayment as long as the debtor agrees to pay a prepayment fee.[5] Prepayment

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[1] *See Scary Nightmares For Secured Lenders*, Presented at the 18th Annual American Bankruptcy Institute Southeast Bankruptcy Workshop, 246 (Jul. 18–21, 2013), http://materials.abi.org/sites/default/files/2013/Jul/ScaryNightmares.pdf [hereinafter *Scary Nightmares*].

[2] *Id.*

[3] *Id.* at 263 ("Defeasance fees are prepayment penalties intended to compensate a secured creditor for the bargained-for interest it loses when a debtor pays the principal due prior to the loan's maturity date.").

[4] Scott K. Charles & Emil A. Kleinhaus, *Prepayment Clauses in Bankruptcy*, 15 AM. BANKR. INST. L. REV. 537, 542–43 (2007).

[5] *Id.* at 537.

fee type provisions have been commonly referred to as make-whole provisions. Defeasance fees are supposed to compensate lenders for the loss of expected interest payments when the debtor pays the principal prior to the maturity date.[6] The fees are calculated in two different ways: some are based on yield maintenance formulas, and others are based on a fixed percentage of the amount being prepaid.[7]

Make-whole premiums help determine the rights of the borrower and the lender if the borrower decides to prepay the loan.[8] A rational borrower will repay a loan when the transaction costs are lower than the amount of savings that a new loan will generate.[9] In other words, debtors may seek to refinance their loans when interest rates drop. By replacing a high interest rate loan with a low interest rate loan, debtors can create savings. This is costly to the original lender because they will lose the expected stream of higher interest payments. Therefore, savvy lenders will want to make sure that if interest rates go down, their yields are protected.[10] Most lenders will have factored the borrower's interest payments into their future cash flow analysis.[11] It is pertinent that courts clarify the enforceability of defeasance fees before rising interest rates diminish the issues pertaining to make-whole premiums.[12]

Prepayment premiums are generally enforceable outside of bankruptcy under state law to the extent that they are not true penalties under a liquidated damages analysis. In addition to undergoing a liquidated damages analysis under state law, the provision must be triggered under the loan agreement in order to be enforceable. The issue is more complicated if the debtor seeks to refinance its debt in bankruptcy. Once in bankruptcy, state law continues to apply, but there are additional hurdles that the Bankruptcy Code imposes. First,

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6 *Scary Nightmares*, *supra* note 1, at 263.

7 Charles & Kleinhaus, *supra* note 4, at 538.

8 *Id.*

9 *Id.*

10 *See id.* ("Prepayment clauses, in sum, allow a lender to negotiate for yield protection and a borrower to negotiate for freedom of action.").

11 *Scary Nightmares*, *supra* note 1, at 264.

12 *See* G. Ray Warner, *Make Whole Premiums and Unmatured Interest*, GT RESTRUCTURING REVIEW (Sept. 25, 2014), http://www.gtlaw-restructuringreview.com/2014/09/make-whole-premiums-and-unmatured-interest/.

the Code provides that a secured creditor is entitled to interest on its claim and "any reasonable fees, costs, or other charges *provided for under the agreement*," to the extent the secured creditor is oversecured.[13] This is not a large hurdle to clear because lenders can easily provide for make-whole provisions in their agreements. However, there is a question of whether the make-whole provision is reasonable. Second, the Code provides that a creditor's claim cannot include "unmatured interest."[14] The third limitation is that there must in fact be a *pre*-payment.[15] If the bankruptcy filing itself accelerated the loan, any plan that would subsequently refinance the indebtedness would then be a payment, not a prepayment.

The Code provides that "[a]n allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property."[16] Thus, a prepayment penalty may be allowed under bankruptcy law only to the extent the value of the secured creditor's collateral exceeds its claim and the loan agreement provides for a prepayment penalty. Section 502 permits a claim unless, among other things, it amounts to a payment for unmatured interest.[17] Therefore, even if the value of the collateral exceeds the claim and the provision is triggered under the loan agreement, a prepayment penalty will not be enforceable if a court renders the provision tantamount to unmatured interest.

The third complication with the Code is that loan agreements frequently provide that the filing of bankruptcy is an event of default that automatically accelerates the debt.[18] Acceleration makes the loan due immediately, i.e., it accelerates the loan's maturity. So if bankruptcy accelerates the loan, this raises the question of whether refinancing *after* acceleration qualifies as a *prepayment*.

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[13] 11 U.S.C. § 506(b) (2012) (emphasis added).
[14] 11 U.S.C. § 502(b)(2) (2012).
[15] Charles & Kleinhaus, *supra* note 4, at 546.

[16] 11 U.S.C. § 506(a)(1) (2012).
[17] 11 U.S.C. § 502(b)(2) (2012).
[18] Charles & Kleinhaus, *supra* note 4, at 546.

If a lender purposely accelerates debt, either inside or outside of bankruptcy, courts have held that the lender has waived their contractual rights to prepayment fees.[19] Courts have held this because, upon acceleration, the debt has matured. This maturation of the debt means that any subsequent payment can no longer be seen as a prepayment.[20] Also, most prepayment provisions are only enforceable if the debtor takes the "option" to prepay.[21]

Generally, make-whole provisions are enforceable under state law when the debtor is outside of bankruptcy.[22] Once the debtor is in bankruptcy, the court's analysis should begin by determining whether the agreement covers prepayment penalties and, if so, (1) whether that provision is an unenforceable penalty and (2) whether that provision has been triggered. If the provision is a valid liquidated damages clause and it has been triggered under the loan document, then the court should consider whether or not the provision should be disallowed as unmatured interest. Courts are split on whether make-whole provisions are allowable as liquidated damages in bankruptcy or disallowable as unmatured interest.[23] All of these positions presuppose that a prepayment clause is still applicable after the automatic acceleration of a debt.[24]

No-call provisions are generally unenforceable in bankruptcy because they violate the Bankruptcy Code's goal of reorganization by allowing the creditor to contract around it.[25] However, whether or not damages may be collected for the breach of a no-call is another story. No-call provisions simply memorialize the common law

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19 *Id.* at 547.

20 *Id.*

21 *Id.*

22 Ingrid Michelsen Hillinger & Michael G. Hillinger, *The Story of YMPS ("Yield Maintenance Premiums") in Bankruptcy*, 3 DEPAUL BUS. & COM. L.J. 449, 450–51 (Spring 2005).

23 Matthew I. Knepper, *Lipstick on a Pig: Disallowing Make-Whole Clauses as Unmatured Interest*, 31 AM. BANKR. INST. J. 40, 40–41 (Dec. 2013) (noting that the characterization of make-wholes as allowable liquidated damages claims is the current majority position.).

24 Charles & Kleinhaus, *supra* note 4, at 556.

25 *Scary Nightmares*, *supra* note 1, at 264.

default rule of "perfect tender in time."[26] Although this rule has been highly criticized, it remains the law in some states and does not allow for prepayment of a loan unless the contract allows for it.[27] Make-whole premiums effectively contract out of the default rule and allow prepayment as long as the premium is paid.[28]

There are important questions of whether make-whole provisions are beneficial overall. When a make-whole provision is enforced in bankruptcy, a creditor is given a larger claim against the estate, which diverts money away from unsecured creditors. If make-whole provisions are enforced, this effectively allows two private parties, the lender and the borrower, to contract around a public law. A finely drafted lending agreement may be able to displace the Bankruptcy Code in determining the distribution of the estate.

This Comment will discuss these larger policy issues created by the enforcement of make-whole provisions. This Comment focuses on cases where the effect of the automatic acceleration due to a bankruptcy filing is not contemplated in the loan document. There have been recent conflicting decisions in U.S. district courts of New York, Delaware, and others states regarding to the enforceability of defeasance fees in bankruptcy. The ambiguity created by the courts' decisions has caused uncertainty for all parties involved in these kinds of loan documents. The goal of this Comment is to analyze when these provisions should be enforceable. In order for a make-whole or a no-call provision to be upheld, a number of hurdles must be cleared. The provisions must be valid under both state law and bankruptcy law. Part II of this Comment will address whether or not these provisions should be deemed valid liquidated damages clauses under the governing state law. Part II of this Comment will also address situations where the creditor is oversecured, and whether or not the provision must pass the reasonableness test under section 506(b) of the Code. Part III of this Comment will address whether or not the plain language of the loan documents provides for defeasance fees in the given circumstances. Part IV of this Comment will

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[26] Charles & Kleinhaus, *supra* note 4, at 540–41 (explaining that a debtor does not have the right to pay off a loan before maturity in the absence of a contract term to the contrary).

[27] *Id.* at 541.

[28] *Id.* at 543.

address whether or not these types of provisions violate the Code's prohibition on unmatured interest. Part V of this Comment will address situations where the debtor is solvent and how this changes the analysis. Finally, Part VI of this Comment will address the implications of these rulings going forward and important policy considerations. Part VII will conclude the Comment.

I. LIQUIDATED DAMAGES UNDER STATE LAW

The first inquiry in the enforceability of make-whole provisions is whether the provision is enforceable as a valid liquidated damage claim under state law. Bankruptcy courts have differed on the method by which to calculate liquidated damages, but courts agree that a liquidated damages analysis should be applied.[29] Some courts have held that the prepayment premium must reflect actual damages that have been incurred in order to be a valid liquidated damages clause.[30] Other courts have held that parties should be free to contract, under a liquidated damages clause, for whatever amount based on a calculation they deem reasonable as long as it is not inequitable and unconscionable.[31] The freedom of contract line of thought argues that it should not matter whether or not the prepayment clause is related to the actual amount of damages incurred.[32] Most courts will only construe a prepayment clause as a liquidated damages provision if the loan document says that the provision should be construed that way or the lender successfully makes that argument in court.[33]

In *School Specialty*, the court stated that under New York state law, a prepayment premium will be enforceable as liquidated damages when "(i) actual damages are difficult to determine, and (ii) the sum stipulated is not 'plainly disproportionate' to the possible loss."[34] The reasonableness of the damages is determined at the time

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[29] *See* John C. Murray, *Prepayment Premiums: A Bankruptcy Court Analysis of Reasonableness and Liquidated Damages*, 105 COM. L.J. 217 (2000).

[30] *Id.* at 223.

[31] *Id.* at 227–28.

[32] *Id.* at 228.

[33] *But see In re* Hidden Lake Ltd. P'ship, 247 B.R. 722, 726 (Bankr. S.D. Ohio 2000); *Id.* at 235.

[34] *In re* Sch. Specialty, Inc., No. 13-10125, 2013 WL 1838513, *2 (Bankr. D. Del. Apr. 22, 2013).

the agreement was formed.[35] The court also said that when determining whether or not the loss is "plainly disproportionate," it will consider "(i) whether the prepayment fee is calculated so that the lender will receive its bargained-for yield, and (ii) whether the prepayment fee is the result of an arms-length transaction between represented sophisticated parties."[36] Generally, courts like the one in *School Specialty* will uphold yield maintenance type make-whole provisions as valid liquidated damages.[37] Courts will also generally reject make-wholes with minimum charge provisions that result in automatic premiums.[38]

Some courts have applied state liquidated damages analyses and found the prepayment provisions were penalties. In *Skyler Ridge*, the court found that the prepayment provision was a penalty because the yield was tied to certain U.S. treasury instruments, and this was not the appropriate way to calculate the premium.[39] The Court said that the rate should have been that of a comparable first mortgage market rate.[40] Also, the lender failed to convert the difference in the interest rates to present value.[41] The court went on to hold that the provision was unenforceable under section 506(b) for the same reasons it was unenforceable under Kansas state law.[42] Because the parties agreed to treat the make-whole provision as liquidated damages, the court conceded that there was no need for the court to question this characterization.[43] Because these cases found the prepayment provisions unenforceable under state law, the court did not have

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35 *Id.*

36 *Id.* at *3 (citing *In re* Vanderveer Estates Holdings, Inc., 283 B.R. 122, 130 (Bankr. E.D.N.Y. 2002)).

37 Jeffrey H. Davidson, *No-Call and Make-Whole Provisions in Bankruptcy*, SV036 ALI-ABA 497, 501 (May 1–2, 2014).

38 *Id.*

39 *In re* Skyler Ridge, 80 B.R. 500, 505 (Bankr. C.D. Cal. 1987); *see also In re* Kroh Bros. Dev. Co., 88 B.R. 997, 1000–02 (Bankr. W.D. Mo. 1988) (holding that the prepayment premium was an unenforceable penalty under state law and unreasonable under section 506(b) because the contractual formula would have charged an amount equal to 25% of the principle. Also, the court was concerned that paying this premium would leave nothing for the other creditors).

40 *Skyler Ridge*, 80 B.R. at 505.

41 *Id.*

42 *Id.* at 507.

43 *Id.* at 504.

much opportunity to consider their effectiveness under section 506(b).[44]

In *AJ Lane & Co.*, the court held that the Bankruptcy Code alone is the test for whether or not the provisions should be enforced and used common law to fill in the reasonableness standard.[45] Here, the prepayment provision was a fixed percentage of the amount outstanding.[46] The court found that the provision did not approximate anticipated or actual damages because interest rates had actually risen and the lender benefited from the prepayment.[47] The court also found that damages were not difficult to prove.[48] This case is a good example of the large assumptions some courts make about lenders being able to determine the market rate and other variables when trying to approximate damages.[49]

Other courts have found provisions enforceable under state law regardless of whether they reflect actual damages or overcompensate the lender. In *Hidden Lake*, the court held that the yield-maintenance make-whole provision was enforceable as a liquidated damages clause.[50] Hidden Lake, the debtor, procured a loan from Atena, the creditor, to finance a large apartment building.[51] Multiple times over the course of the agreement, the debtor attempted to modify the prepayment clause to no avail.[52] Before the maturity date, the debtor defaulted and the lender accelerated the loan, which subsequently led to the debtor filing for bankruptcy.[53] Even though the loan document did not provide that the premium be construed as a liquidated damages claim, the court held it to be anyway.[54] While the court

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44 Charles & Kleinhaus, *supra* note 4, at 560.

45 *In re* A.J. Lane & Co., Inc., 113 B.R. 821, 823–25 (Bankr. D. Mass. 1990); Murray, *supra* note 29, at 225; Charles & Kleinhaus, *supra* note 4, at 560–61.

46 *A.J. Lane*, 113 B.R. at 822–23 (noting that the make-whole provision was based on a formula that took the amount prepaid times one percent (1%) times the number of years or portions thereof expressed as a fraction remaining on term of the Loan).

47 *Id.* at 829.

48 *Id.* at 829–30.

49 Murray, *supra* note 29, at 226.

50 *Id.* at 218.

51 *In re* Hidden Lake Ltd. P'ship, 247 B.R. 722, 724–25 (Bankr. S.D. Ohio 2000).

52 *Id.* at 725–26.

53 *Id.* at 726.

54 *Id.*

acknowledged that the premium would overcompensate the lender and take away unencumbered assets from the pool, it ultimately upheld the provision because sophisticated parties made a reasonable estimation of the damages at the time the contract was made.[55] The debtor argued that the clause was not a liquidated damages provision because the premium was not sufficiently uncertain under Ohio law.[56] The court found that "[t]here are significant variables which make the exact calculation of potential losses from prepayment difficult to calculate."[57] The *Hidden Lakes* decision did not address whether or not the premium needed to be reasonable under 506(b). This decision comports with earlier case law that is discussed below.

A. *Reasonableness Test Under Code Section 506(b)*

In situations where the creditor is oversecured, courts are split on whether or not the provision must also pass a reasonableness test under section 506(b) of the Code in addition to a liquidated damages analysis. Prepayment premiums must be valid under both state law and bankruptcy law. Bankruptcy courts in various jurisdictions have struggled with how a liquidated damages analysis should be performed, and whether the premium must be reasonable under section 506(b).[58] Section 506(b) of the Code allows for an oversecured creditor, up to the value of the collateral, to collect interest on the claim and any reasonable fees, costs, or charges that are provided for in the loan documents.[59] If the premium is characterized as interest or as a reasonable fee or charge, the premium should be enforceable.[60] Prepayment fees are usually characterized as "charges" or "fees" under section 506(b), which makes them subject to a reasonableness test.[61] Courts have interpreted the relationship between a state law

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55 *Id.* at 728–29.

56 Richard F. Casher, *Prepayment Premiums: Hidden Lake is a Hidden Gem*, 19 AM. BANKR. INST. J. 1, 32 (Nov. 2000).

57 *Hidden Lake*, 247 B.R. at 726–27 (explaining the difficulty in determining the loan amount, the term remaining, the interest rate available, and whether a suitable reinvestment vehicle will be available).

58 Murray, *supra* note 29, at 221.

59 11 U.S.C. § 506(b) (2012).

60 Charles & Kleinhaus, *supra* note 4, at 557.

61 *Scary Nightmares*, *supra* note 1, at 265; Charles & Kleinhaus, *supra* note 4, at 557.

liquidated damages analysis and a reasonableness test under section 506(b) in different ways. Some courts have held that the provision must pass both tests.[62] These courts have reasoned that section 506(b) simply adds a reasonableness requirement to section 502(b)(1)'s requirement that "the validity of claims be determined according to non-bankruptcy law."[63] Other courts have held that if a defeasance fee is valid under state law, then it is reasonable under section 506(b).[64] This second interpretation equates the two analyses. Others see the liquidated damages analysis as a "guidepost" in determining reasonableness.[65]

In *Foertsch*, the court stated that "an oversecured creditor in bankruptcy has 'a perfected security interest' in the equity cushion afforded by the value of the collateral which secures its claim."[66] The court held that in order to recover fees, charges, or costs, a creditor must establish "(1) that it is oversecured in excess of the amount requested; (2) that the amount requested is reasonable; and (3) that the agreement giving rise to the claim provides for recovery of the fee, cost or charge requested."[67]

The interaction between state liquidated damages and section 506(b) remains one of the least tested theories regarding make-whole provisions.[68] In *GMX Resources*, the court held that premiums that resulted from an automatic acceleration due to a bankruptcy filing were not subject to a reasonableness test.[69] The court based its holding on the grounds that section 506(b) only applies to post-petition fees, charges, and costs.[70] *School Specialty* held that a

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62 Charles & Kleinhaus, *supra* note 4, at 558.
63 *Id.*
64 *Id.* at 558–59.
65 *Id.* at 559.
66 *In re* Foertsch, 167 B.R. 555, 560 (Bankr. D.N.D. 1994).
67 *Id.* at 562; Murray, *supra* note 29, at 217.
68 Davidson, *supra* note 37, at 503.
69 *Id.*
70 *See In re* Sch. Specialty, Inc., No. 13-10125, 2013 WL 1838513, *4 (Bankr. D. Del. Apr. 22, 2013) (stating that the majority view is that 506(b) does not apply to interest, costs, or charges that accrue prior to the bankruptcy filing); Davidson, *supra* note 37, at 503.

make-whole provision that is reasonable under state law is also reasonable under the Code.[71]

Some courts have held that the prepayment premium must reflect actual damages that have been incurred. In *Coronado Partners*, the court held that the state law allowed for the liquidated damages claim, but section 506(b) limits the damages to the actual damages incurred.[72] In order to determine the actual damages, the court calculated "the difference between the contract rate and the market rate from the date of prepayment until the date of maturity."[73]

In *Kroh Brothers*, the court also invalidated the prepayment provision because it improperly failed to approximate actual damages.[74] The court went on to say that section 506(b) only applies to actual damages, independent of state law considerations.[75] In *Duralite Truck Body*, the court held that a prepayment fee based on a specific formula[76] did not effectively represent actual damages and was therefore unenforceable under a liquidated damages analysis and section 506(b).[77] The court explained that if the prepayment fee did not estimate actual damages, then the charge would either result in a windfall to the lender or a penalty to the borrower.[78]

Cases that found prepayment provisions enforceable under state law were able to examine section 506(b) in more depth. In *Financial Center Associates*, the court held that a prepayment fee using a discount rate tied to U.S. treasury bonds that resulted in a fee of 25% of the value of the loan was enforceable under state law and section 506(b).[79] The debtor argued that the fee was not commensurate with

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71 *In re* Sch. Specialty, Inc., No. 13-10125, 2013 WL 1838513, *5 (Bankr. D. Del. Apr. 22, 2013).

72 *In re* Imperial Coronado Partners, Ltd., 96 B.R. 997, 1001 (9th Cir. B.A.P. 1989).

73 *Id.* at 1001; *see* Murray, *supra* note 29, at 224–25.

74 *In re* Kroh Bros. Dev. Co., 88 B.R. 997, 1000–02 (Bankr. W.D. Mo. 1988).

75 *Id.* at 1002.

76 *In re* Duralite Truck Body & Container Corp., 153 B.R. 708, 710 (Bankr. D. Md. 1993); Murray, *supra* note 29, at 224 (calculating the formula was based on the average total interest earned on the loan, multiplied by the remaining number of months until maturity, and then divided by two).

77 *Duralite Truck Body*, 153 B.R. at 714–15.

78 *Id.*

79 *In re* Fin. Ctr. Assocs. of East Meadow, 140 B.R. 829, 839 (Bankr. E.D.N.Y. 1992); Charles & Kleinhaus, *supra* note 4, at 561.

actual damages.[80] However, the court rejected this argument and disagreed with the reasoning in *Skyler Ridge* and *Kroh Brothers*.[81] The court reasoned that damages are not easily proven because "many unknown factors" are present in determining actual damages.[82] The court noted that hindsight should not be used in determination of the reasonableness of the damages.[83] With regard to section 506(b), the court stated that "at best we are willing to view the 'reasonable' standard of section 506(b) in the context of pre-payment clauses as a safety valve which must be used cautiously and sparingly as all discretionary powers that are not subject to close scrutiny and statutory standard."[84]

In *Anchor Resolution*, the debtor conceded that the prepayment premium was enforceable under state law, but contested that the provision must also be reasonable under the Code.[85] The court held that the formula for the premium was reasonable because unlike other cases that had a fixed rate of interest, here, the formula "accounts for changes in the Treasury rate, decreases over time, and has no 'minimum charge.'"[86] The court found the premium reasonable for the formula used and the amount as a percentage of the principle.[87]

B. *The Interaction Between Liquidated Damages and 506(b)*

Most courts agree that the first step in determining whether a make-whole provision is enforceable is to apply a liquidated damages analysis under state law.[88] Under section 502(b)(1), claims should be determined by applicable non-bankruptcy law, i.e., state liquidated damages. Courts should not hold that parties are only entitled to actual damages under a liquidated damages analysis because there are many uncertain variables that make it difficult to ascertain actual damages at the time the agreement was made. Also,

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80 *Fin. Ctr. Assocs. of East Meadow*, 140 B.R. at 835–36.
81 *Id.* at 837.
82 *Id.* at 836.
83 *Id.* at 837.
84 *Id.* at 839 (The court noted that it is possible that a clause is valid under state law and not under the Code because it is extremely unjust to the estate).
85 *In re* Anchor Resolution Corp., 221 B.R. 330, 341 (Bankr. D. Del. 1998); Murray, *supra* note 29, at 228.
86 *Anchor Resolution Corp.*, 221 B.R. at 341.
87 *Id.*
88 *See supra* Part I.

damages should not be limited to actual damages when represented and sophisticated parties negotiated these agreements. This clash among courts between actual damages and the negotiated agreement illustrates that two goals of contract law, inside and outside of bankruptcy, are in conflict. These two goals are compensation for losses suffered and freedom of contract.[89]

The reasoning in *Skyler Ridge* and *AJ Lane* makes numerous assumptions about the ability of a lender to take the money from the prepaid loan and reinvest it into a similar transaction with a similar yield.[90] These presuppositions assume low transaction costs, which may not be the case. The reasoning also assumes that determining actual damages at the time an agreement is made is quite simple. In reality, it is not simple at all. The courts in *Hidden Lakes* and *Financial Associates* found that there were many variables that were difficult to ascertain, such as the amount of interest lost on the prepaid loan; the costs and delays of obtaining a similar loan with another borrower; the applicable rate of return; the risk involved with the new loan; the extent and realizability of the collateral; and other uncertainties.[91] As the court noted in *Financial Associates*, "[t]he mere need for a formula, and the existence of different formulas used by different lenders show that the actual loss to be incurred may be difficult to determine."[92] Because of the impossibility of accurately predicting most variables in these types of loan agreements, courts should allow lenders to collect on prepayment fees regardless of whether they are representative of actual damages. Courts should not use the clarity of hindsight to interpret whether something was reasonable in calculating anticipated damages at the time of contracting. Parties to these types of agreements should be aware of the consequences of prepaying a loan even if the prepayment premiums end up being much larger than actual damages to the lender.

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89 Hillinger & Hillinger, *supra* note 22, at 474.

90 *In re* Skyler Ridge, 80 B.R. 500, 504–06 (Bankr. C.D. Cal. 1987); *In re* A.J. Lane & Co., Inc., 113 B.R. 821, 829–30 (Bankr. D. Mass. 1990).

91 Charles & Kleinhaus, *supra* note 4, at 562.

92 *In re* Fin. Ctr. Assocs. of East Meadow, 140 B.R. 829, 837 (Bankr. E.D.N.Y. 1992).

The court's reasoning in *Financial Associates* and *Hidden Lakes* is most appropriate regarding the interaction between state liquidated damages and section 506(b). Liquidated damages provisions are necessary because it is hard to determine actual damages from large loans at the time the agreement was made. It is also most appropriate that make-whole provisions must separately pass a liquidated damages analysis under state law and the 506(b) reasonableness test. The Code seems to be a slightly stricter examination of the provisions on top of the liquated damages analysis. This conclusion comports with a distinction proffered by one court that just because a provision is enforceable under state law, does not mean it is reasonable under section 506(b).[93] Unless the provision is extremely inequitable, courts should leave the parties contractual relationships as intact as possible.[94] Sophisticated lenders specifically bargained for their interest and courts should not be disallowing it. However, courts should be entitled to reduce an inequitable claim by lessening the amount of a make-whole provision because the main goal of bankruptcy is equitable reorganization.

When lenders make loan agreements containing make-whole provisions, they should be aware that yield maintenance formulas are upheld more often because they are actually attempting to approximate damages. Courts will look at agreements that provide for a fixed fee or a percentage of the outstanding amount with greater scrutiny because such clauses do not attempt to approximate damages. However, yield maintenance formulas are more likely to be struck down as unmatured interest.[95]

II. PLAIN MEANING INTERPRETATION

Courts have analyzed the plain meaning of contractual provisions to determine if make-whole and no-call provisions were triggered under a specific agreement. If a defeasance fee was not triggered under the agreement, a discussion of its enforceability is null

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93 Hillinger & Hillinger, *supra* note 22, at 478.

94 *See In re* Fin. Ctr. Assocs. of East Meadow, 140 B.R. at 839.

95 *See infra* Part III.

and void. As discussed in Part II,[96] the provision must also be enforceable under a state law liquidated damages analysis. *AMR Corp.*, *School Specialty*, and *GMX Resources* illustrate that courts will allow or disallow make-whole provisions based on whether or not contracts have been finely drafted to be triggered under the given circumstances.[97]

Additionally, there are questions of whether filing for bankruptcy affects the maturity date of the loan agreement. Courts have concluded under section 502(b)(1)[98] that filing for bankruptcy will accelerate the principle amount of all claims against the debtor.[99] Loan agreements can also provide that filing for bankruptcy is an event of default that accelerates the maturity date.[100] These situations implicate the larger policy question of whether acceleration of the loan should be determined by the Code or by private contract. If the prepayment provisions are no longer applicable because the payment is no longer prepayment, then there is no reason to go deeper into the analysis. The lender can provide in the loan documents that a prepayment fee is due as long as the loan's *original* maturity has not passed.[101] As long as the loan's *original* maturity has not passed, the lender will likely be able to collect the prepayment premium inside or outside of bankruptcy.[102] The reason for acceleration provisions in loan agreements is to avoid any problems with the automatic stay that bankruptcy imposes.[103] In other words, the question is, even if the clause is a valid liquidated damages clause, has the bankruptcy filing triggered that clause?

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96 *See supra* Part I.

97 John F. Ventola & Sean M. Monahan, *Caution: Make-Whole Provisions are Taken at Face Value*, LAW360 (Nov. 14, 2013), https://www.choate.com/uploads/1178/doc/Caution_Make_Whole_Provisions_Are_Taken_At_Face_Value.pdf.

98 11 U.S.C. § 502(b)(1) (2012).

99 Charles & Kleinhaus, *supra* note 4, at 546.

100 *Id.*

101 *See In re* Chemtura Corp., 439 B.R. 561, 601 (Bankr. S.D.N.Y. 2010).

102 Charles & Kleinhaus, *supra* note 4, at 546.

103 Brian M. Resnick, Darren S. Klein & P. Alexandre De Richemont, *Bondholders Encounter Unexpected Turbulence: Second Circuit Grounds Make-Whole Provision in* AMR, 32 AM. BANKR. INST. J. 38, 39, 78 (Nov. 2013).

In *AMR Corp*., the court held that the make-whole provision was unenforceable because the contract only provided for a premium if the prepayment was voluntary.[104] American Airlines ("AMR Corp.") voluntarily declared bankruptcy.[105] However, according to the plain text of the contract, no make-whole premium was due upon automatic acceleration due to a bankruptcy default.[106]

U.S. Bank was the holder of certain notes stemming from a series of three transactions with AMR Corp.[107] The contract between the two parties clearly stated that a make-whole premium will be due in the event of a voluntary redemption, but a premium will not be due in the event of a mandatory redemption.[108] U.S. Bank argued that AMR Corp.'s debt payment plan was properly construed as a voluntary prepayment and therefore subject to a make-whole premium.[109] U.S. Bank also argued that it did not choose to accelerate the debt as a remedy, which would make the payment a prepayment and trigger the prepayment premium.[110] In addition, U.S. Bank argued that these provisions were unenforceable ipso facto clauses.[111] Lastly, U.S. Bank argued that they should have been allowed to waive the acceleration of the debt or waive the event of the default.[112] When the bankruptcy court denied all of U.S. Bank's arguments, it appealed directly to the Second Circuit.[113]

The Second Circuit agreed with the bankruptcy court that a voluntary petition for bankruptcy was an event of default under the contract provisions and that this default automatically accelerated the debt (this was according to Section 4.02(a)(i) of the indenture).[114] While the loan trustee had the option of accelerating in the event of other types of default, this was not the case with acceleration under

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[104] U.S. Bank Trust Nat'l Ass'n v. AMR Corp. (*In re* AMR Corp.), 730 F.3d 88, 99–100 (2d Cir. 2013).
[105] *Id.* at 95.
[106] *Id.* at 99–00.
[107] *Id.* at 92.
[108] *Id.* at 94.
[109] *Id.* at 98.
[110] *Id.*
[111] *Id.*
[112] *Id.*
[113] Ventola & Monahan, *supra* note 97.
[114] *In re AMR Corp.*, 730 F.3d at 99–100.

a voluntary petition.[115] U.S. Bank made the previously illustrated arguments attempting to refute the court's finding, but they were to no avail.[116]

The Second Circuit agreed with AMR Corp. that this was a post-maturity date repayment of an accelerated debt, instead of a prepayment, which would not trigger a make-whole premium under the contract.[117] The court also held that this did not violate section 365(e) of the Code because it was not an executory contract, and a deacceleration of the debt would violate the automatic stay because it would modify the contractual rights of the parties.[118]

In *School Specialty*, the make-whole provision was enforced because sophisticated parties bargained for a premium to be paid due to an automatic acceleration of the loan.[119] School Specialty Inc. and a few affiliated companies entered into a credit loan agreement with Bayside for an aggregate principle amount of 70 million.[120] Under the credit loan agreement, the debtors were liable for a make-whole fee for prepayment or acceleration of the loan.[121] New York law governed this loan document.[122] The court determined that the provision was an enforceable liquidated damages clause because precedent supported the use of an interest rate tied to treasury bills as the basis for the premium.[123]

The committee argued that the provisions must also pass the section 506(b) reasonableness standard.[124] The court held that the premium was reasonable because it was not plainly disproportionate to the lender's probable loss.[125] The court did not actually say whether or not the standard even applied.[126] The creditor's committee also argued that the premium should be disallowed as unmatured interest

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115 *Id.* at 98.
116 *Id.* at 100.
117 Ventola & Monahan, *supra* note 97.
118 11 U.S.C. § 365(e) (2012); *In re AMR Corp.*, 730 F.3d at 105–07.
119 Ventola & Monahan, *supra* note 97.
120 *In re* Sch. Specialty, Inc., No. 13-10125(KJC), 2013 WL 1838513, *1 (Bankr. D. Del. Apr. 22, 2013).
121 *Id.*
122 *Id.* at *2.
123 *Id.* at *4.
124 *Id.*
125 *Id*. at *5.
126 *Id*.

because the payment was intended to compensate for lost future interest.[127] The court held, in agreement with the majority of other courts, that the claim was not unmatured interest because the loan was fully matured under the contract due to the acceleration.[128]

In *GMX Resources*, the indenture clearly provided for a make-whole premium upon automatic acceleration due to bankruptcy.[129] The creditor's committee argued that it was a penalty, but the court held the provision was a permissible claim for liquidated damages.[130] Similar arguments to the ones in *School Specialty* were made and rejected by the court.[131] In a recent bench ruling in *MPM Silicones*, the court held there was no unambiguous clause that made the make-whole premium due upon acceleration.[132] Section 6.02 of the agreement stated "the principle of, premium, if any, and interest on the notes shall ipso facto become and be immediately due and payable."[133] The court held that this was not specific enough for the make-whole to be triggered by acceleration.[134]

A. *Finely Drafted Agreements Are Key*

The courts in all of these cases looked to the plain meaning of the contract. While this sounds rather simple, the key to interpretation lies in whether the agreement requires a premium for post-acceleration repayment or only pre-maturity prepayment.[135] In *AMR Corp.*, the agreement only provided for a make-whole premium upon prepayment.[136] Therefore, the court held that no premium was triggered by the automatic acceleration due to the bankruptcy filing.

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127 *Id*.

128 *Id*. at *5 (citing Skyler Ridge for the proposition that prepayment premiums mature at the time of the breach and do not represent unmatured interest).

129 Davidson, *supra* note 37, at 509.

130 *Id*.

131 *Id.*

132 *In re* MPM Silicones, LLC, No. 14-22503-rdd, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014); Geraldine Ponto & Ferve E. Ozturk, *Getting the Whole Make-Whole: Momentive and Energy Future Holdings Consider Equity*, 33 AM. BANKR. INST. J. 38, 38–39 (Nov. 2014).

133 *MPM Silicones*, 2014 WL 4436335 at *13.

134 *Id.* at *14.

135 Resnick, Klein & De Richemont, *supra* note 103, at 38.

136 U.S. Bank Trust Nat'l Ass'n v. AMR Corp. (In re AMR Corp.), 730 F.3d 88, 103 (2d Cir. 2013).

[137] In *GMX Resources* and *School Specialty*, the parties contracted for a make-whole premium in the event of prepayment or automatic acceleration.[138] In both cases, the court upheld the make-whole provisions. Bankruptcy courts seem hesitant to enforce make-whole provisions that are not clearly spelled out in the contract.[139] Many bankruptcy courts will look for reasons to disallow make-whole provisions in order to keep assets unencumbered for other creditors.[140] Drafters need to be acutely aware of this going forward.

When sophisticated lenders are fighting in bankruptcy, it is good policy for the court to give the lender nothing more than what it bargained for in order to protect other creditors. Sophisticated lenders should receive their bargained for exchange, but only to the extent that it is specifically included in the plain meaning of the contractual agreement. Lenders need to be aware of what they are putting in their contracts and whether or not it will hold up in court. It seems likely that these types of lenders will learn their lesson from *AMR Corp.* and begin to include make-whole provisions that are triggered by either prepayment or acceleration due to bankruptcy. Finely drafted loan agreements will prevent lenders' make-whole provisions from being disallowed due to ambiguities in the contract. Therefore, whether or not the prepayment premium has been triggered should become a non-issue in most cases.

III. UNMATURED INTEREST UNDER SECTION 502(B)(2)

A final question is whether the make whole provision—even if a valid liquidated damages clause that was triggered in the bankruptcy—is impermissible "unmatured interest" under Section 502. Section 502 says a claim is allowed unless, among other things, it amounts to a payment for unmatured interest. Most courts have held that make-whole provisions are not subject to the Code's prohibition on unmatured interest. However, some courts and scholars believe that the majority view is just a way to get around section

137 *Id.* at 103–04.
138 Resnick, Klein & De Richemont, *supra* note 103, at 38.
139 *Id.*
140 Ventola & Monahan, *supra* note 97.

502(b)(2).[141] Whether the lender is oversecured or undersecured is crucial to the analysis. The timing of the default and acceleration is also a key factor to be considered.

Section 502(a) of the Code states that a claim or interest, which is properly filed under section 501, is allowed, unless a party in interest objects.[142] Generally, claims are allowed, unless a party in interest can point to an exception under section 502(b). Section 502(b)(1) of the Code states "such claim is unenforceable against the debtor and property of the debtor, under any agreement or applicable law for a reason other than because such claim is contingent or *unmatured*."[143] Section 502(b)(2) states "such claim is for *unmatured interest*."[144] Section 502(b)(2) is an exception to otherwise allowable claims that gives the party in interest the ability to object to a claim for unmatured interest.[145] Section 506(b) of the Code allows for an oversecured creditor, up to the value of the collateral, to collect interest on the claim and any reasonable fees, costs, or charges that are provided for in the loan documents.[146] Therefore, if a prepayment fee is considered unmatured interest, then it is not allowed under section 502. And if the claim is not allowed under section 502, then it is not a secured claim under section 506.[147] For purposes of this Comment, it is assumed that section 506(b) precludes post-petition claims of interest and reasonable fees and charges to everyone excluding oversecured creditors.[148]

The biggest problem in the overall enforceability of make-whole provisions in bankruptcy is the interaction between liquidated damages and unmatured interest. The more the prepayment penalty is calculated as lost interest payments (actual damages), the more likely it will be enforceable under state law.[149] However, the more the prepayment penalty looks like unmatured interest, the less likely it will be enforceable under section 502(b)(2).

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141 Knepper, *supra* note 23, at 41.
142 11 U.S.C. § 502(a) (2012).
143 11 U.S.C. § 502(b)(1) (2012) (emphasis added).
144 11 U.S.C. § 502(b)(2) (2012) (emphasis added).
145 Knepper, *supra* note 23, at 40–41.
146 11 U.S.C. § 506(b) (2012).
147 Hillinger & Hillinger, *supra* note 22, at 462–63.
148 *But see* Charles & Kleinhaus, *supra* note 4, at 575–80.
149 *See supra* Part I.

Some scholars argue that sections 502(b)(2) and 506(b) must be read in conjunction with each other.[150] When doing so, these scholars argue it becomes clear that the Code only wanted the oversecured creditor to be able to accrue post-petition interest.[151] The Supreme Court held in *United Savings Association of Texas* that an undersecured creditor is not entitled to lost interest.[152] Section 506(b) provides for an exception to section 502(b)(2) for oversecured creditors if the agreement allows for reasonable fees, costs, or charges.[153] The majority view is that section 502(b)(1) acts to accelerate all debts at the petition date.[154] Even though a claim may be unmatured before the filing, the bankruptcy petition has matured the debt.[155]

The minority view is that although the unmatured claim is allowable under section 502(b)(1), the nine prohibitions are cumulative, and section 502(b)(2) clearly does not allow for unmatured interest.[156] These scholars view section 502(b)(2) as a specific prohibition to section 502(b)(1)'s general allowance of a claim for a make-whole provision for undersecured creditors.[157] When a debtor cannot even pay all the principle amounts of its debt, it would be inequitable to allow certain creditors to deplete the pool of assets by collecting interest.[158] Once bankruptcy is filed, the Code displaces state law. In the context of make-whole provisions, these scholars argue that the bargained for premiums can be disallowed when it cuts against section 502(b)(2)'s prohibition on unmatured interest[159].

Courts that hold prepayment clauses are not unmatured interest base their holdings on the view that everything has matured pursuant to the terms of the contract.[160] If everything has matured pursuant to

150 Knepper, *supra* note 23, at 41.
151 *Id.*
152 United Savings Ass'n of Texas v. Timbers of Inwood Forest Associates, Ltd., 484 U.S. 365, 373 (1988); Knepper, *supra* note 23, at 41.
153 Knepper, *supra* note 23, at 41.
154 *Id.*
155 *Id.*
156 *Id.*
157 *Id.*
158 *Id.* at 96.
159 *Id.*
160 Charles & Kleinhaus, *supra* note 4, at 580.

the contract, then nothing is still unmatured when the right to payment of the loan in full has been triggered.[161] Therefore, section 502(b) doesn't apply even though the premium is essentially equal to the present value of the remaining interest payments.[162] It is much easier to invalidate a yield maintenance formula as unmatured interest as compared to a fixed fee because a fixed fee looks nothing like unmatured interest.[163] The analysis is made easier if acceleration happens before the bankruptcy petition. In *Hidden Lake*, Aetna argued that the prepayment fee is matured, is not interest, and is part of its claim.[164] The court held that this claim is not for unmatured interest because the charge matured at the time the debt was accelerated.[165] It did not matter that the premium was, in essence, for the estimated interest.[166] However, the court did note that result might be different if there had been no prepetition acceleration.[167]

The minority view holds that make-wholes are just an attempt to collect a loss in interest income and that is exactly what 502(b)(2) is attempting to stop.[168] In *Ridgewood Apartments*, the court disallowed a make-whole provision as a claim for unmatured interest because the claim was for contingent interest that was not matured at the time of the bankruptcy filing.[169] The lender, Fannie Mae, accelerated the debt prior to the debtor voluntarily filing for bankruptcy.[170] The contract stated that the premium would be due if the prepayment was voluntary or involuntary.[171] The court held that the prepayment must actually take place under the terms of the contract in order for the make-whole premium to be triggered.[172] Because this claim was for contingent interest that was not due at the petition

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161 *Id.*
162 *Id.* at 581.
163 *Id.*
164 *In re* Hidden Lake Ltd. P'ship, 247 B.R. 722, 730 (Bankr. S.D. Ohio 2000).
165 *Id.*
166 *Id.*
167 *Id.*
168 Charles & Kleinhaus, *supra* note 4, at 580.
169 *In re* Ridgewood Apartments of Dekalb Cnty., Ltd., 174 B.R. 712, 720–21 (Bankr. S.D. Ohio 1994).
170 *Id.* at 716.
171 *Id.* at 720.
172 *Id.*

date, an undersecured creditor will not be able to claim such amount.[173]

Recently, in *Hyde Park*, the court held that a yield maintenance make-whole provision was correctly construed as unmatured interest.[174] Here, the debtor borrowed approximately $50 million secured by the hospital's real estate.[175] The court first held that the premium was not an unenforceable penalty.[176] The court then went on to hold that the premium was unmatured interest.[177] The court reasoned that the premium was unmatured at the time of the petition because the premium was triggered three months after the petition date by an acceleration of the loan due to a default.[178] While the loan agreement did not define "interest," the court found that the economic substance of the premium was indeed interest because it accelerated the interest on the loan that had not been accrued and made it all due immediately.[179] The court compared the premium to an original issue discount, which courts have determined is definitely interest.[180] The court also held that a premium can be a valid liquidated damages claim and still be disallowed as unmatured interest.[181] *Hyde Park* illustrates that post-petition claims for a prepayment premium will have a harder time getting around the Code's prohibition on unmatured interest.

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[173] *Id.*

[174] Ferve Ozturk, *Timing is Everything: Disallowing Prepayment Premiums*, LAW360 (May 28, 2014), http://www.law360.com/articles/541196/timing-is-everything-disallowing-prepayment-premiums.

[175] Paloian v. LaSalle Bank National Association (*In re* Doctors Hosp. of Hyde Park, Inc.), 508 B.R. 697, 701 (Bankr. N.D. Ill. 2014).

[176] *Id.* at 703.

[177] *Id.* at 706.

[178] *Id.*

[179] *Id.* at 705.

[180] *Id.* at 706.

[181] *Id*; *but see in re* Trico Marine Services, Inc., 450 B.R. 474, 480–81 (Bankr. D. Del. 2011) (holding that the make-whole was in the nature of liquidated damages and not unmatured interest. This assumes that the two are mutually exclusive).

A. *Analysis of the Applicability of Section 502(b)(2) to Make-Whole Provisions*

Some scholars argue that oversecured creditors that have a claim under section 506(b) are not subject to section 502(b)(2)'s prohibition on unmatured interest.[182] However, this should not be the case. Section 506(a)(1) says that "an *allowed* claim of a creditor secured by a lien . . . is a secured claim."[183] Section 502 tells us what an "allowed claim" is, and section 502(b) excludes unmatured interest. Therefore, if a prepayment penalty is construed as unmatured interest, then it should not be allowed under section 502. And if it's not allowed under section 502, then it's not a secured claim for an oversecured creditor. If the creditor is undersecured, it does not fall under section 506(b)'s protection and will not be able to collect on a prepayment fee anyway.

These discrepancies present a substance versus form argument of whether section 502(b) should apply to make-whole premiums at all. The Code does not define unmatured interest. Case law has defined unmatured interest as "interest that is not yet due and payable at the time of a bankruptcy filing, or is not yet earned."[184] One can argue that a prepayment fee is a charge that looks nothing like interest in form.[185] This argument is easier to make when the fee is a flat rate or a fixed percentage of the outstanding loan. When the fee is based on a yield maintenance formula, it looks much more like interest.[186] On the substance side, it can be argued that one should not be able to get around section 502(b)(2) by calling unmatured interest a make-whole provision.[187] A yield maintenance make-whole provision is usually a complex formula that approximates the present value of all unmatured interest at the time of default.

Section 502(b)(2) should stop make-wholes that are triggered once in bankruptcy where the loans are clearly not matured on the

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182 Knepper, *supra* note 23, at 40–41.

183 11 U.S.C. § 506(a)(1) (2012) (emphasis added).

184 HSBC Bank USA, Nat'l Ass'n v. Calpine Corp., No. 07 Civ 3088(GBD), 2010 WL 3835200, *5 (S.D.N.Y. Sept. 15, 2010).

185 Warner, *supra* note 12.

186 *Id.*

187 *Id.*

petition date. Make-wholes should be allowed when the debt is accelerated prior to bankruptcy and the provision has been triggered. The real question that courts need to decide definitively is whether section 502(b)(2) is a block to make-wholes when the acceleration is automatic due to a bankruptcy filing. It is hard to say with a straight face that the present value of all unmatured interest payments is not unmatured interest under 502(b)(2). However, the majority of courts have accepted the argument that nothing is still unmatured when the debt is automatically accelerated due to a bankruptcy filing.

The imposition of yield maintenance type prepayment fees is a preferable lending policy. These are more likely to be accepted under state liquidated damages analysis, as mentioned in Part II.[188] Courts have been reluctant to follow the minority view of disallowing premiums because they are unmatured interest. Therefore, overall, the make-whole is more likely to be enforced if a yield maintenance type fee is implemented.

IV. Solvent Situations

Many relevant assumptions in insolvent cases, such as the bankruptcy court's goal of equitable distribution, do not apply in solvent cases.[189] In insolvent cases, the bankruptcy court must use its discretion in order to fairly distribute assets to creditors.[190] It would not be equitable to allow one creditor to impose a massive prepayment premium or collect interest when the other creditors are not going to get their principle back.[191] If the proverbial pie is big enough to satisfy all creditors, then any prepayment provision that is enforced in full does not serve to injure other creditors of the estate.[192] While it is the exceptional situation that a debtor is solvent in bankruptcy, some scholars argue that undersecured and unsecured creditors

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188 *See supra* Part I.

189 Charles & Kleinhaus, *supra* note 4, at 582.

190 *Id.*

191 *Id.*

192 *Id.*

should also be allowed to collect interest notwithstanding section 502(b)(2).[193]

Recently, in *Energy Future Holdings*, the court allowed discovery to determine whether the debtor was solvent.[194] The court stated that "even in bankruptcy, a solvent debtor cannot escape its contractual obligations, but an insolvent debtor may rely on equitable principles to argue [that] the premium should be reduced or not paid."[195] If the debtors were solvent, then the provisions of the contract would be strictly enforced under the applicable state law.[196]

If an agreement contains a no-call provision, but does not expressly provide for damages upon breach of the no-call, then courts have held that there is not a secured claim because the damages were not provided for under the agreement.[197] However, there may be unsecured claims. Also, the lender may have a claim for common law damages even if all prepayment premiums are inapplicable due to acceleration.[198] Courts will allow damages from a breach of a no-call only in solvent scenarios. As shown in *MPM Silicones*, the lender's claim for damages from a breach of a no-call provision in an insolvent scenario was rejected as unmatured interest.[199]

Chemtura may have laid some much needed groundwork in interpreting make-whole and no-call provisions. In *Chemtura*, there were two sets of notes with maturity dates of 2016 and 2026.[200] The 2016 notes contained a make-whole provision, and the 2026 notes contained a no-call provision.[201] The settlement, under the plan of reorganization in Chapter 11 bankruptcy, proposed an allowed claim of 50 million dollars under the make-whole provision to the holders

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193 *Id.* at 583.

194 *In re* Energy Future Holdings Corp., 513 B.R. 651 (Bankr. D. Del. 2014); Ponto & Ozturk, *supra* note 132, at 39.

195 *Energy Future Holdings*, 513 B.R. at 658.

196 *Id.*

197 David S. Elkind & James Chang, *The Treatment of No-Call Provisions, Prepayment Premiums, and Make-Whole Damages Under the Bankruptcy Code*, 7-5 PRATT'S J. BANKR. L. 387, 388–97 (July/August 2011).

198 *Id.*

199 *See in re* MPM Silicones, LLC, No. 14-22503-rdd, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014); Ponto & Ozturk, *supra* note 132, at 38–39.

200 *In re* Chemtura Corp., 439 B.R. 561, 568 (Bankr. S.D.N.Y. 2010).

201 *Id.* at 570.

of the 2016 notes.[202] The equity committee challenged the reasonableness of this settlement because the allowed claim was 42% of the make-whole provision and 39% of the no-call provision if the provisions were found enforceable. [203] It is to be noted that the court was not deciding the issues on the merits, but simply whether or not the settlement reached the level of reasonableness required by the Bankruptcy Code.[204]

The court suggested that a two-prong test to determine the enforceability of these provisions was necessary.[205] First, the court would determine whether or not the provision was triggered under the agreement and whether or not this was an enforceable state law claim, which includes calculating the amount due in order to determine if it is a penalty.[206] The indenture document's make-whole provisions did not address whether or not a premium was triggered due to an automatic acceleration under a bankruptcy filing.[207] The indenture with the maturity date in 2016 contained separate definitions of "maturity" and "maturity date."[208] The court concluded that the acceleration only affected "maturity."[209] Therefore, the "maturity date" was never changed and the prepayment occurred before the "maturity date," which triggered the prepayment premium.[210] The court also stated that the yield maintenance formula would require more investigation to determine if it was a disallowable penalty.[211] Nevertheless, the court noted that it would be reluctant to disallow the provision because sophisticated parties negotiated the contract.[212]

Second, if the provision were enforceable under state law, the court would have to determine if the special considerations in the

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202 *Id.* at 596.
203 *Id.* at 597.
204 *Id.* at 600.
205 *Id.*
206 *Id.*
207 *Id.* at 598.
208 *Id*. at 601.
209 *Id*.
210 Davidson, *supra* note 37, at 506.
211 *Chemtura Corp.*, 439 B.R. at 600.
212 *Id.*

Bankruptcy Code would also allow the claim.[213] These special considerations are whether or not section 502(b)(2) or 506(b) require disallowance or reduction of the claim.[214] The court stated that section 502(b)(2) should only apply to situations where the debtor was insolvent, which was not the case here.[215]

It is helpful to discuss the two prongs of this proposed test in the context of other relevant cases. The *Chemtura* court discussed multiple recent decisions in order to reach its conclusion that the settlement was reasonable.[216] In *Calpine*, the debtors filed for Chapter 11 bankruptcy on December 5, 2005.[217] Prior to the petition date, one of Calpine's subsidiaries entered into a series of three lien financings for approximately 2.6 billion.[218] The debtors filed a motion to seek financing in order to, among other things, repay the subsidiary's debt.[219] The refinancing would replace high interest rate debt with low interest rate debt, and this would save the company around 100 million.[220] Calpine subsidiary's secured lenders raised objections arguing that they were entitled to make-whole premiums.[221] Six of the seven tranches of the debt had no-call provisions.[222] The court cited many cases illustrating that, although no-call provisions are generally enforced outside of bankruptcy, upholding no-call provisions in bankruptcy would defeat the goal of equitable reorganization.[223] "The essence of bankruptcy reorganization is to restructure debt . . . and adjust debtor-creditor relationships."[224] All of the loan agreements did say that filing for bankruptcy was an event of default that would automatically accelerate the debt.[225] However, the agreement

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213 *Id.*

214 Ryan M. Murphy, *Great Expectations:* Chemtura *Revisits the Treatment of "Make-Whole" and "No-Call" Provisions Under the Bankruptcy Code*, 20 NORTON J. BANKR. L. & PRAC. 6, Art. 6, 881 (December 2011).

215 *Chemtura Corp.*, 439 B.R. at 604.

216 *Id.* at 597–00.

217 *In re* Calpine Corp., 365 B.R. 392, 394 (Bankr. S.D.N.Y. 2007).

218 *Id.* at 395.

219 *Id.* at 396.

220 *Id.*

221 *Id.*

222 *Id.* at 397.

223 *Id.*

224 *Id.*

225 *Id.* at 398.

did not provide for damages upon this acceleration.[226] The court held that the breach of the no-call provisions did not allow for the right to enforce make-whole provisions.[227] Also, the court held that the breach did not entitle the lender to secured claims, but the lender would have an unsecured claim for their expectation damages in an amount equal to that of a make-whole provision.[228]

However, on appeal in district court, the court disallowed the unsecured claim for expectation damages because the indentures did not provide for such damages upon acceleration.[229] The court reasoned that if the no-call provisions were unenforceable, then one could not incur liability for breaching them.[230] The court also held that the claim is disallowed under section 502(b)(2) because the interest had not matured as of the petition date.[231]

The *Solutia*[232] court agreed with the district court in *Calpine*. This court chose not to give damages for a breach of a no-call provision.[233] The court reasoned that there was no prepayment because the notes had matured under the contract through automatic acceleration at the petition date.[234] If the notes were considered mature, then there could not be a *prepayment*.[235] Because there was no *prepayment*, the no-call provision had not been breached.[236] The court in *Solutia* opined that the automatic acceleration provision shows the intent of the lenders "to give up their future income stream in favor of having an immediate right to collect their entire debt."[237] The *Chemtura* court disagreed, stating that there would be situations in

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226 *Id.*

227 *Id.* at 399.

228 *Id.* at 399–00.

229 David M. Hillman & Lawrence S. Goldberg, *Treatment of "Make-Whole" and "No-call" Provisions by Bankruptcy Courts*, 7-3 PRATT'S J. BANKR. L. 195, 196–01 (April/May 2011).

230 *Id.*

231 HSBC Bank USA, Nat'l Ass'n v. Calpine Corp., No. 07 Civ 3088(GBD), 2010 WL 3835200, *5 (S.D.N.Y. Sept. 15, 2010).

232 *In re* Solutia Inc., 379 B.R. 473 (Bankr. S.D.N.Y. 2007).

233 *Calpine Corp.*, 2010 WL 3835200, at *4.

234 Hillman & Goldberg, *supra* note 229.

235 *Id.*

236 *Id.*

237 Elkind & Chang, *supra* note 194.

which damages for a breach of a no-call provision would be enforceable.[238]

Premier Entertainment also disagreed with the district court's analysis in *Calpine*. In *Premier Entertainment*, section 6.02 of the indenture said that if there was an event of default before February 1, 2008, with the intention of avoiding the no-call provisions, then a prepayment premium would be due.[239] The creditors argued that the default was willful and that the default was done with the intention of avoiding the no-call provision.[240] The court found in favor of the debtors.[241] The premium was not triggered because the debtors offered sufficient evidence that they filed for bankruptcy in order to obtain insurance proceeds.[242] The claimants were not able to meet their burden of showing the debtors' requisite intent.[243] The court found that there was no secured claim under section 506(b) because the automatic acceleration provision made the prepayment provision inapplicable.[244] However, the court did hold that the breach of the no-call provision would give rise to an unsecured claim when the debtor is solvent.[245] The court reasoned that the lender is not precluded from a monetary remedy just because specific performance is not allowed with respect to a no-call in bankruptcy.[246] The *Chemtura* court agreed with this analysis of no-call provisions in bankruptcy when the debtor is solvent.[247]

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238 *See In re* Chemtura Corp., 439 B.R. 561, 603–04 (Bankr. S.D.N.Y. 2010).

239 Premier Entm't Biloxi LLC v. U.S. Bank Nat'l Ass'n (In re Premier Entm't Biloxi LLC), 445 B.R. 582, 619 (Bankr. S.D. Miss. 2010).

240 *Id.*

241 *Id.* at 624.

242 *Id.*

243 *Id.*

244 Elkind & Chang, *supra* note 194.

245 *Premier Entm't*, 445 B.R. at 640.

246 My Chi To & Shannon M. Rebholz, *Making Sense of Bankruptcy Make-Wholes, No-Calls*, LAW360 (Dec. 7, 2010), http://www.law360.com/articles/213308/making-sense-of-bankruptcy-make-wholes-no-calls.

247 *See In re* Chemtura Corp., 439 B.R. 561, 604–05 (Bankr. S.D.N.Y. 2010) (disagreeing with the broad statement in *Calpine II* regarding no-calls).

A. *Bankruptcy Limitations Are Not Applicable When the Debtor Is Solvent*

As evidenced by the above examples, most scholars and courts agree that bankruptcy limitations regarding make-whole provisions should be lifted in situations in which the debtor is solvent. The limitations should be lifted because there will be no harm done to any other creditors in a situation where everyone can be paid. Therefore, only state law considerations should apply when the debtor is solvent. The *Chemtura* courts's two-pronged analysis is a great framework by which to analyze the enforceability of make-whole and no-call provisions in bankruptcy. The lender in *Chemtura* was successful because the court confirmed its claims as reasonable, but this was largely due to the fact that the debtor was solvent. The court noted that it would likely have held the minority view of disallowing defeasance fees as unmatured interest in insolvent cases.[248] Lenders should take notice of this decision because if section 502(b)(2)'s prohibition on unmatured interest becomes the majority view, make-whole and no-call provisions could become useless in bankruptcy.

V. IMPLICATIONS AND POLICY CONSIDERATIONS

The easiest way for a lender to secure enforcement of a make-whole provision is to make sure the agreement is finely drafted so that it will be triggered after a bankruptcy filing. *AMR Corp.* and *Solutia* have confirmed that courts will consider payment after acceleration as repayment and not prepayment, absent contractual language to the contrary.[249] Lenders should make sure that the premium is due in the event of automatic acceleration and voluntary prepayment. Alternatively, the lender could require a prepayment fee whenever a debtor repays prior to the *original* maturity date.[250] Lenders need to make sure there are no exceptions to a make-whole

[248] Murphy, *supra* note 214, at 888.
[249] *See supra* Parts II and IV.

[250] Mark A. Salzberg & Peter R. Morrison, *Rejecting Market-Based Cramdown Interest Rates, and Making Words Count for Make-Whole Payments*, 33 AM. BANKR. INST. J. 52, 114–15 (Dec. 2014). This type of provision was used in *Chemtura*.

premium, like the one found in *AMR Corp*.[251] Savvy lenders will also include an explicit statement that damages are due when a no-call provision is breached. Specifying details about when damages are due gives the lenders a better chance to recover on a no-call in a solvent situation. Drafting issues should become a non-issue if lenders are paying close attention to these rulings.[252] If agreements are already in place, then the lender should use any leverage it has to amend the agreement with unambiguous language.[253]

Based on the recent case law, it is best for lenders to include yield maintenance type make-whole provisions, instead of fixed fees. Yield maintenance provisions have a much better chance of being enforceable under state law because they actually attempt to approximate damages.[254] While yield maintenance formulas are more likely to be seen as unmatured interest than a fixed fee, the majority view, as of now, is that make-whole provisions are not unmatured interest. Plus, debtor-creditor relationships will not always end up in bankruptcy. While lenders should always prepare for the worst-case scenario, it is more important that the premiums are enforceable under state law because that is usually the first inquiry. This analysis can change, however, if the minority view with respect to unmatured interest becomes the majority view, and courts may be leaning that way, as shown in *Chemtura* and *MCM Silicones*.

The enforceability of make-whole provisions raises some interesting legal arguments. Article Nine of the U.C.C. allows for non-advances, such as interest and attorney's fees, and future advances, in some circumstances, to share the same priority as the original debt under a security agreement.[255] Having the same priority as the original debt means that the later incurred non-advances and future advances will have priority relating back to the time the security interest was first perfected. Non-advances will have an easier time relating back to the original perfection date because future advances are

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[251] Ventola & Monahan, *supra* note 97.

[252] *See supra* Part II.

[253] Salzberg & Morrison, *supra* note 250, at 115.

[254] *See supra* Part II.

[255] U.C.C. § 9-323.

subject to knowledge, buyer in the ordinary course, and other stipulations that may prevent relation back. Therefore, it can be argued that prepayments should also share the same priority as non-advances under Article Nine. Prepayments look more like non-advances than future advances. In a typical future advance, the lender extends more money to the debtor, which is secured under the original agreement. This is not the case with prepayments, which look more like a charge or the present value of the interest outstanding. Prepayments, just like attorney's fees, must be provided for under the agreement in order to be enforceable or permitted. Both attorney's fees and prepayments are negotiated for with an eye on the possibility of default and bankruptcy, and the resulting issues that will arise.

Future expectation damages are usually allowed under the Code, but they are not with respect to interest.[256] Under common law, a creditor is entitled to damages for a breach of a no-call provision, just like any other type of breach.[257] Under contract law, an aggrieved party "is entitled to all damages proximately caused by the breach if the damages were reasonably foreseeable at the time of contracting, they were unavoidable, and the aggrieved party can prove them with a reasonable degree of certainty."[258] Therefore, a creditor should be entitled to damages for a breach of a no-call provision if it meets the contract law stipulations even in insolvent situations. However, most courts have held that the legislative intent of section 502(b)(2) was to disallow future interest expectation damages.[259]

There is a looming policy question of whether make-whole provisions are beneficial overall. These rulings are a mixed bag as discussed previously. Some are encouraging lending by providing certainty because bargained for provisions are being upheld inside and outside of bankruptcy. Others are making lenders much more skeptical about disbursing funds because the lenders are unsure if they will receive their full expectation damages if the debtor's business results in bankruptcy. This type of uncertainty is a large problem

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256 Warner, *supra* note 12.
257 Hillinger & Hillinger, *supra* note 22, at 481.
258 *Id.*
259 Warner, *supra* note 12.

going forward and one that needs to be resolved. Most people should agree that encouraging lending is a good thing because it increases the flow and availability of money, which strengthens the economy. However, secured lenders can hurt other types of creditors if make-whole provisions are enforced.

Once the debtor is in bankruptcy, the trustee is in control of the estate and any money that is distributed to a secured creditor will come out of the pocket of other unsecured creditors.[260] Even if two sophisticated parties negotiated the original agreement, if the secured party receives the benefit of a make-whole provision in bankruptcy, the secured creditor will be taking money away from the estate and other unsecured creditors who may be unsophisticated. These unsecured creditors did not have a say in the negotiations of the loan agreement, but their distributions under the Bankruptcy Code are being affected by a private agreement. Therefore, there is a question of whether two parties should be able to privately contract around a public law that sets forth how distributions are to be allocated in bankruptcy. In partnership law, parties are able to contract around the default rules as long as it is explicitly stated in the operating agreement. So should the same be true of the Code? The Code is not a set of default rules that are only followed if the loan agreement does not address an issue. However, make-whole clauses operate within the confines of the Code's restrictions.

It is most appropriate that a party is given what it bargained for if it is within the rules of the Code. Unsecured creditors should know the rules of the game and realize the risks they are taking by lending on an unsecured basis. It can be argued that secured creditors should contemplate that a debtor can declare bankruptcy, which is well within debtor's rights as determined by congress, and this displaces certain parts of the loan agreement. However, value should not be reallocated from secured creditors to unsecured creditors when a make-whole provision is otherwise enforceable under the Bankruptcy Code just because one group has been injured. While there is a good argument that secured creditors have found a loophole in the Code to get around unmatured interest,[261] the majority of courts have not seen it this way, and therefore, secured creditors should not

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[260] Hillinger & Hillinger, *supra* note 22 at 450–51.

[261] *See supra* Part III.

be punished for working within the Code. Another example of a workaround in the Code is the allowance of the payment of "performance bonuses" when retention bonuses are not allowed.[262] This is very similar to the allowance of a yield maintenance make-whole provision when unmatured interest is prohibited. By not enforcing make-whole provisions, courts would be giving the other creditors of the estate a backdoor way out of the original agreement the debtor had with the secured creditor.

It is true that there are contract provisions that will not be enforced in bankruptcy, such as a blanket default provision giving a secured creditor collateral in all of the debtor's property. Legislatures do not want to allow these types of provisions because they could easily be put into every lending agreement and bargaining power will not be equal in all circumstances. A blanket default provision would greatly reduce a debtor's ability to finance anything else after a default because it could no longer give first position in its collateral. A make-whole provision is not the type of provision that should be invalidated because it does not have the same concerns. In fact, make-whole clauses may give a debtor a better opportunity to finance their business because the debtor can chose to opt out of a loan agreement after payment of a fee if there are possible savings to be had. Also, a bankruptcy court can use its equity powers and lessen a make-whole provision, while still rendering it enforceable.

CONCLUSION

In order for a make-whole provision to be enforceable, the provision must be a valid liquidated damages clause under state law, it must be provided for and triggered under the agreement, and it must not be tantamount to unmatured interest. Often, a ruling can come

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[262] Andrew Scurria, *Federal Ch. 11 Watchdog Stays Resolute Against Bonuses*, LAW360 (Oct.7, 2014), http://www.law360.com/articles/583227/federal-ch-11-watchdog-stays-resolute-against-bonuses (illustrating that, because changes to the Bankruptcy Code in 2005 have made retention bonuses for key employees much more difficult to pay in bankruptcy, debtors have had to guise the bonuses as performance based incentive plans in order to workaround the change in the Code).

down to which party the court feels should prevail.[263] Even if the agreement is perfectly drafted, a court could reject an outcome to preserve the estate for other creditors using the wiggle room provided for in either a state liquidated damages analysis or a section 506(b) reasonableness analysis.[264] Also, most debtors in bankruptcy are insolvent, so the equities of the case can come into play in order to partially invalidate a make-whole provision.[265] Lenders can improve their chances of having make-whole clauses enforced, but they can never be certain of all of the risks involved because of the wiggle provided by the Code and the valid policy arguments discussed in Part V.[266]

Overall, it is the best policy to enforce make-whole provisions negotiated between sophisticated parties, unless the result of the provision is unconscionable. While unsecured creditors will suffer in circumstances where make-whole provisions are enforced, they will have the ability to more easily obtain financing because lenders will be more certain of the enforceability of their agreements. The results of more generous lending will benefit the economy and outweigh the harm caused to the unsecured creditors in individual cases. The increased ease of financing is the rising tide that will benefit all parties involved.

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263 Hillinger & Hillinger, *supra* note 22, at 488.

264 *Id.*

265 *Id.* at 483–84 (explaining that in *Schwegmann Giant Supermarkets Partnership*, the court concluded the make-whole provision was not reasonable under 506(b). The court had to "consider the equities in making the determination as whether the prepayment premium is reasonable." The court was worried about junior secured and unsecured creditors not receiving their fair share.).

266 *See supra* Part VI.