Understanding Make-Whole and No-Call Provisions:
Key Takeaways from Recent Decisions
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Make-Whole Provisions

- Loan agreements and bond indentures often permit a borrower to repay part or all of outstanding debt prior to maturity
  - Early repayment may be conditioned upon borrower paying a premium to compensate the lender for loss of future debt service payments
  - Such premiums are often referred to as make-whole or prepayment premiums
In re MPM Silicones, LLC (Momentive)

- Recent bench decision in In re MPM Silicones, LLC, Case No. 14-22503 (RDD) (Bankr. S.D.N.Y. August 26, 2014) (Momentive), is culmination of Second Circuit opinions on scope and applicability of make-whole and no-call provisions
  - Trustees for first and 1.5 lien notes argued that noteholders have claim for make-whole premium based on prepayment of notes
  - Bankruptcy court first considered whether claim would be valid under applicable nonbankruptcy (state) law and then whether there are limitations on claim under Bankruptcy Code
  - Under New York law (which governed the notes), parties can amend rule of “perfect tender” to allow for prepayment of debt
    - In addition, it is well-settled under New York law that a lender forfeits right to prepayment premium by accelerating balance of loan
    - Exceptions are where (i) debtor intentionally defaults to trigger acceleration or (ii) there is clear, unambiguous provision requiring prepayment premium even in the event of acceleration
In re MPM Silicones, LLC (Momentive) (cont’d)

- Bankruptcy court determined in *Momentive* that “absent specificity, which is here lacking, the first and 1.5 indentures do not create an enforceable claim for the applicable premium following the acceleration automatically of the debt pursuant to [Section] 6.02 of the indenture.”
  - Citing to decision on make-whole premiums in *In re Chemtura Corp.*, 439 B.R. 561 (Bankr. S.D.N.Y. 2010), the bankruptcy court further found that indenture must make clear that make-whole premium would be payable notwithstanding bringing forward of maturity date upon acceleration.
- In conclusion, bankruptcy court stated that “there is no specific provision in the note or the indenture that overcomes or satisfies the requirement under applicable New York law requiring that a make-whole be payable specifically notwithstanding acceleration or payment prior to the maturity date under the terms of the contract.”

In re MPM Silicones, LLC (Momentive) (cont’d)

- Bankruptcy court further noted that Second Circuit made clear in *In re AMR Corp.*, 730 F.3d 88 (2d Cir. 2013) (*American Airlines*) that debtor’s compliance with automatic acceleration provision is not voluntary act of debtor.
  - Automatic acceleration therefore does not give rise to make-whole premium where debtor intentionally triggers acceleration.
- Trustees also argued that indentures contained no-call provisions that gave rise to damages.
  - Bankruptcy court found that Section 502(b)(2) of the Bankruptcy Code prohibits claims for unmatured interest against insolvent debtors and prevents allowance of claim for future interest based on no-call provisions.
  - In addition, indentures did not contain specific agreement on fee charge in the event of prepayment.
In re Solutia Inc.

- Bankruptcy Court stated that, under applicable New York law, borrower does not have right to prepay debt absent a prepayment clause.
- However, note indenture provided for automatic acceleration upon filing of bankruptcy petition, which moved maturity date from original date to petition date and rendered payment not a “prepayment.”
  - “By incorporating a provision for automatic acceleration, the 2009 Noteholders made a decision to give up their future income stream in favor of having an immediate right to collect their entire debt.”
- In addition, indenture lacked language requiring payment of premium upon automatic acceleration.

In re Solutia Inc. (cont’d)

- Noteholders also argued that notes contained implied no-call provision
  - No-call provision was not relevant because acceleration of notes changed maturity date so notes were not prepaid.
- Faced with absence of clear contractual right to damages, bankruptcy court concluded that “[t]he time and place to have obtained the additional rights the 2009 Noteholders seek was at the bargaining table. This court is limited to interpreting the terms of the contracts as they exist.”

District court found that terms of notes provided that voluntary bankruptcy filing constituted event of default that accelerated and matured the notes:

- Thus, notes were due and payable immediately notwithstanding no-call provisions.

District court also held that, even without acceleration provisions, no-call provisions were unenforceable because filing of bankruptcy petition renders debtor’s outstanding debts mature and payable:

- “Debtor’s bankruptcy filing rendered the no-call provision in the notes unenforceable and liability cannot be incurred pursuant to an unenforceable contractual provision.”

District court further found that noteholders were not entitled to expectation damages because notes did not provide for payment of premiums upon acceleration:

- “Parties frequently provide for damages in these situation precisely because acceleration deprives borrowers of the payment streams for which they contracted. . . . Without such a provision, however, no damages are recoverable after acceleration.”

In addition, district court found that:

- Trustees’ claims for expectation damages violates prohibition against unmatured interest under Section 502(b)(2) of the Bankruptcy Code.
- Trustees’ claims are proscribed by Section 506(b) of the Bankruptcy Code because expectation damages were not provided for “under the agreement[s]” as required by Section 506(b) and claims were not “allowed.”
In re Chemtura Corp.

- In *In re Chemtura Corp.*, 439 B.R. 561 (Bankr. S.D.N.Y. 2010), equity committee objected to debtors’ chapter 11 plan that allowed bondholders’ claims for make-whole premiums and no-call damages
  - Bankruptcy court was tasked with determining whether debtors’ settlement with bondholders under plan “falls below the lowest point in the range of reasonableness”
- Bankruptcy Court considered merits of make-whole and no-call provisions under both state law and bankruptcy law
  - State law considerations:
    - Make-whole likely not affected by acceleration because notes referred to payment prior to particular “Maturity Date” and not more general “Maturity”
    - Many courts would be reluctant to invalidate make-whole provisions if they approximated lenders’ loss rather than imposed unjustifiable penalty
    - Bondholders faced greater uncertainty on enforceability of no-call provisions due to inadequate drafting that did not give rise to clear rights under state law

In re Chemtura Corp. (cont’d)

- Bankruptcy Court considered merits of make-whole and no-call provisions under both state law and bankruptcy law (cont’d)
  - Bankruptcy law considerations:
    - Damages for breach of no-call may be sustainable, as bankruptcy courts frequently allow claims for damages for breach of contract
    - Argument that make-whole premiums and damages for breach of no-call provisions should be disallowed as proxies for unmatured interest may be persuasive in case of insolvent debtor
    - Chemtura debtor was solvent and therefore contractual provisions should be enforced
      - “As matters of bankruptcy law, since we here have a solvent debtor, I think the bondholders are likely to get whatever they’re entitled to under state law. . . .”
In re AMR Corp. (American Airlines)

- In *In re AMR Corp.*, 730 F.3d 88 (2d Cir. 2013) (*American Airlines*), the trustee under notes issued by the debtors argued that noteholders were entitled to make-whole premiums in connection with repayment of debt
  - Second Circuit found that indentures clearly provided that where an event of default occurred as a result of bankruptcy filing, the debt would automatically accelerate and no make-whole payments would be due
    - “American’s bankruptcy petition triggered a default, and this default automatically accelerated the debt. That acceleration ‘changed[d] the date of maturity from some point in the future . . . to an earlier date based on the debtor’s default under the contract.’” (citation omitted)
    - Thus, repayment of debt did not constitute prepayment under indentures

In re AMR Corp. (American Airlines) (cont’d)

- Second Circuit also found that, although acceleration clauses under indentures were *ipso facto* clauses, they were not rendered unenforceable under the Bankruptcy Code
  - Of particular note, acceleration clauses were not rendered unenforceable under Section 365(e)(1) of the Bankruptcy Code because the indentures were not executory contracts or unexpired leases
Key Takeaways

- Early cases gave an unsecured claim for breach and trend is away from that
- Effort to deal with acceleration problem via right to rescind not effective (Solutia, American)
  - Parties should expressly address whether make-whole premiums or no-call damages are payable upon automatic acceleration of debt
- Courts have emphasized language of indenture, and, absent compliance with rule of explicitness and clear language, make whole will fail
  - Make sure business deal is unambiguous in documentation
- Make-whole premiums should compensate lenders for loss and not be impermissible penalty
- Consider disclosing circumstances under which make-whole premiums and/or no-call damages would not be owed in “risk factors” section of prospectus
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• Adversary proceeding in which the trustee for an issuance of notes seeks declaratory judgments that EFIH is obligated to pay a $665.2 million redemption premium in connection with a proposed refinancing of those notes through DIP financing.

• Trustee argued that valuation and solvency of a debtor are relevant to payment of make-whole premiums and could potentially bear on an assessment of whether a debtor has taken voluntary action to evade payment of an applicable premium or other make-whole amount.

• Additionally, Trustee argued that a third-party’s view of a debtor’s value and solvency are relevant if, as here, they played a central role in negotiation of a restructuring support agreement.
EFIH


Takeaways:

• Debtor’s valuation and solvency is discoverable in context of make-whole litigation because solvent debtors are held to their contractual obligations so long as those obligations are legally enforceable under applicable non-bankruptcy law.

• Court recognized that discovery of valuation and solvency information is time consuming, expensive and would delay resolution of the adversary proceeding. Court proposed three alternatives – (a) EFIH Debtors could concede their insolvency for purposes of the make-whole litigation; (b) EFIH Debtors could waive their right to assert any defense to payment of the make-whole premium based upon insolvency; and/or (c) parties could agree to bifurcate the trial such that the issue of solvency and the related discovery will only arise if the Court finds, in the first instance, that the EFIH Debtors are liable in whole or in part for a make-whole premium.

DENVER MERCHANDISE

• Lender appealed District Court for the Northern District of Texas’ disallowance of the lender’s claim for a contractual prepayment premium valued at $1.8 million

• A promissory note was issued in exchange for a $30 million loan

• Debtor stopped making payments on the promissory note and defaulted under its terms; no payment was made by the Debtor for the 3 months prior to the petition filing

• Lender obtained ex parte order appointing a receiver and the Debtor filed for bankruptcy.
DENVER MERCHANDISE

*In re Denver Merchandise Mart, Inc., et al.,* 740 F.3d 1052 (5th Cir. 2014)

Takeaways:

- *Plain language of the contract must require the payment of make-whole amount in the event of acceleration.*

- *Under Colorado law, a prepayment “penalty” is not a remedy for breach of contract but consideration for the borrowers right or privilege to prepay. Accordingly, a prepayment penalty is not liquidated damages and, therefore, is not subject to the rules of reasonableness for liquidated damages and does not trigger application of section 506(b).*

GMX RESOURCES

- In bench ruling, Court rejected the Official Committee of Unsecured Creditors’ challenge to first lienholders’ claim (which included $66 million make-whole premium) arguing make-whole premium (a) constituted an unenforceable penalty under state law and is thus not allowed under section 502(b)(1), (b) constituted unmatured interest which is not allowable under section 502(b)(2), and (c) is an amount that is unreasonable under section 506(b) and should not be allowed

- The parties stipulated to certain undisputed facts prior to the contested hearing
GMX RESOURCES

In re GMX Resources, Inc., et al., Case No. 13-11456 (SAH) (Bankr. W.D. Ok. August 27, 2013)

Takeaway:

• Court will enforce prepayment premium where unambiguous language of acceleration provision provides for such payment.

SCHOOL SPECIALTY

• Court denied Official Committee of Unsecured Creditors’ challenge by contested motion to the amount of lender’s aggregate claim stipulated to in connection with DIP financing.

• $70 million term loan was to mature on October 31, 2014 unless the Debtors were able to refinance certain debentures. Upon such refinancing, the maturity date of the term loan was extended to December 31, 2015.

• Upon either prepayment or acceleration during the first year and a half of the term loan, the “Early Payment Fee” was equal to approximately $23.7 million.

• 24 days prior to the filing of the petitions. The Lender entered into a forbearance agreement with the Debtors in which the Debtors acknowledged their covenant breach, triggering the make-whole payment.
In re School Specialty, Inc., et al., Case No. 13-10125 (KJC) (Bankr. D. Del. April 22, 2013)

Takeaway:

• Make-whole payments triggered by prepetition acceleration and matured prior to the filing of a petition are not claims for unmatured interest.
Many, if not most, of larger issue deals involving more sophisticated Lenders or Borrowers today are likely to contain make whole provisions; however, unless they are special situation loans, the precise language of those provisions is frequently not a prime focus of the parties, and particularly the Borrowers.

- In new par loans, many Borrowers, even if aware of the possible effects of those provisions, may not want to make too big a deal about what they may consider "lawyers’ language" regarding post-default remedies.

- From a business perspective, it is important to keep in mind that the number of cases where these provisions are likely to have a material economic effect on the parties and/or be litigated is probably fairly limited.

  - In voluntary refinancings, it will be fairly hard for Borrowers to close without paying the relevant make-whole premium, although for non-liquidated provisions (e.g., not a typical 3/2/1, or similar provision frequently used today), there may still continue to be debate on the right number.

  - Where more involuntary refinancings or pay-offs occur, they are likely to be meaningful (i) primarily when the Lender(s) are fully in the money, or (ii) less often when the additional claims may swing voting control of relevant classes.

That said, assuming Courts continue to follow the trend seen in the cases discussed today, we would expect significant tightening of language by Lenders’ counsel related to make whole provisions to be inserted in new issue loans.

However, many of the loan documents distressed debt buyers and insolvency professionals are likely to be dealing with in the near future will probably contain provisions that may not have been as carefully drafted as Courts are requiring to make them fully enforceable.

Accordingly, we wouldn't be surprised to see both healthy and distressed Lenders’ counsel (and their clients) to start looking to clarify these provisions in amendments or forbearance agreements, which may raise some interesting avoidance action sparring when these provisions have a material economic effect in a case.
Faculty Biographies
Bryan Kaplan is Of Counsel in Paul Hastings LLP’s Corporate Practice in New York, where he focuses on restructuring and general corporate matters. He represents debtors, unsecured and secured creditors, investors, asset purchasers, borrowers, lenders and other parties. He also has experience in general litigation matters. Mr. Kaplan received his B.A. from Vassar College and both his M.B.A. and H.D. from Columbia University.

Charles Reardon is a senior managing director with Asgaard Capital LLC in Vienna, Va., where he directs operational and financial restructurings, healthy and distressed M&A, debt and equity capital financing and real estate development. His extensive experience includes conceptualizing and executing complex commercial, legal and financial transactions with multiple stakeholders and changes in control and capital structures. He has advised public and private companies across a broad spectrum of industries including defense, financial services, hospitality, manufacturing, mining, technology, telecommunications, real estate and retail. Mr. Reardon has served as interim CEO or COO for portfolio companies on behalf of two privately held investment entities active in M&A and real estate development. In addition, he has served as a board member for a number of public and privately held companies. He is currently serving as a director of a NYSE traded Florida based homebuilder, WCI Communities, Inc (WCIC). He has been named a top debtor investment banker by Bankruptcy Insider. He is a frequent speaker and a member of both TMA and ABI. Mr. Reardon received his B.A. with highest distinction from the University of Virginia, where he was a member of Phi Beta Kappa and his J.D. from Yale Law School.

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Andrew V. Tenzer is a partner in the Finance and Restructuring practices at Paul Hastings in New York, where he represents lenders, troubled companies and buyers and sellers of distressed assets in Chapter 11 reorganizations and in out-of-court and cross-border restructurings. He also has experience in non-insolvency related syndicated financings, securitizations and structured finance transactions. Mr. Tenzer was named a top “40 under 40” international restructuring professional by Global Insolvency & Restructuring Review. He is the former Chairman of the New York City Bar Association’s Bankruptcy & Reorganization Division’s Committee on Cross-Border Restructurings and Chapter 15.
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