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Inside The Latest Make-Whole Claim Case

Law360, New York (April 30, 2013, 1:54 PM ET) -- A lender's right to recover a make-whole premium as part of its allowed claim in a bankruptcy case has been the subject of several recent court decisions. A Delaware bankruptcy court recently allowed a make-whole premium of $23.7 million on a $67 million term loan[1] and found that the premium was not "plainly disproportionate" to the creditor's possible loss. As a result, the make-whole was not an unenforceable penalty under New York law. In re School Specialty Inc., No. 13-10125, Slip Op. (Bankr. D. Del. Apr. 22, 2013).

Facts

In May 2012, School Specialty and its affiliated debtors (collectively, the "debtors") borrowed $70 million (the "term loan") from Bayside Finance LLC. Id. at 2. The term loan was to mature on Oct. 31, 2014, unless certain existing bond debt was refinanced, in which case the maturity date would be extended to Dec. 31, 2015. Id. at 2. The term loan credit agreement provided for the payment of a fee if, among other things, the term loan was prepaid or the maturity accelerated during the first 18 months after the loan was originated. Id. at 2. The fee, referred to as the "Make-Whole Payment," was "calculated by discounting the future stream of interest payments between the date on which the principal is repaid or accelerated and the Conditional Maturity Date of Dec. 31, 2015." Id. at 2. The discount rate set forth in the agreement was 50 basis points over the applicable U.S. Treasury rate. Id. at 2.

Six months later, the debtors breached a liquidity covenant, which the debtors acknowledged accelerated the term loan and triggered their obligation to pay the make-whole payment. Id. at 3. The debtors and Bayside executed a forbearance agreement in January 2013 pursuant to which the debtors acknowledged: (i) the outstanding principal amount under the term loan was $67 million; (ii) there was accrued and unpaid interest of $1.6 million; and (iii) Bayside was entitled to a make-whole payment in an amount in excess of $25 million (later recalculated to be $23.7 million) reflecting the present value of interest payments through Dec. 31, 2015 (the "make-whole claim"). Id. at 3.

Bayside later provided interim debtor-in-possession financing to the debtors, and under the interim DIP order, the debtors stipulated they were liable to Bayside for more than $95 million including the $23.7 million make-whole claim. Id. at 1. The creditors' committee sought to disallow the make-whole claim on three principal grounds: (i) the make-whole claim should be disallowed under § 502(b)(1) of the Bankruptcy Code as an unenforceable penalty under New York law because the claim amount was allegedly disproportionate to Bayside's possible loss; (ii) the make-whole claim is unreasonable under § 506(b) of the Code; and (iii) the make-whole claim should be disallowed under § 502(b)(2) of the Code as a claim for unmatured interest. Alternatively, the committee argued that even if the make-whole claim were allowed, the payment should be calculated using the earlier maturity date of Oct. 31, 2014, rather than the conditional maturity of Dec. 31, 2015. School Specialty, slip op. at 6.

Court's Ruling

The court began its analysis by looking to applicable state law (here, New York) to determine whether the contractual provision was enforceable. Id. at 4. Under New York law, "prepayment provisions and early termination fees are analyzed under the standards applicable to liquidated damages." Id. at 4. New York courts will enforce a prepayment premium "when: (i) actual damages are difficult to determine and (ii) the sum stipulated is not 'plainly disproportionate' to the possible loss." Id. at 5 (quoting In re South Side House LLC, 451 B.R. 248, 270 (Bankr. E.D.N.Y. 2011)). The reasonableness of the damages is determined at the time of contract, not the time of breach. School Specialty, slip. op. at 5.

1. Make-Whole Claim Was "Not Plainly Disproportionate" to Potential Loss. The court focused on whether the amount of the make-whole claim was plainly disproportionate to the lender's probable loss. Under New York law, courts will consider: (i) whether the prepayment fee is calculated so the lender will receive its bargained-for yield and (ii) whether the prepayment fee is the result of an arms-length transaction. Id. at 6 (citing South Side House, 451 B.R. at 270). The court answered both questions in the affirmative. School Specialty, slip op. at 7-8. The court determined that the make-whole claim enabled Bayside to receive its bargained-for yield and was justified in using the conditional maturity date of Dec. 31, 2015, to calculate the make-whole claim because Bayside was obligated to keep funds available through 2015. Id. at 7.

Even though the make-whole claim constituted 37 percent of the principal amount of the term loan, a fact that gave the court "pause," the court held that the "applicable standard … is whether the payment is 'plainly disproportionate' to the possible loss — not whether the payment … is disproportionate to the principal of the loan." Id. at n.7. A principal at Bayside had testified at the hearing that Bayside typically aims for a 1.4 – 1.5x return on its investment, which the make-whole claim would achieve. Id. at n.7. The court cited other New York courts that had found prepayment premiums not plainly disproportionate to a lender's potential losses when the claim amount was calculated based on the aggregate value of the future interest payments discounted, using U.S. Treasury bond rates. Id. at 8.[2]

2. Make-Whole Claim Was the Product of an "Arms-Length Negotiation." The court also found that the credit agreement was the result of an arms-length negotiation because the debtors had selected Bayside out of multiple proposals. Id. at 8. Although the debtors were "distressed" when they

negotiated the term loan, the court found "no credible evidence … revealing that the relative strengths or weaknesses of the parties' respective bargaining positions was anything but common under the circumstances." Id. at 8.

3. Make-Whole Claim Amount Was Reasonable. The committee argued that the make-whole claim should be disallowed under § 506(b) of the Code (even if it was enforceable under New York law) because the claim amount was unreasonable. In response, Bayside argued that § 506(b) only applied to the allowance of postpetition fees. Id. at 9. The court declined to decide whether § 506(b) applied in this case, and found that the make-whole claim amount was reasonable (to the extent that § 506(b) applied) because the amount of the fee was not "plainly disproportionate" to the lender's probable loss." Id. at 9-10.

4. Make-Whole Payment Was Not a Claim for Unmatured Interest. The committee also alleged that the make-whole claim should be disallowed under § 502(b)(2) of the Code as a claim for "unmatured interest." The Code does not define "unmatured interest"; but courts have explained that interest is unmatured when it has not been earned as of the petition date. See In re United Artists Theatre Co., 406 B.R. 643, 651 (Bankr. D. Del. 2009); In re U.S. Lines Inc., 199 B.R. 476, 481 (Bankr. S.D.N.Y. 1996). Here, the make-whole claim became due when the liquidity covenant was breached, which occurred more than a month before the debtors filed their Chapter 11 petitions. The court agreed with Judge Shannon's recent decision in In re Trico Marine Services, 450 B.R. 474 (Bankr. D. Del. 2011), adopting the majority view that make-whole premiums are more akin to allowable liquidated damage claims rather than unmatured interest disallowed under § 502(b). School Specialty, slip op. at 10-11.

Observation

The School Specialty decision is consistent with the general trend of allowing make-whole claims[3] when, as here: (i) the contractual entitlement is clear and unambiguous; (ii) the stipulated amount is not plainly disproportionate to the lender's potential loss; and (iii) the contract was the product of an arms-length negotiation.

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For additional analysis of the treatment of make-whole claims by bankruptcy courts, see David M. Hillman and Lawrence S. Goldberg, "Treatment of 'Make-Whole' and 'No-Call' Provisions by Bankruptcy Courts," 7 Pratt's J. Bankr. L. 195 (2011); and David M. Hillman and Karen S. Park, "Recovery of 'Make-Whole' Premiums: Importance of Clear Drafting in In re AMR Corporation," The Bankr. Strategist (forthcoming May 2013).

[1] The parties originally stated the make-whole premium was more than $25 million (approximately 37 percent of the outstanding term loan balance of $67 million). The premium, however, was subsequently reduced to $23.7 million. Despite the reduction, the court continued to refer to the make-whole premium as 37 percent of the term loan.

[2] After finding that Bayside received its bargained-for yield and the term loan had been the product of arms-length negotiations, the court also rejected the Committee's argument that Bayside had a duty to mitigate its damages because "a valid liquidated damages claims obviates the duty to mitigate." Id. at 11.

[3] Earlier this year, the U.S. Bankruptcy Court for the Southern District of New York added to the debate by denying bondholders the right to payment of a make-whole premium in connection with the debtor's refinancing of the bond debt. U.S. Bank Trust Nat'l Ass'n v. American Airlines, Inc. (In re AMR Corp.), 485 B.R. 279 (Bankr. S.D.N.Y. Jan. 17, 2013) ("AMR Corp."). Although the court denied allowance of the make-whole premium, its decision was based entirely on contractual interpretation and expressly held that "there is no dispute that make whole amounts are permissible." Id. at 303.