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Recovery of Make-Whole Premiums

The Importance of Clear Drafting: In re AMR Corp.

By David M. Hillman and Karen S. Park

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 considerable judicial debate over the past number of years, with some courts allowing recovery and others denying it. 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.*).

While the decision does not canvass, much less resolve, the myriad legal issues related to this topic, it does highlight the significant role that drafting plays in determining a lender's entitlement to a make-whole premium. 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." *AMR Corp.*, at 303.

Make-Whole Premiums

In General

A make-whole premium (also referred to as prepayment premium) is a contractual obligation often contained in bond indentures. It requires a borrower to pay a sum certain in the event the borrower elects to prepay or redeem the debt before its stated maturity. The make-whole amount is generally intended to act as a liquidated damages clause and to provide a formula for determining what amount the borrower must pay in exchange for the right to prepay its debt prior to the stated maturity date. *See, e.g., In re Trico Marine Servs.*, 450 B.R. 474, 480 (Bankr. D. Del. 2011). Make-whole amounts are generally intended to ensure that a lender receives the benefit of its bargain for interest payments. *AMR Corp.*, 285 B.R. at 285 n.3 (citing *HSBC Bank USA v. Calpine Corp.*, 2010 WL 3835200, at *4, 2010 U.S. Dist. Lexis 96792, at *14 (S.D.N.Y 2010); *In re Solutia, Inc.*, 379 B.R. 473, 485 n.7, 488 (Bankr. S.D.N.Y 1007)). The entitlement to the make-whole amount, and the amount of any such payment, is a matter of contract. *Id.*

Facts

American Airlines, Inc. (American) and its affiliated debtors (collectively, the Debtors) filed for Chapter 11 on Nov. 29, 2011. *AMR Corp.*, 485 B.R. at 284. Before the bankruptcy, American had entered into three separate financing transactions (collectively, the Prepetition Financing), each of which was secured by a discrete aircraft pool. *Id.* The aggregate debt was approximately $1.3 billion. *Id.* at 286. The indentures governing the Prepetition Financing (the Indentures) provided that a bankruptcy filing constituted an "event of default," which, in turn, resulted in automatic debt acceleration without any further action by any party. *Id.* at 284. The Indentures expressly provided that a make-whole amount (the Make-Whole Amount) was not required to be paid upon an event of default resulting from a bankruptcy filing. *Id.* at 285-86. Separately, the Indentures permitted American to voluntarily redeem the notes only if it, among other things, paid the Make-Whole Amount. *Id.* at 285.

Nearly a year into the bankruptcy case, the Debtors sought court approval to obtain new post-petition financing in the amount of $1.5 billion, the proceeds of which would be used to repay the Prepetition Financing. *Id.* at 286-87. The Debtors admitted that the purpose of the new financing was to take advantage of the low interest rates and other favorable market conditions. *Id.*

The interest savings alone were estimated to be in excess of $200 million. *Id.* The trustee under the indentures objected and argued that the Debtors' early redemption required it to pay the Make-Whole Amount. *Id.* The Debtors countered that their bankruptcy filing had triggered an event of default under the Indentures that resulted in an automatic acceleration that did not contractually require payment of the Make-Whole Amount pursuant to Section 4.02(a)(i) of the Indentures. *Id.*

The Court's Ruling

The court held that, under the plain language of the Indentures, the Debtors were not required to pay the Make-Whole Amount. *Id.* at 290. The court reasoned that the Indentures provided that the filing of the bankruptcy petition constituted an event of default and that, under Section 4.02(a)(i), such default automatically resulted in acceleration of the debt. *Id.* Section 4.02(a)(i), the court held, further provided that the Debtors were "not required to pay any Make-Whole Amount where there [had] been such a default and

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David M. Hillman is a partner at Schulte Roth & Zabel LLP, where he practices in the area of corporate restructuring and creditors' rights litigation. **Karen S. Park** is a senior associate in the business reorganization group at the firm.

resulting acceleration." *Id*. The court's conclusion was also based upon additional language in the Indentures. *Id*.

Specifically, Section 3.03 of the Indentures provided that "[n]o Make-Whole Amount shall be payable on the … Notes as a consequence of or in connection with an Event of Default or the acceleration of the … Notes." *Id*. The court held that the broad language of Section 3.03 clearly "cover[ed] the situation at hand" which involved both an event of default and acceleration. *Id*.

The court rejected each of the trustees' arguments.

1. No Automatic Acceleration

The trustee argued that acceleration (by virtue of the Chapter 11 filing) was not automatic because the trustee had not affirmatively accelerated the obligations. *Id*. The court found, however, that this position was not supported by the language of the Indentures. *Id*. That is, under Section 4.02(a)(i), the unpaid principal amount of the notes, along with accrued but unpaid interest, automatically became due and owing upon the bankruptcy filing. *Id*. at 291.

2. No Right to Waive Default

The trustee also argued that it had the option to waive the default and decelerate the debt. *Id*. at 294. The court disagreed and held that "a deceleration of these notes would have the effect of assessing the Debtors with a Make-Whole not currently owed under the Indentures, and thwart the Debtors' reliance on the Indentures as written." *Id*. The court further held that a lifting of the automatic stay to permit the lender to decelerate would be inappropriate. *Id*. at 295-96.

3. No Voluntary Redemption After Acceleration

The trustee argued that the Make-Whole Amount was due because underlying events should be viewed as a "voluntary redemption" under Section 2.11 of the Indentures (which required payment of the Make-Whole Amount) and not a "post-maturity date repayment" (which does not require payment of the Make-Whole Amount). *Id*. at 298.

In support of this argument, the trustee argued that, under New York law, a borrower could not repay an obligation prior to the stated maturity date unless permitted to do so under the governing contract. *Id*. The court disagreed and noted the difference between a "prepayment" and a post-maturity date "repayment." *Id*. (citing *In re Solutia*, 379 B.R. 473, 488 (Bankr. S.D.N.Y. 2007)). Because the amounts due (and the maturity date) had been accelerated as a result of the bankruptcy filing, any repayment by the Debtors would not be a prepayment, which can only occur prior to the maturity date. *AMR Corp*. at 298.

4. Estoppel

Finally, the trustee asserted that the Debtors' position was inconsistent with its prior election under section 1110 of the Bankruptcy Code. *Id*. at 304. Section 1110 of the Bankruptcy Code grants special rights to an aircraft financing lender. Generally, if a debtor elects to keep the aircraft on which the secured lender has a lien, then the debtor must, among other things, cure all non-bankruptcy defaults and perform under the relevant contract within 60 days of the bankruptcy filing. *Id*. 304-306; *see also* 11 U.S.C. 1110. While the Debtors had elected to perform under the Indentures, the court held that that election did not "constitute a permanent commitment on the part of a debtor to permanently bind itself to the terms of a contract." *AMR Corp*. at 306.

The court also held that the Debtors were not required by Section 1110 to cure the bankruptcy default under the Indentures. *Id*. Accordingly, the court found in favor of the Debtors and held that the Make-Whole Amount was not required by paid to the noteholders. At press time, the bankruptcy court's decision was on appeal.

Practical Obsewrvations

There are many obstacles to payment of a make-whole premium. First and foremost, a debtor's obligation to pay a make-whole premium is a question of contractual interpretation. Thus, unambiguous drafting is absolutely critical. The court in *AMR Corp*. made clear that its decision was a "matter of contract, not policy," stating:

> If the parties wished for the Make-Whole Amount to be due in these circumstances, they could have bargained for such a provision. Instead, the parties bargained for the exact opposite result, with the Indentures stating clearly, explicitly and unambiguously that the Make-Whole Amount is not due in the event of payment following acceleration.

Id. at 303-304. *See also id*. at 285 n.3 ("[T]he entitlement to a Make-Whole Amount — and the amount of any such payment — are a matter of contract.") (internal citations omitted).

To maximize the odds of recovering a make-whole premium in a bankruptcy case, lenders should: 1) avoid any contractual ambiguity on the circumstances giving rise to the payment of the make-whole amount; 2) expressly require payment of the make-whole amount if at any time the debt is repaid for any reason before the stated maturity; 3) use separate defined terms for "stated maturity" (which should be a fixed date) and "maturity" (which might occur before the stated maturity by reason of acceleration); and 4) if at all possible under the circumstances, trigger the contractual right to payment of the make-whole amount before the borrower files bankruptcy.

Schulte Roth&Zabel

Schulte Roth & Zabel LLP
919 Third Avenue, New York, NY 10022
212.756.2000 tel | 212.593.5955 fax | www.srz.com
New York | Washington DC | London