ALERTS

Fifth Circuit Holds Mere Acceleration Does Not Trigger Prepayment Premium

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The U.S. Court of Appeals for the Fifth Circuit held on Jan. 27, 2014 that a lender's acceleration due to a borrower's payment default did not trigger a prepayment premium. *In re Denver Merchandise Mart, Inc.*, 2014 WL 291920, *1 (5th Cir. Jan. 27, 2014) ("Denver Merchandise"). Affirming the lower courts' application of state law, the court held that "the plain language of the contract does not require the payment of the Prepayment Consideration in the event of mere acceleration." *Id.* at *5.

Relevance

Prepayment premiums, also known as "make-whole" provisions, are routinely challenged in bankruptcy cases. *Denver Merchandise* is consistent with other rulings that have refused to approve prepayment premiums when debt instruments lacked the right language. *See*, e.g., *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. 2013), *aff'd* 730 F. 3d 88 (2d Cir. 2013) (denying payment of a make-whole premium in connection with debtor's refinancing of bond debt based on the language of the governing indenture); *HSBC Bank USA, N.A. v. Calpine Corp. (In re Calpine Corp.)*, 2010 WL 3835200, at *4 (S.D.N.Y. Sept. 15, 2010) (after reviewing debt instruments, district court agreed with bankruptcy court that lenders not entitled to make-whole premiums; plain language of debt instruments did not provide for payment of premiums after acceleration); *Premier Entm't Biloxi, LLC v. U.S. Bank N.A. (In re Premier Entm't Biloxi LLC)*, 445 B.R. 582, 625-27 (Bankr. S.D. Miss. 2010) (trust indenture provided for automatic acceleration of notes upon bankruptcy default; noteholders had no

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contractual right to prepayment premium); *In re Solutia, Inc.*, 379 B.R. 473, 485 n.7 (Bankr. S.D.N.Y. 2007) (when indenture provided for automatic acceleration upon filing of Chapter 11 petition but was silent as to whether any make-whole amount would be payable on acceleration, court refused to "read into agreements between sophisticated parties provisions that are not there;" *held*, no make-whole amount due).

Facts

One of the debtors in *Denver Merchandise* signed a note (the "Note") in 1997 in favor of a lender (the "Lender"). *Id.* at *1. The Note included an acceleration clause, providing that if required payment "is not paid prior to the tenth (10th) day after the date when due or on the Maturity Date or on the happening of any other default," certain sums become immediately due and payable, including the principal balance, interest, default interest, plus "all other moneys agreed or provided to be paid by Borrower in this Note, the Security Instrument or the Other Security Documents." *Id.* Additionally, the Note included a prepayment premium, pursuant to which the Borrower could prepay the Note under certain circumstances with a required "Prepayment Consideration, which is essentially a penalty for prepayment." *Id.*

By October 2010, the debtor-noteholder stopped making payments on the Note and defaulted. *Id.* The Lender issued a notice of default that the debtor failed to cure. The Lender then obtained an *ex parte* state court order appointing a receiver, but the debtor then filed a Chapter 11 petition, owing the Lender approximately $24 million. *Id.* In addition to principal and interest, the Lender claimed the debtor owed a $1.8 million prepayment premium, despite the debtor's nonpayment of the Note prior to maturity. *Id.*

The Lower Courts

The bankruptcy court allowed the Lender's $25 million secured claim, but disallowed the asserted prepayment premium claim. It reasoned that: (1) some pre-maturity payment must be made to trigger the prepayment premium; (2) the rationale for a prepayment premium did not apply; (3) other courts allowed the premium only when the acceleration clause specifically provided for the premium, which was not the case here; and (4) it would have been "easy" for the Lender to have provided for a

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premium in the event of acceleration. *Id.* The district court affirmed the bankruptcy court. *Id.* at *2.

The Reasoning of the Court of Appeals

The Fifth Circuit looked to applicable Colorado law to interpret the Note. *Id.* at *2. Contrary to other jurisdictions, a prepayment penalty does not constitute liquidated damages under Colorado law, and is not subject to the rules of reasonableness for liquidated damages. *Id.* at *3 (*citingPlanned Pethood Plus, Inc. v. KeyCorp, Inc.*, 228 P.3d 262, 264-65 (Colo.App.2010)). *But see In re School Specialty Inc.*, 2013 WL 1838513 at *2 (Bankr. D. Del. 2013) (in New York, "prepayment provisions…are analyzed under the standards applicable to liquidated damages."); *In re Trico Marine Servs.*, Inc., 450 B.R. 474, 480-81 (Bankr. D. Del. 2011) (noting that "the substantial majority of courts considering this issue have concluded that make-whole or prepayment obligations are in the nature of liquidated damages"). Prepayment penalties also do not trigger application of Bankruptcy Code § 506(b), which places reasonableness restrictions on the allowance of an oversecured creditor's claims for "fees, costs, or charges." *Id.* Therefore, "[p]arties are free to contract however they wish around these general rules." *Id.*

The Fifth Circuit then looked to the language of the Note in *Denver Merchandise*, noting that ordinarily "a lender's choice to accelerate acts as a waiver of the right to a prepayment penalty." *Id.* at *3. It found that "the plain language contemplates an actual prepayment [to trigger the prepayment premium], which did not occur here." *Id.* at *5. Thus, as a matter of contract interpretation, the "language of the contract does not require the payment of the [prepayment premium] in the event of mere acceleration" and "no [prepayment premium] is owed unless there is an actual prepayment, whether voluntary or involuntary." *Id.*

Comment

Unlike other contested prepayment premium cases, *Denver Merchandise Mart* did not turn on whether the prepayment premium was enforceable under state law or under the Bankruptcy Code. *See,* e.g.*, In re Ridgewood Apts.,* 174 B.R. 712, 721 (Bankr. S.D. Ohio 1994) (make-whole premiums not allowed under section 502(b)(2))*; see also United Merchs. & Mfrs. v. Equitable Life Assurance Soc'y of the U.S.* (*In re United Merchs. & Mfrs.*), 674 F.2d 134, 141 (2d. Cir. 1982) (bankruptcy court must look to state law to

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determine validity of a damage clause in contract). Instead, like *UPS Capital Bus. Credit v. Gencarelli (In re Gencarelli)*, 501 F. 3d 1 (1st Cir. 2007), the reasonableness requirement of Bankruptcy Code § 506(b) was inapplicable; "the bankruptcy rule is that where there is a contractual provision, valid under state law…the bankruptcy court will enforce [it]." *In re Gencarelli*, 501 F. 3d at 7 (*citing Debentureholders Protective Comm. of Cont'l Inv. Corp. v. Cont'l Inv. Corp.*, 679 F.2d 264, 269 (1st Cir.1982)).

Denver Merchandise Mart confirms the importance of careful drafting. No language in the operative documents explicitly deemed prepayment to have been made in the event of acceleration, but, as the court noted, it would not be "difficult to achieve that goal." *Id.* at *5 (*citing In re CP Holdings, Inc.*, 332 B.R. 380, 382 (Bankr. W.D. Miss. 2005) ("if the …[lender] accelerates the whole or any part of the principal sum…[borrower] agrees to pay a prepayment premium"). Other courts agree. *See AMR Corp.*, 485 B.R. at 287 (denying payment of make-whole premium under plain language of indenture precluding payment "where a bankruptcy default… has triggered an automatic acceleration of the amounts due … 'without Make–Whole Amount.'"), *aff'd* 730 F. 3d 88 (2d Cir. 2013); *Premier Entm't Biloxi LLC*, 445 B.R. at 627 (Bankr. S.D. Miss. 2010) ("[P]repayment penalties are not allowed when a loan is paid after default and acceleration unless clear contract language requires it") (internal citations and quotation marks omitted); *Solutia*, 379 B.R. at 488 (disallowing noteholders' claims for prepayment premiums for debtors' post-acceleration repayment because noteholders failed to provide for any post-acceleration "yield maintenance"). Furthermore, as suggested by two recent decisions, a court's willingness to find in favor of a lender's right to recover a make-whole premium will be bolstered by clear and unambiguous language in the governing documents. *See School Specialty* 2013 WL 1838513 (Bankr. D. Del. 2013) (approving make-whole premium after finding that credit agreement provided for such payment); *In re GMX Resources, Inc.*, No 13-11456 (Bankr. W.D. Okla Aug. 27, 2013) (lenders' claim properly included make-whole premium based on language of the governing credit agreement).

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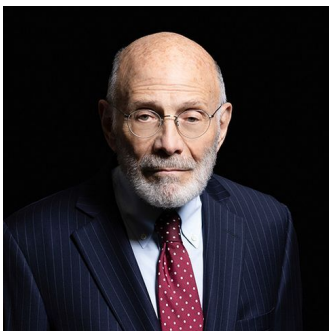

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