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Bankruptcy Advisory

Another Court Rules That Availability of Make-Whole Premiums in Bankruptcy Depends on Governing Documents

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BY KEVIN J. WALSH AND ERIC R. BLYTHE

In a recent bench decision in *In re MPM Silicones, LLC et al.*, Case No. 14-22503-RDD (Bankr. S.D.N.Y. August 26, 2014), the Bankruptcy Court considered bondholders' right to recover make-whole premiums (premiums paid for early repayment of debt) upon the payment of accelerated debt following the borrower's bankruptcy default. The Court ruled that the governing loan documents lacked specific language requiring a make-whole premium upon acceleration.

When a borrower repays a loan prior to the maturity date, a lender loses future, unaccrued interest payments. Lenders on prepayable loans typically include provisions designed to mitigate prepayment risk by requiring that the borrower pay a fee upon prepayment. A make-whole premium is a category of prepayment fee designed to protect lenders from prepayment at a time when interest rates have fallen relative to those in effect on the date of the original loan. A make-whole premium is generally sized at the present value, at a stated discount rate, of the difference in remaining interest payable to the maturity date and the interest that would be received over the same period at the reinvestment rates available on the prepayment date. However, loan documents generally do not specify that a make-whole premium applies if the lender demands repayment from the borrower upon default.

MPM is the latest reported case in which lenders have sought recovery of a make-whole premium upon a payment acceleration initiated automatically under terms of the applicable documents by a borrower's bankruptcy filing. Courts reviewing this issue have consistently looked to the terms of the loan documents to determine whether a lender is entitled to the make-whole premium in such circumstances or whether the borrower is free to refinance the debt at a lower rate without paying the premium.

In *MPM*, the debtor's reorganization plan contemplated the issuance of replacement bonds to repay two groups of senior bondholders (the "Senior Holders") in the event the Senior Holders voted against the plan (which they did, though they have since moved to change their vote). The proposed replacement bonds would repay Senior Holders their outstanding principal, but not any make-whole premium, and would have a reduced interest rate. The Senior Holders argued they were entitled to receive make-whole premiums (the "Premium") on their bonds (the "Bonds") as a result of the debtor's use of the automatic acceleration of the Bonds upon the filing of the bankruptcy case to pay the Bonds prior to their stated maturity date.

The first question the Court addressed was whether the bankruptcy default and acceleration constituted an optional early redemption by the debtor, or an acceleration by the Senior Holders. The Court concluded that the general rule (under applicable New York law), subject to certain exceptions discussed below, is that if a lender accelerates the balance of a loan, it is not entitled to a prepayment premium. The indenture for both Bond issuances (the "Indentures") allowed the debtor to redeem the Bonds, at its option, prior to October 15, 2015. The Premium was owed if the debtor exercised this call right. However, the Indentures also provided that upon the debtor's bankruptcy, the Bonds automatically accelerated such that all principal and accrued interest became immediately due and payable. The *MPM* Court explained that the Indentures made clear that upon the debtor's bankruptcy, acceleration was automatic, not optional – the debtor had no choice in the matter. The Court noted that the Second Circuit previously had ruled that such an automatic acceleration provision cannot be considered a voluntary prepayment on the debtor's part. Therefore, the Bonds were not voluntarily prepaid by the debtor, but rather were effectively accelerated by the Senior Holders under the terms

Kevin J. Walsh, *Member*

Eric R. Blythe, *Associate*

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of the loan documents.

Upon concluding that the Bonds were effectively accelerated by the Senior Holders, the Court noted two exceptions to the general rule that make-whole premiums are not payable upon a lender's acceleration: 1) when a debtor intentionally defaults to evade a prepayment premium, and 2) when a clear and unambiguous clause in the governing documents provides for a premium even in the event of a lender's acceleration. The first exception did not apply based on the facts of this case. Examination of the Indentures was required to determine if the second exception applied.

The Court found that the Indentures lacked the specificity needed to enforce a claim for the Premium upon automatic acceleration. The Court explained that the loan documents had to include explicit terms that 1) required payment of the Premium upon the automatic acceleration of the loan on account of the bankruptcy filing, or that 2) required the borrower to pay the Premium whenever the debt was repaid prior to its original maturity. Because the Court found that the Indentures did not contain any such terms, the Premium was not allowed as part of the Senior Holders' claim.

The Senior Holders' further attempts to convince the Court that the Premium should be allowed were also ineffective. The Senior Holders argued 1) that the Indenture provision that allowed the debtor to redeem the Bonds, at its option, prior to October 15, 2015 entitled the Senior Holders to the Premium upon any repayment prior to that date (the Court disagreed); 2) that the disclosures in the Bond prospectus failed to disclose the risk that, upon bankruptcy, no Premium would be owed (the Court noted that many bankruptcy risks were not disclosed); 3) that the Senior Holders could rescind the automatic acceleration, and thereby the acceleration's adverse effect on their entitlement to the Premium (the Court ruled that the automatic stay applied to sending an acceleration rescission notice that would trigger a prepayment penalty, and denied relief from stay); and 4) as a subset of argument three, that sending the rescission notice would be liquidating a securities contract pursuant to Section 555 of the Bankruptcy Code (the Court ruled that it was unlikely that the Indentures were securities contracts, and that the Senior Holders were attempting to create a different claim as opposed to fixing a claim that existed on the petition date, so Section 555 was not applicable).

The *MPM* Court's decision does not appear to be inconsistent with other Second Circuit precedents and decisions from other jurisdictions. These decisions do not hold that payment of a make-whole premium is *per se* barred upon a bankruptcy filing and a related contractual acceleration, but they do require clear and unambiguous language in the debt documents that the make-whole provision applies in such circumstances.

If you have any questions about this advisory or its implications, please call your principal Mintz Levin attorney or one of the attorneys noted on this advisory.

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