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JOURNAL
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# The Enforceability of Make-Whole Premiums in Bankruptcy

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Loan documents often contain provisions that require borrowers to pay an additional fee, known as a make-whole or prepayment premium, to the extent that they pay their debt in full prior to the loan's maturity date. This additional fee is intended to "compensate the lender [for] the loss of anticipated interest" or "yield that was expected at the time they made their loans."[1]

To determine whether the additional fee is collectible in bankruptcy, courts typically conduct a multi-pronged inquiry into whether it (1) has been triggered by the loan agreement, (2) is enforceable under applicable state law, and (3) is allowed under applicable bankruptcy law.[2] Despite the consistent framework, the Second, Third, Fifth and Ninth Circuits have, in some instances, issued conflicting decisions on the enforceability of prepayment premiums. However, generally, most courts will enforce prepayment premiums in bankruptcy if the loan document explicitly requires it or if the borrower is deemed a solvent chapter 11 debtor.

## Analytical Framework

### Was the Make-Whole Provision Triggered?

As a threshold matter, courts look to the terms of the loan agreement to determine whether the prepayment premium was triggered.[3] However, many loan agreements are unclear about what constitutes a prepayment. For example, a borrower's bankruptcy filing constitutes an event of default that automatically accelerates the loan's maturity date to the date of default, thus technically obligating the borrower to "prepay" the loan prior to the original maturity date. Whether an additional fee is triggered under these and similar circumstances is largely dependent on three factors: (1) what constitutes an "event of default"; (2) whether acceleration of the loan's original maturity date is deemed voluntary or involuntary; and (3) how the make-whole provision ties into the "maturity," "redemption" or "prepayment" definitions in the loan documents.

For example, the Second and Third Circuits are split on (1) whether a prepayment premium is triggered by the automatic acceleration of debt caused by a bankruptcy filing; (2) what constitutes a "voluntary" redemption; and (3) whether a redemption and a prepayment are distinct.[4] The Ninth Circuit Bankruptcy Appellate Panel (BAP) has aligned with the Third Circuit.[5] Notwithstanding the circuit splits, courts are more likely to allow the additional fee if the debt instrument clearly describes all of the events of default that obligate a borrower to prepay the loan.

### Is the Prepayment Premium Enforceable Under State Law?

Assuming that a debt instrument is clear about what a prepayment is, the next inquiry is whether the prepayment premium is enforceable under applicable state law.[6] Most make-whole provisions are analyzed as liquidated damages, which state law typically enforces if (1) actual damages were difficult to determine at the time the agreement was drafted, and (2) the additional fee is not plainly disproportionate to the possible loss. The enforceability of prepayment premiums under every state's liquidated damages law is beyond the scope of this article.

1 *See In re Chemtura Corp.*, 439 B.R. 561, 596 (Bankr. S.D.N.Y. 2010).
2 *Id.* at 600, 602.
3 *Id.* at 600.
4 *See generally Matter of MPM Silicones LLC*, 874 F.3d 787 (2d Cir. 2017) (*Momentive II*); *In re Energy Future Holdings Corp.*, 842 F.3d 247 (3d Cir. 2016).
5 *See generally In re Imperial Coronado Partners Ltd.*, 96 B.R. 997 (B.A.P. 9th Cir. 1989).
6 *Chemtura*, 439 B.R. at 600-01.

### Is the Prepayment Premium Enforceable Under Bankruptcy Law?

If prepayment premiums are enforceable under applicable state law, courts will next determine whether they are enforceable under the Bankruptcy Code.[7] Courts have looked to two Code provisions: (1) § 502(b)(2), which prohibits the payment of unmatured interest;[8] and (2) § 506(b), which allows secured claims to include post-petition "interest" and "fees, costs, or charges," provided they are "reasonable" and called for under the agreement or state statute under which the claim arose.[9]

The convergence of §§ 502(b) and 506(b) has split courts on the characteristics — and actual accrual dates — of make-whole premiums. First, courts have considered whether make-whole provisions are proxies for unmatured interest, which is disallowed under § 502(b)(2).[10] Although the Code does not define "unmatured interest," some courts have defined it to include make-whole provisions because they arguably compensate lenders for the loss of future "interest" payments resulting from the earlier payment of "unmatured" debt.[11] However, most courts view claims for prepayment premiums as liquidated damages "charges," which fully mature once triggered by the prepayment.[12] Those courts analyze make-whole claims under the reasonableness standard in § 506(b).[13] If the prepayment fee is triggered by a pre-petition acceleration of the loan's maturity date as opposed to a post-petition voluntary prepayment, some courts will forgo the "reasonableness" analysis under § 506(b), which is reserved for post-petition fees and charges, and instead enforce the fee as long as it is enforceable under applicable state law.[14]

Determining whether a prepayment premium is enforceable following the reinstatement of a defaulted loan in bankruptcy implicates another Code provision.[15] Under § 1124(2), a debtor has the right to deaccelerate (or reinstate) a loan in its reorganization plan.[16] A plan that reinstates debt generally must compensate the lender for any damages caused by reasonable reliance on its contractual right to accelerate.[17] Courts have not ruled out the possibility that reasonable reliance damages may include prepayment premiums,[18] but some lower courts have held that a make-whole premium is not owed following reinstatement.[19]

## State of the Law

The circuits that have addressed the enforceability of prepayment premiums in bankruptcy have issued conflicting decisions and used varying analyses. The Second Circuit began the trend of courts relying on the debt instrument's specific contractual language in determining the enforceability of a make-whole provision,[20] followed by the Third and Ninth Circuit BAPs, despite them not presuming the enforceability of such provisions. The Second and Third Circuits differed regarding (1) whether a prepayment premium survives the automatic acceleration of debt caused by a bankruptcy filing, (2) what constitutes a "voluntary" redemption, and (3) whether a redemption and a prepayment are distinguishable.[21] On the other hand, the Fifth Circuit recently held that make-whole premiums are unmatured interest and disallowed under § 502(b)(2), although the judicially created "solvent-debtor exception" can operate to suspend disallowance of a creditor's claim for a make-whole premium.[22]

### Second Circuit

In the Second Circuit, prepayment premiums are generally unenforceable following the automatic acceleration of a debt that is triggered solely by a bankruptcy filing, unless the debt instrument clearly provides otherwise.[23] Thus, parties can contract around that general rule by explicitly providing that the make-whole premium is not disallowed due to the existence of an automatic acceleration clause or that the borrower is required to pay a make-whole premium whenever it repays debt prior to the original maturity date.[24]

In *In re AMR Corp.*, the debtor paid its debt in full using post-petition financing, and the lender argued for the enforcement of the make-whole provision.[25] The Second Circuit concluded that because the indenture was "explicit" and "unambiguous" in providing that no make-whole premium would be due following the automatic acceleration of a debt due to a voluntary bankruptcy filing, the debtor was not required to pay a prepayment premium.[26]

The court relied on the indenture's "plain" language, which allowed a make-whole if the debtor voluntarily redeemed the debt but disallowed it if the lender accelerated the debt or the borrower filed a voluntary bankruptcy petition.[27] In addition, the court held that the debtor's payment could not be considered a "voluntary prepayment," because acceleration advanced the maturity date such that the debtor's payment actually occurred *after* the new maturity date.[28]

In *In re MPM Silicones LLC* (*Momentive II*), the Second Circuit then affirmed that unless there is explicit language stating otherwise, a make-whole provision is unenforceable following the automatic acceleration of a debt.[29] The notes contained optional redemption clauses providing for the payment of a make-whole premium if the debtor "redeemed" the notes "*at its option*" prior to maturity.[30] One year before the

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7 *Id.* at 604.
8 11 U.S.C. § 502(b)(2).
9 11 U.S.C. § 506(b).
10 Some courts have suggested that there may be an exception for solvent debtors that allows claims for unmatured interest for both secured and unsecured creditors. *See In re Ultra Petroleum Corp.*, 51 F.4th 138, 156 (5th Cir. 2022); *Chemtura*, 439 B.R. at 604-06 ("[The] Bankruptcy Code's prohibition against the payment of unmatured interest is irrelevant when the debtor is solvent.").
11 *See Chemtura*, 439 B.R. at 604.
12 *See In re Trico Marine Servs. Inc.*, 450 B.R. 474, 480-81 (Bankr. D. Del. 2011) ("Research reveals that the substantial majority of courts considering this issue have concluded that make-whole or prepayment obligations are in the nature of liquidated damages rather than unmatured interest, whereas courts taking a contrary approach are distinctly in the minority.").
13 *See* 11 U.S.C. § 506(b); *see, e.g., In re Vanderveer Estates Holdings Inc.*, 283 B.R. 122 (Bankr. E.D.N.Y. 2002).
14 *See, e.g., In re School Specialty Inc.*, 2013 WL 1838513 (Bankr. D. Del. 2013) (prepayment premium was not subject to reasonableness analysis under § 506(b) because it was pre-petition fee).
15 *See* 11 U.S.C. § 1124(2).
16 *Id.*
17 11 U.S.C. § 1124(2)(C).
18 *See In re Skyler Ridge*, 80 B.R. 500, 509 (Bankr. C.D. Cal. 1987).
19 *See In re EP Energy Corp.*, Case No. 19-35654 (Bankr. S.D. Tex. March 6, 2020) (Plan Confirm. Hrg. Tr. at 18-20), ECF No. 1025; *see also In re Mallinckrodt PLC*, No. 20-12522 (Bankr. D. Del. Nov. 5, 2021) (Plan Confirm. Hrg. Tr. (Day 4) at 108-09), ECF No. 5220.
20 *See In re AMR Corp.*, 730 F.3d 88 (2d Cir. 2013).
21 *See generally Momentive II*, 874 F.3d 787 (2d Cir. 2017); *Energy Future Holdings*, 842 F.3d 247 (3d Cir. 2016).
22 *In re Ultra Petroleum Corp.*, 51 F.4th at 156.
23 *Momentive II*, 874 F.3d at 801-02.
24 *See In re MPM Silicones LLC*, 2014 WL 4436335, at *15 (Bankr. S.D.N.Y. Sept. 9, 2014) (*Momentive I*); *see, e.g., In re 1141 Realty Owner LLC*, 598 B.R. 534, 541 (Bankr. S.D.N.Y. 2019) (enforcing make-whole premium where provision explicitly stated that it would be due "in connection with any payment made after an event of default, not just a prepayment").
25 *Id.* at 96.
26 *AMR*, 730 F.3d at 98-100, 112.
27 *See id.* at 93, n.8, 99-100.
28 *See id.* at 103-04 (emphasis in original).
29 *Momentive II*, 874 F.3d at 802.
30 *Id.* (emphasis added).

original maturity date, the debtors issued replacement notes pursuant to their bankruptcy plan, so the noteholders accelerated the debt and argued for the make-whole payment.[31]

The court concluded that "a payment made mandatory by operation of an automatic acceleration clause is not one made at [the debtors'] option."[32] The court also rejected the noteholders' attempt to distinguish AMR's "prepayment" from a "redemption" by clarifying that "the plain meaning" of redemption is to repay a debt "*at or before* maturity."[33] Because the acceleration advanced the maturity date, the court concluded that the debtors' payment was a "*post*-maturity payment."[34] In holding that a make-whole premium, whether labeled a "prepayment" or "redemption," was unenforceable following acceleration absent explicit language to the contrary, the Second Circuit created a split with the Third Circuit.[35]

### Third Circuit

In the Third Circuit, there is a general presumption of enforceability of prepayment premiums in bankruptcy, unless the debt instrument clearly provides otherwise.[36] In *In re Energy Future Holdings Corp.*, the Third Circuit enforced a make-whole claim almost identical to the one in *Momentive II* because, contrary to the Second Circuit, it found that a debtor's decision to file for bankruptcy is a voluntary act, and that unless "clearly state[d]," automatic acceleration does not impact the analysis of whether a make-whole provision is triggered.[37] Two notes were at issue, both of which had make-whole provisions with language providing for the payment of an "Applicable Premium" if the debtors "redeem[ed]" the debt.[38] Both notes also contained acceleration provisions, but the first note provided that "all outstanding notes [would] be immediately due and payable if [the debtor] filed for bankruptcy," while the second note only provided that the payment of a "premium, if any" would be required.[39]

In holding that both make-whole provisions were triggered, the court found that the debtors "redeem[ed]" their debt because, contrary to the Second Circuit,[40] the court deemed redemption to include "both pre- and post-maturity repayments of debt."[41] The court also determined that the debtors' redemption was "optional" because they filed for bankruptcy "voluntarily" to refinance their debt, and they had the *option* to reinstate the original maturity date.[42] Finally, the court rejected *Momentive I*'s holding that a bankruptcy-caused acceleration cannot trigger a make-whole payment, reasoning that a premium tied to a redemption would be unaffected by the acceleration of a debt's maturity.[43]

### Ninth Circuit

In the Ninth Circuit, the BAP found that prepayment premiums can be enforceable upon acceleration due to a bankruptcy filing.[44] In *In re Imperial Coronado Partners*, the court concluded that a prepayment premium was enforceable, despite the note being accelerated by the debtor's bankruptcy filing, because the debtor "voluntarily" repaid its debt.[45] The note's prepayment clause provided that the debtor "*may* prepay this note" in exchange for "a charge … equal to six months interest on the amount of each *prepayment*."[46]

The court focused only on the voluntary nature of the repayment. Because the provision used the word "may," the court found that provision to be "clearly permissive in nature" and thus only enforceable if the prepayment was voluntary. The court, like the Third Circuit, concluded that the debtor's decision to pay off the loan was voluntary because it had the right to reinstate or deaccelerate the loan, but chose not to do so.[47] The court held that because the debtor's choice led to the acceleration, the advanced maturity date was irrelevant. The prepayment premium was deemed "clearly a 'charge provided for under the agreement'" and, thus, subject to the reasonableness standard under § 506(b).[48]

## Conclusion

Although nuanced in their analyses, bankruptcy courts will generally enforce prepayment premiums if loan documents explicitly require it or if the borrower is a solvent debtor, provided that the premium is not unenforceable under applicable state law. Therefore, practitioners should be careful in drafting loan documents to ensure that the parties' contractual intent is clearly memorialized. abi

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31 *Id.* at 787, 801-02.
32 *Id.* at 803.
33 *Id.* (emphasis added).
34 *Id.* (emphasis added).
35 *Id.*; *Energy Future Holdings*, 842 F.3d at 255, 257-58.
36 *See Energy*, 842 F.3d at 260; *see also In re Hertz Corp.*, 637 B.R. 781, 788-89 (Bankr. D. Del. 2021) (enforcing payment of make-whole premium for note that required it "prior to the Stated Maturity," defined as original maturity date, but not enforcing payment for note that required payment "prior to maturity").
37 *See Energy Future Holdings*, 842 F.3d at 255, 260.
38 *Id.* at 254.
39 *Id.* at 251.
40 *See Momentive II*, 874 F.3d at 803.
41 *See Energy Future Holdings*, 842 F.3d at 255.
42 *Id.*
43 *See id.* at 259-260.
44 *See Imperial*, 96 B.R. at 1000.
45 *Id.*
46 *Id.* at 999 (emphasis added).
47 *Id.* at 1000.
48 *See id.*