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Bankruptcy ADVISORY ■

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# Prepayment Premium Claims Disallowed by Bankruptcy Courts

Recent case law reminds practitioners and lenders to pay careful attention when drafting prepayment premium provisions in debt instruments or risk having the premiums disallowed in a borrower's bankruptcy case. The trend emerging from courts interpreting prepayment provisions in bankruptcy is to read those provisions narrowly and disallow claims for prepayment premiums absent ***explicit*** contractual language mandating payment following acceleration by the lender.[1] Courts disallowing these claims carefully scrutinize the language of the prepayment premium and acceleration provisions, underscoring the importance of precise drafting.

## Background

Debt instruments often contain provisions requiring the payment of prepayment premiums upon the borrower's early redemption of debt. These provisions protect lenders from the lost stream of interest payments originally contemplated by the terms of the instrument. Prepayment premiums typically take one of three forms: 1) "no-call" provisions, where a debtor is prohibited from early repayment; 2) yield maintenance fees, where the fee is based on a formula approximating the actual loss to the creditor; and 3) fixed-rate fees, which are typically either a predetermined figure or a percentage of the outstanding principal balance.[2] Although these provisions are routinely allowed outside of bankruptcy, the enforceability of these provisions in bankruptcy has proved uncertain.

As a general rule, although courts routinely recognize that prepayment/yield-maintenance premiums are valid and enforceable, these same courts often conclude that the right to them is forfeited when the debt is accelerated

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1 *See, e.g., In re MPM Silicones, LLC* (*In re Momentive*) 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014*); HSBC Bank USA, N.A. v. Calpine Corp.* (*In re Calpine Corp.*), 2010 WL 3835200 (S.D.N.Y. 2010) (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) (noteholders had no contractual right to prepayment premium under language of indenture); *In re Solutia, Inc.,* 379 B.R. 473, 485 n.7 (Bankr. S.D.N.Y. 2007) (court refused to "[read] into agreements between sophisticated parties provisions that are not there" where indenture was silent as to whether prepayment premiums would be payable on acceleration).

2 For a detailed discussion of the different types of fees, see Scott K. Charles & Emil A. Kleinhaus, *Prepayment Clauses in Bankruptcy,* 15 Am. Bankr. Inst. L. Rev. 537, 541 (Winter 2007).

by the lender.[3] This rule logically follows from the effect of acceleration, which is to advance the maturity date of a debt. Any post-acceleration payment would not precede the new maturity date and thus would not be an *early* voluntary repayment. The two recognized exceptions to this rule are 1) when a borrower intentionally defaults to accelerate the debt and avoid a prepayment premium and 2) when "a clear and unambiguous clause calls for the payment of a prepayment premium or make-whole even in the event of acceleration of, or the establishment of a new maturity date for, the debt."[4]

## Recent Significant Cases

### *Denver Merchandise Mart*

In *In re Denver Merchandise Mart, Inc.*,[5] the Court of Appeals for the Fifth Circuit affirmed a bankruptcy court ruling disallowing a $1.8 million prepayment premium claim. The court concluded that the mere prepetition acceleration of a $30 million note, without an actual prepayment by the borrower, did not trigger payment of a prepayment premium in the absence of a clear and unambiguous contractual provision providing for payment upon acceleration.

Under the terms of the note, the borrower's default accelerated the debt's maturity date, requiring payment of principal, interest and all other sums required under the note. In the event of a "Default Prepayment," the borrower owed "the entire Debt, including, without limitation, the Prepayment Consideration."[6] "Default Prepayment" was defined as "a *prepayment* of the principal amount of this Note *made* during the continuance of any Event of Default or after an acceleration of the Maturity Date under any circumstances. . . ."[7] The premium was due whether the prepayment was deemed "voluntary or involuntary (including without limitation in connection with Lender's acceleration of the unpaid principal balance of the Note). . . ."[8]

The bankruptcy court concluded that the language of these provisions made payment of the prepayment premium contingent on a prepayment by the borrower. Because the borrower-debtor had not attempted to make any payment, the court disallowed the lender's claim for the prepayment premium. The Fifth Circuit affirmed the decision, concluding that "there is no language in the Note which would *deem* the prepayment to have been made in the event of acceleration. . . ."[9] The court further admonished the lender, noting that "It is not difficult to achieve that goal."[10]

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3 *See In re Momentive, LLC,* 2014 WL 4436335 at *12 (applying New York law).

4 *Id.* at *13 (applying New York Law); *Bank of New York Mellon v. GC Merchandise Mart, LLC (In re Denver Merchandise Mart, Inc.)*, 740 F.3d 1052, 1056 (5th Cir. 2014).

5 740 F.3d 1052 (5th Cir. 2014).

6 *Id.* at 1057.

7 *Id.* at 1057-58 (italics in the original).

8 *Id.* at 1058.

9 *Id.* at 1058-59 (italics in the original).

10 *Id.*

As an example of language that might have sufficed to allow the claim, the court quoted approvingly language from *In re CP Holdings, Inc.*[11] In that case, the provision stated that, "The undersigned [borrower] agrees that if the holder of this Note [lender] accelerates the whole or any part of the principal sum . . . the undersigned waives any right to prepay said principal sum in whole or in part without premium *and agrees to pay a prepayment premium*."[12]

***AMR (American Airlines)***

In *U.S. Bank Trust National Association v. AMR Corporation* (*In re AMR*),[13] the Court of Appeals for the Second Circuit disallowed a claim for prepayment premiums, concluding it was prohibited by the language of an indenture and that post-maturity redemption could not constitute a prepayment.

The debtor in that case defaulted on debt and then sought to repay it in bankruptcy using postpetition financing. The terms of the *AMR* indenture made the filing of a bankruptcy petition an event of default triggering acceleration of the debt. The indenture also specifically provided that a "make-whole" payment would not be due if the debt had been accelerated due to default. Because the premium payment was not triggered by the acceleration and default, the lender argued that it instead was triggered by the borrower's repayment of the debt in bankruptcy prior to the original maturity date.

The court relied on the terms of the acceleration clause, which advanced the maturity of the debt, in concluding that any post-acceleration payment could not, by definition, be a prepayment.[14] Because the prepayment provision did not specify that the premium was due if prepayment was made prior to the *original* maturity date, the debtor's proposed post-acceleration payment did not trigger payment of the prepayment premium.

***In re MPM Silicones***

Recently, in *In re MPM Silicones, LLC*,[15] the bankruptcy court for the Southern District of New York interpreted an indenture under the "well-settled law" of the state that denies a lender a prepayment premium unless it is clearly and specifically provided for in a debt instrument. There, an indenture provided that notes redeemed prior to a date certain (the maturity date) were subject to a premium for their prepayment.[16] The indenture did not, however, specifically make the premium due upon acceleration but provided that the borrower's bankruptcy accelerated "the principal of, *premium, if any*, and interest on all the Notes."[17] The lender argued that this language specifically implicated payment of the prepayment premium upon acceleration.

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11 332 B.R. 380, 382 (Bankr. W.D. Mo. 2005).

12 740 F.3d at 1059 (italics in the original).

13 730 F.3d 88 (2d Cir. 2013).

14 *Id.* at 104.

15 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014).

16 *Id.* at *14.

17 *Id.* at *15 (italics added).

The court concluded that the "premium, if any" language lacked the specificity required for a prepayment premium to be payable post-acceleration. The court considered prepayment premiums an allocation of risk between parties that "must be specific if the parties want it to apply even after acceleration of the debt."[18] The court stated that the lenders could have included a provision that either explicitly recognized that the prepayment premium would be payable notwithstanding acceleration of the loan or a provision requiring the borrower to pay the premium whenever the debt is paid prior to the original maturity date.[19]

## Conclusion

In these recent cases, the courts have disallowed prepayment premiums in bankruptcy based on interpretation of the relevant contractual provisions. Failure to specifically and unambiguously provide for the payment of these premiums upon acceleration may cost a lender the bargained for premium. The cases suggest that making the premium due upon payment prior to the *original* maturity date may suffice to protect this right. However, a provision making the payment due upon acceleration may be more prudent in protecting the lender when no payment is made.

The following language may protect lenders from losing the rights to these premiums in bankruptcy:

> The automatic or declared acceleration of the debt pursuant to the Loan Agreement constitutes an involuntary prepayment for which the Yield Maintenance Premium provided for herein shall be due and payable. Thus, notwithstanding the automatic acceleration of the debt in accordance with the Loan Agreement, the outstanding amount due and owing under the loan shall include the unpaid principal hereof, together with accrued interest, outstanding default interest, and the Yield Maintenance Premium. For the avoidance of doubt, the Yield Maintenance Premium shall be due and owing if following an acceleration of the debt, (i) the Borrower tenders payment (voluntarily or involuntarily), (ii) the Lender obtains a recovery through an exercise of remedies or otherwise, or (c) the Loan is satisfied as a result of a foreclosure sale, deed in lieu, or by any other means.

This provision is merely an example provided to add clarity and does not constitute legal advice. Alston & Bird's Bankruptcy Group can help craft language more specifically tailored to the needs of individual lenders.

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[18] *Id.*

[19] *Id.*

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