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NEW YORK BANKRUPTCY COURT AFFIRMS ENFORCEABILITY OF WELL-DRAFTED MAKE-WHOLE PROVISION AGAINST BANKRUPT DEBTOR IN IN RE 1411 REALTY OWNER, LLC

To Our Clients and Friends:

A recent bankruptcy court decision from the Southern District of New York held that a make-whole premium in a loan agreement was enforceable against a bankrupt borrower, notwithstanding the Second Circuit's 2017 decision in *Momentive*. The bankruptcy court held that, while make-whole premiums contingent on "prepayment" of a loan are presumed not to be triggered by a payment after acceleration of the underlying debt, because such a payment is not a prepayment, parties can—and in this case, did—contract around that rule with clear and unambiguous language stating that the premium is payable even if the debt is paid before the original maturity date as the result of acceleration.

State of the Law Concerning the Enforceability of Make-Whole Provisions

In negotiating loan agreements or note indentures, lenders frequently insist on including provisions for the payment of make-whole premiums, sometimes styled as "prepayment premiums," "redemption premiums," or "yield maintenance premiums." These types of provisions are designed to compensate lenders for the loss of future interest payments if and when borrowers repay their debts prior to the relevant debt instrument's agreed-upon maturity date. Likewise, they insure that lenders will not lose the benefit of their bargain if circumstances prevent them from redeploying the principal on similarly advantageous terms—for example, if prevailing interest rates have declined. Accordingly, courts generally treat make-wholes as liquidated damages provisions, which, under New York law, are enforceable according to their terms provided that the premium is not "plainly or grossly disproportionate to the [lender's] probable loss." *JMD Holding Corp. v. Cong. Fin. Corp.*, 4 N.Y.3d 373, 380 (2005).

Make-whole provisions vary in the language they use to describe the event that triggers a premium—for example, one loan agreement might refer to "prepayment" of a debt, and another an "optional redemption." Accordingly, courts have reached differing conclusions about whether they are enforceable against borrowers who have filed for bankruptcy, an event that typically triggers a default and automatic acceleration of the underlying debt. In a 2013 decision, the Second Circuit held that, since acceleration moves the maturity date forward to the date of the bankruptcy filing, any subsequent payment would not trigger the "voluntary prepayment" clause at issue in that case, as "prepayment can only occur *prior* to the maturity date." *In re AMR Corp.*, 730 F.3d 88, 103 (2d Cir. 2013) (emphasis added). By contrast, in its 2016 decision in *In re Energy Future Holdings Corp.*, the Third Circuit held that certain second-lien secured noteholders were entitled to an "optional redemption" premium following the borrower's bankruptcy, reasoning that (1) as opposed to "prepayment," "redemption"

encompasses both pre- and post-maturity repayments of a debt; and (2) the debtor's redemption of the accelerated notes was "optional," since it could have reinstated the notes with their original maturity date pursuant to the Bankruptcy Code, but chose not to do so. 824 F.3d 247, 254 (3d Cir. 2016).

The Second Circuit had the occasion to re-visit the enforceability of make-whole provisions in *In re MPM Silicones, LLC* ("*Momentive*"), holding that a make-whole provision—which permitted the debtor to "redeem" certain notes "at its option" in return for payment of a premium—was not triggered by a post-bankruptcy repayment of the notes. 874 F.3d 787, 801–2 (2d Cir. 2017). Applying the same reasoning as in *AMR*, the Second Circuit held that, where a default results in acceleration, changing the date of the notes' maturity, any repayment was neither a "prepayment" nor "optional," since the obligation to redeem the notes arose automatically by operation of the acceleration clauses." *Id.* at 802–3. In so doing, the Second Circuit appeared to reject the distinction between "prepayment" and "redemption" made by the Third Circuit and, instead, noted that the "plain meaning of the term 'redeem' is to 'repay[ ] . . . a debt security . . . at or before maturity.'" *Id.* at 803 (citations omitted).

***1141 Realty Owner, LLC* Confirms That Well-Drafted Make-Whole Provisions May Still Be Enforced**

Despite construing make-whole provisions strictly against lenders, neither *AMR* nor *Momentive*appeared to preclude lenders from enforcing contractual language that explicitly provides for payment of a make-whole premium upon acceleration of a debt. For instance, the *AMR* decision cited with approval an unpublished 2010 district court opinion that held that the parties to a loan agreement "*could have* provided for the payment of premiums in the event of payment pursuant to acceleration." *See AMR*, 730 F.3d at 104 (citing *HSBC Bank USA, Nat'l Ass'n v. Calpine Corp.*, No. 07–cv–3088, 2010 WL 3835200 (S.D.N.Y. Sep. 15, 2010) (emphasis added). That proposition, however, remained untested until Judge Bernstein's March 18 opinion in *In re 1441 Realty Owner, LLC*, which was the first issued by a bankruptcy court in the Second Circuit to rule on the enforceability of a make-whole provision since *Momentive.*

The dispute in *1441 Realty Owner, LLC* arose in the context of the bankruptcy of the owner of the Flatiron Hotel, a 62-room property encumbered by a mortgage loan with outstanding principal of approximately $24.2 million. No. 18-12341 (SMB), 2019 WL 1270818, at *1 (Bankr. S.D.N.Y. Mar. 18, 2019). The Loan Agreement—entered into in 2015, several years after the Second Circuit's decision in *AMR*—defined the Maturity Date for the loan as May 6, 2025 "*or such other date* on which the final payment of the principal of the Note becomes due and payable as therein or herein provided, *whether at such stated maturity date, by declaration or acceleration,* or otherwise." *Id.*(emphasis in original). The Loan Agreement also provided that "[i]f, following an Event of Default […] payment of all or any part of the Debt is tendered by Borrower or otherwise recovered by Lender, such tender or recovery *shall be deemed a voluntary prepayment by Borrower* in violation of the prohibition against prepayment set forth in Section 2.3.1 and Borrower shall pay, in addition to the Debt, (i) an amount equal to the *Yield Maintenance Default Premium* …." *Id.*(emphasis in original).

In September 2017, after the hotel owner (the "Debtor") failed to maintain valid and effective liquor licenses for the hotel—an event of default under the Loan Agreement—the holder of the mortgage,

Wilmington Trust, N.A., declared a default and elected to accelerate and demand repayment of the outstanding indebtedness, plus accrued interest and "all other sums due under the Loan Documents." *Id.* at *2. After the Debtor filed for bankruptcy in July 2018, Wilmington Trust filed a proof of claim for $32,048,285, which included $3,108,096.78 attributed to the Yield Maintenance Default Premium. *Id.*

Relying on the Second Circuit's decisions in *Momentive* and *AMR*, the Debtor argued that the premium must be disallowed because Wilmington Trust had accelerated the debt. *Id.* at *2, *5. The Debtor contended that courts "will only uphold prepayment premiums after acceleration where the applicable loan agreement expressly provides that the premium is due following an acceleration" and noted that "the word 'acceleration' is 'conspicuously absent' from the relevant provision of the Loan Agreement." *Id.* at *3 (quoting Debtor's Reply at ¶ 12, 16).

Wilmington Trust responded that the premium was payable under the unambiguous terms of the Loan Agreement, which, unlike the agreements at issue in *AMR* and *Momentive*, provided that the premium would be triggered by *any* post-default payment, which includes post-acceleration payments. *Id.* at *2. The bankruptcy court agreed, holding that, while the Second Circuit has indeed held that "[g]enerally, a lender that accelerates a loan following a default forfeits the right to a prepayment premium," *id.* at *4, nevertheless "parties can and here did contract around the general rule," *id.* at *5. In holding that the Loan Agreement was unambiguous that the make-whole premium would be payable post-acceleration, the bankruptcy court noted that, insofar a note agreement "deemed" a repayment made pursuant to a lender's exercise of remedies to be a "prepayment" that would trigger a make-whole provision, the absence of a specific reference to acceleration was "irrelevant." *1141 Realty Owner, LLC*, 2019 WL 1270818 at *5 (citing *In re AE Hotel Venture*, 321 B.R. 209, 218–19 (Bankr. N.D. Ill. 2005)).[1]

Lessons for Lenders and Debtors from *1141 Realty Owner, LLC*

Judge Bernstein's opinion in *1141 Realty Owner, LLC* holds that neither *AMR* nor *Momentive* created a *per se* rule barring the enforceability of make-whole provisions following the acceleration of a debt in the Second Circuit. As the court noted, a lender's rights in any given case "depend on the terms of [the relevant agreement], not upon the wholly different agreements in [*Momentive*] and *AMR*." *1141 Realty Owner, LLC*, 2019 WL 1270818 at *5. Likewise, while the burden remains on lenders to draft clear agreements that protect their rights to make-whole premiums post-acceleration, there are no mandatory "magic words"; rather, "parties can provide for their rights with any language that plainly conveys their intent." *Id.* at *6. Nevertheless, lenders would be well-advised to be as explicit as possible, since a debtor in bankruptcy facing liability for a multimillion-dollar make-whole as well as junior creditors have strong incentives to contest the matter where there is any ambiguity in the underlying agreement.

Likewise, debtors should think twice before assuming that a bankruptcy filing in the Southern District of New York will allow them to avoid incurring a hefty make-whole premium in a credit agreement or note indenture. Notably, however, the Debtor in *1141 Realty Owner, LLC* did not raise the arguments addressed in the Fifth Circuit's recent opinion in *In re Ultra Petroleum Corporation*, which suggested that a make-whole premium constituted "unmatured interest" that a creditor is barred from recovering

under section 502(b)(2) of the Bankruptcy Code. *In re Ultra Petroleum Corp.*, 913 F.3d 533, 547–548 (5th Cir. 2019).

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[1] Having decided the main issue of contract interpretation, the court went on to hold that Loan Agreement's Yield Maintenance Default Premium was an enforceable liquidated damages clause under New York law, noting that the "[t]he party seeking to avoid the liquidated damages clause bears the burden of proving that it is [an unenforceable] penalty," and that the Debtor "gave short shrift" to this issue, raising it only once in a footnote. *Id.* at **4–5.

Gibson, Dunn & Crutcher's lawyers are available to assist with any questions you may have regarding these issues. For further information, please contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's Business Restructuring and Reorganization practice group, or any of the following:

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