

Lien on Me

BY ELAN A. GERSHONI AND TALLY M. WIENER

Acceleration and Prepayment Fees



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Interest-bearing promissory notes and bond indentures typically contain a number of provisions that protect a lender from the consequences of a borrower's nonpayment or early repayment. Acceleration clauses provide that upon the borrower's default, the lender may unilaterally accelerate the entire outstanding indebtedness to be immediately due. In other words, if the borrower defaults on its obligations, it immediately owes the entire amount of the unpaid debt, even though the subject loan was not set to mature until a later date. Other provisions protect lenders' rights when borrowers wish to prepay, such as no-call clauses, which forbid prepayment, and prepayment or make-whole clauses, which allow a borrower to prepay its obligations for a fee.

Until recently, there was scant published case law analyzing the enforceability and interplay of no-call, prepayment, and acceleration clauses in the context of bankruptcy cases. Over the past few years, however, a body of case law has developed that clarifies parties' rights under these provisions. Before analyzing the recent guidance given by the U.S. Courts of Appeals for the Second and Fifth Circuits, we provide an overview of enforcement issues arising in bankruptcy.

Enforceability and Damages for Breach of No-Call Provisions

Specific Enforceability of No-Call Provisions

In order to protect their expected profit from a loan, lenders might include no-call provisions in lending documents that prevent a borrower from prepaying its obligations. Borrowers who find it economically efficient to prepay their debts have fought to have these provisions found to be not specifically enforceable. In *Calpine*,¹ the U.S. District Court for the Southern District of New York affirmed the bankruptcy court's determination that no-call provisions are not enforceable in bankruptcy cases.

The debtors had issued multiple series of secured notes containing no-call provisions prohibiting repayment prior to April 1, 2007. They initiated bankruptcy cases in late 2005, and in early 2007 sought to incur post-petition financing to prematurely refinance the subject obligations. The noteholders objected to early repayment on the basis that it violated the no-call provision.

Ultimately, the district court held that no-call provisions are not specifically enforceable in bankruptcy cases and that borrowers are entitled to prematurely repay their obligations despite any prohibitions in the lending documents.

Damages for Breach of No-Call Provisions

After affirming the bankruptcy court's decision that no-call provisions are not specifically enforceable in bankruptcy cases, the next issue before the *Calpine* court was whether the noteholders were entitled to any monetary damages for the borrowers' prepayment and contractual breach. In reversing the bankruptcy court, the district court held that the noteholders were not entitled to any monetary damages for breach of the no-call provision. The court reasoned that any damages for breach of a no-call provision are essentially claims for unmatured interest, which are not allowable in bankruptcy cases pursuant to § 502(b)(2) of the Bankruptcy Code.

To the contrary, in *Premier Entertainment Biloxi*,² the U.S. Bankruptcy Court for the Southern District of Mississippi held that noteholders and bondholders are entitled to unsecured claims for breach of contract damages when a debtor breaches a no-call provision, even if the no-call provision is not specifically enforceable. The court elaborated that "the nonbreaching party is not deprived of a monetary remedy just because no-call provisions are not subject to the remedy of specific performance in bankruptcy cases." The court ultimately awarded the lenders their "actual damages," calculated as the difference, at the time that the debt was repaid, between the present value of the expected interest payments at the contract rate and the market rate, plus post-payment interest at the federal rate.

Enforcement of Prepayment Provisions in Bankruptcy Cases

Unlike no-call provisions, prepayment clauses authorize a borrower to prematurely repay its outstanding obligations in exchange for paying a fee. Determining whether these fees are future interest payments, liquidated damages or something else is particularly important in the bankruptcy context as it could determine whether they are allowable at all. As previously discussed, the dis-

1 *HSBC Bank USA, Nat'l Ass'n v. Calpine Corp. (In re Calpine)*, 2010 WL 3835200 (S.D.N.Y. 2010); *aff'd In re Calpine Corp.*, 365 B.R. 392 (Bankr. S.D.N.Y. 2007).

2 *Premier Entertainment Biloxi LLC v. U.S. Bank Nat'l Ass'n (In re Premier Entertainment Biloxi LLC)*, 2010 WL 3504105 (Bankr. S.D. Miss. 2010).

tion is significant because to the extent that a court determines that prepayment fees are claims for unmatured interest, they are not allowable.

In *Trico Marine*,³ the U.S. Bankruptcy Court for the District of Delaware held that prepayment fees should be construed as liquidated damages and not as unmatured interest. In adopting the majority position, Hon. **Brendan Linehan Shannon** reasoned that prepayment fee obligations are fully matured obligations pursuant to a contract. Stated differently, since the fee becomes payable at the time of the prepayment, any such fee is not “interest” merely because it might be based on calculations of expected future interest.

Similarly, in *School Specialty*,⁴ the U.S. Bankruptcy Court for the District of Delaware held that prepayment fees are a form of liquidated damages. In that case, the creditors’ committee had objected to a lender’s claim for a prepayment fee, arguing that it was an unenforceable penalty and was actually a claim for unmatured interest. The lender responded that the fee was not a penalty, but was instead liquidated damages calculated to compensate it for the expected value of future interest payments. Hon. **Kevin J. Carey** concluded that “prepayment provisions and early termination fees are analyzed under the standards applicable to liquidated damages,” and that a liquidated damages provision is enforceable when actual damages are difficult to determine and the sum stipulated is not “plainly disproportionate” to the possible loss. Judge Carey also warned that courts should be hesitant to interfere with parties’ agreements. After determining that the liquidated damages provision was enforceable, the court also determined that regardless of whether the reasonableness requirement of § 506(b) of the Bankruptcy Code applies, the fee was reasonable and the payment was not disallowable as unmatured interest.

Intersection of Acceleration and Prepayment Provisions

Last year, the U.S. Court of Appeals for the Second Circuit analyzed whether a lender is entitled to a prepayment fee after the underlying debt is accelerated due to the borrower’s bankruptcy filing in the *American Airlines* bankruptcy case.⁵ The subject indentures provided that the outstanding indebtedness was accelerated upon the borrower’s bankruptcy filing. However, the indentures also contained a clause that specifically excluded the entitlement to a prepayment fee when the underlying debt was accelerated due to a bankruptcy filing. In affirming the lower courts’ decisions, the Second Circuit relied on this contractual exclusion to hold that the debtor could redeem the bonds without paying the prepayment fee.

The U.S. Court of Appeals for the Fifth Circuit Court also recently weighed in on the construction of acceleration and prepayment clauses. In *Denver Merchandise*,⁶ the court ratified the principle that a lender’s entitlement

to a prepayment premium upon acceleration of a debt is to be determined by the express language of the underlying loan documents. In *Denver Merchandise*, the debtor executed a promissory note containing both acceleration and prepayment clauses. The acceleration clause provided that upon the borrower’s failure to make any required payment within 10 days of its due date, the entire principal balance, interest, default interest, “other sums, as provided in this Note,” and “all other moneys agreed or provided to be paid by Borrower in this Note” were immediately due and payable. The note also contained a prepayment clause that, in pertinent part, provided that the borrower could prepay its outstanding obligation on the condition that it paid a “prepayment consideration.” The clause also stated that the prepayment consideration was due “whether the prepayment is voluntary or involuntary (including ... in connection with [the] Lender’s acceleration of the unpaid balance of the Note).”

Lenders must pay close attention to acceleration and make-whole clauses in their loan documents to ensure that they clearly and unambiguously contemplate and protect their expected economic interests — or risk having any ambiguity interpreted against them.

After the borrower initiated a bankruptcy case, the lender filed a proof of claim seeking the entire outstanding balance under the loan, based on acceleration, plus the prepayment fee. The debtor objected to the claim to the extent that it included the prepayment fee, arguing that the fee was only payable upon an actual prepayment and that, in any event, the fee was not payable if prepayment was due to acceleration. The lender asserted that taken together, the acceleration and prepayment clauses entitled the lender to a prepayment fee upon acceleration. The district court affirmed the bankruptcy court’s decision to sustain the debtor’s objection.

On appeal, the U.S. Court of Appeals for the Fifth Circuit stated that the issue before it was a “straightforward question of contract interpretation.” The court began its analysis with the principle that parties are free to expressly provide in any lending instrument for which a borrower is obligated for a prepayment fee upon the acceleration of the underlying indebtedness. The court held that absent such an express provision, “a lender’s choice to accelerate acts as a waiver of the right to a prepayment fee,” with the exception that a court may impose the prepayment fee if the borrower defaults to avoid additional interest.

After reviewing the note with a focus on the terms of the acceleration and prepayment clauses, the court determined

³ *In re Trico Marine Servs. Inc.*, 450 B.R. 474 (Bankr. D. Del. 2011).

⁴ *In re School Specialty Inc.*, 13-10125 (KJC), 2013 WL 1838513 (Bankr. D. Del. 2013).

⁵ *U.S. Bank Trust Nat’l Ass’n v. AMR Corp.* (In re AMR Corp.), 2013 WL 4840474, 730 F.3d 88 (2d Cir. 2013).

⁶ *Bank of New York Mellon v. GC Merchandise Mart LLC* (In re Denver Merchandise Mart Inc.), 740 F.3d 1052 (5th Cir. 2014).

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that the prepayment fee was not owed because the fee was only payable upon an actual prepayment (there was no payment after acceleration here) and because the note did not contain language that “would deem *the* prepayment to have been made in the event of acceleration for any reason.” In emphasizing the latter rationale, the court compared contractual language providing that “[t]he [borrower] agrees that if the [lender] accelerates the ... principal sum ... the [borrower] waives any right to prepay said principal sum ... without premium *and agrees to pay a prepayment premium.*” Ultimately, the court held that a lender waives its right to a prepayment fee when it accelerates a borrower’s obligations under the note, absent an express provision that the fee is payable upon acceleration.

Takeaways

Courts are eschewing *per se* rules that prepayment fees are or are not owed upon acceleration of an underlying debt and are instead focusing on the express terms of the loan

documents to make those determinations. Absent carefully crafted contractual provisions stating that prepayment fees are due upon acceleration, regardless of whether the acceleration is caused by a bankruptcy filing or other default, a court is unlikely to determine that a prepayment fee is owed.

To protect their right to collect make-whole premiums, lenders would be well advised to craft loan documents that expressly require the payment of a prepayment fee any time an outstanding obligation is repaid before the maturity date, and that spell out in specific and unambiguous language the triggers for a prepayment fee, including in the event of acceleration and regardless of whether the borrower makes any payment pursuant thereto. In addition, lenders can preserve their rights to prepayment fees by timely satisfying conditions precedent. Lenders must pay close attention to acceleration and make-whole clauses in their loan documents to ensure that they clearly and unambiguously contemplate and protect their expected economic interests — or risk having any ambiguity interpreted against them. **abi**

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