Playing for Profit: The Bondholder's Playbook

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The Role of the Trust Indenture Act in Workouts and Bankruptcy:

Marblegate Asset Mgmt. v. Educ. Mgmt. Corp., 2014 WL 7399041 (S.D.N.Y. Dec. 30, 2014)

The Southern District of New York held that a proposed out-of-court debt restructuring that would have the practical effect of depriving nonconsenting noteholders of meaningful payment likely violated section 316 of the Trust Indenture Act ("TIA"). Nonetheless, the district court denied the motion of two plaintiff-hedge funds that held unsecured notes for a preliminary injunction, because the plaintiffs did not establish that they would suffer irreparable harm or that the equities supported an injunction.

Education Management LLC ("Issuer"), together with its affiliates (collectively, "EDMC") operate for-profit colleges in the United States. At the time of the opinion, Issuer had outstanding over $1.5 billion in debt, including over $1.3 billion in secured debt and approximately $217 million in unsecured notes governed by an indenture; payment of the notes was guaranteed by Issuer's corporate parent ("Parent"). In May 2014, EDMC announced publicly that it was experiencing significant financial distress and would be unable to comply with certain financial covenants under the secured credit facility. Notably, EDMC could not file a bankruptcy petition without losing federal funding necessary to its operations.

With the cooperation of its secured lenders (which collectively also held the vast majority of the unsecured notes), EDMC developed an out-of-court restructuring plan, pursuant to which Issuer would transfer all of its assets to a newly-formed affiliate, and Issuer's creditors would exchange their existing debt for a smaller amount of new debt and equity issued by that affiliate (collectively, the "Restructuring"). The proposed Restructuring would have also stripped the Parent's guaranty from the unsecured notes. Thus, while nonconsenting noteholders would still have their legal claims against the Issuer, the practical effect of the Restructuring was to eliminate their ability to recover their principal and remaining interest payments.

The Restructuring was supported by nearly all of Issuer's creditors except for two hedge funds that owned collectively approximately $20 million in unsecured notes. These funds (together, "Plaintiffs") sued EDMC, alleging that the Restructuring violated Section 316(b) of the TIA, which provides:

> Notwithstanding any other provision of the indenture to be qualified, the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such indenture security, or to institute suit for the enforcement of any such payment on or after such respective dates, shall not be impaired or affected without the consent of such holder[.]

Plaintiffs filed a motion to enjoin the Restructuring, which was opposed both by EDMC and by a group of secured creditors. The relevant test in the Second Circuit required the Plaintiffs to establish four elements to prevail on their motion for a preliminary injunction: (i) a likelihood of irreparable harm, (ii) either a likelihood of success on the merits or sufficiently serious questions as to the merits plus a balance of hardships that tips decidedly in their favor, (iii) that the balance of hardships tips in their favor regardless of the likelihood of success, and (iv) that an injunction is in the public interest. Of these factors, irreparable harm is the most critical and, as the court noted, "[i]n the absence of a showing of irreparable harm, a motion for a preliminary injunction should be denied."

The court concluded that the Plaintiffs did not establish a likelihood of irreparable harm for reasons including that the Plaintiffs were unlikely to recover any meaningful value on their notes even if the Restructuring were enjoined and, if the Plaintiffs prevailed on the merits of their claim that the removal of the Parent's guaranty violated the TIA, they could demand payment from the Parent, which was solvent. The court also stated that if the Restructuring violated the TIA by rendering the Issuer insolvent, "broad principles of veil-piercing would enable the Court to facilitate a demand for payment from EDMC wherever within its corporate structure assets happen to be located." 2015 WL 7399041, at *13.

The balance of harms did not favor the Plaintiffs, the court concluded, because the Plaintiffs, which held just $20 million in debt, were threatening to upset "a painstakingly negotiated $1.5 billion debt restructuring, one which the overwhelming majority of creditors support," which could result in "the end of a company valued . . . at $1.05 billion." The court also determined that the public interest did not favor the Plaintiffs because an injunction threatened to jeopardize EDMC's future and harm its students, employees, and alumni.

While the court determined that the Plaintiffs' motion seeking a preliminary injunction could not be granted due to their inability to demonstrate irreparable harm or that the equities and the public interest favored an injunction, the court considered "the merits of Plaintiffs' claims in the hopes of providing clarity for subsequent litigation in this and other cases." *Id*. at *15. Noting a general lack of authority interpreting TIA claims, the court quoted the legislative history to the TIA, in which both the House and Senate described Section 316(b) in 1939 as preventing "[e]vasion of judicial scrutiny of the fairness of debt-readjustment plans." Citing case law and commentaries, the court stated that "Section 316(b) was intended to force bond restructurings into bankruptcy where unanimous consent could not be obtained." *Id*. at *18. This purpose would not be served, the court found, if "Section 316(b) is limited to preventing formal majority modification of an indenture's payment term." By contrast, the TIA's purpose would be served by protecting individual holders' rights when a majority agrees to modifications that "effect an involuntary debt restructuring." The court explained, "where a debt reorganization that seeks to involuntarily disinherit the dissenting minority is brought about by a majority vote, that violates the fundamental purpose of the Trust Indenture Act." *Id*. at *19.

The court found "little question that the [Restructuring] is precisely the type of debt reorganization that the Trust Indenture Act is designed to preclude," and explained that "the mechanism by which the [Restructuring] is to be carried out operates, in context, to effect a complete impairment of dissenters' right to receive payment." *Id*. at *20. The court concluded that, "whatever the ultimate cost to EDMC, its creditors, its employees, and its students, the Trust Indenture Act simply does not allow the company to precipitate a debt reorganization outside the bankruptcy process to effectively eliminate the rights of nonconsenting bondholders." *Id*. at *21.

***MeehanCombs Global Credit Opp. Funds, LP v. Caesars Entertainment Corp.*, 2015 WL 221055 (S.D.N.Y. Jan. 15, 2015)**

The Southern District of New York holds that the Trust Indenture Act (TIA) protects nonconsenting bondholders' practical ability to receive payment of principal and interest, rather than merely their legal right to payment, and refuses to dismiss a complaint brought by noteholders against the issuing corporation and its parent guarantor. The action alleged that an amendment of the governing indentures that released of the parent guaranty, and which was agreed to by only a simple majority of the noteholders, violated the TIA and breached the indentures, as well as the implied covenant of good faith and fair dealing. The court further holds that the no-action clauses in the indentures do not bar claims under the TIA or to enforce payment of the debt and guaranties.

The plaintiff noteholders held certain of the notes issued by Caesars Entertainment Operating Co. Inc. ("CEOC") and guaranteed by its parent company Caesars Entertainment Corp. ("CEC," and, together with CEOC, "Caesars"). The governing indentures each included unconditional guaranties by CEC and provisions prohibiting CEOC from divesting its assets.

In August 2014, a majority of noteholders were offered the opportunity to sell their notes for par, in exchange for first agreeing to amend the indenture (the "Amendments"). The plaintiffs were excluded from participating in the buyout and thus did not support the Amendments. The Amendments removed the parent guarantee and made it easier for CEOC to transfer its assets. Thus, the plaintiff noteholders were left only with claims against CEOC, which was divesting its assets and was laden with debt well in excess of its assets.

The noteholders alleged that the Amendments were a nonconsensual change to their payment rights and affected their practical ability to recover payment, which violated the section 316 of the TIA, the indentures, and the implied covenant of good faith and fair dealing. The defendants moved to dismiss the complaints. Thereafter, an involuntary chapter 11 petition was filed against CEOC, staying the action as against it, but not as against the non-debtor parent CEC.

The district court concluded that the noteholders sufficiently stated a claim under section 316 of the TIA to survive the motion to dismiss. Section 316 of the TIA mandates that a noteholder's right to receive payment of the principal and interest shall not be impaired or affected without the consent of such noteholder. As result of section 316(b), a company cannot—outside of bankruptcy—alter its obligation to pay bonds without the consent of each bondholder.

CEC argued that the Amendments did not alter CEOC's obligation to make payments when due. Rather, all the Amendments did was release the parent guaranty and make it easier for CEOC to divest its assets. CEOC was still legally bound to pay the entire debt owing to the plaintiff noteholders. The court, however, rejected CEC's narrow reading of the TIA, citing *Marblegate Asset Mgmt. v. Education Mgmt. Corp.*, 2014 WL 7399041 (S.D.N.Y. Dec. 30, 2014), and *Federated Strategic Income Fund v. Mechala Grp. Jam. Ltd.*, 1999 WL 993648 (S.D.N.Y. Nov. 2, 1999), for the proposition that the TIA should be interpreted more broadly and should not be read to permit noteholders to be left with an empty right to assert a payment default from an insolvent issuer.

CEC attempted to distinguish *Education Management* on the grounds that CEOC was going into bankruptcy, and thus the Amendments were not a true out-of-court debt restructuring. The district court, however, found this argument unavailing because, had the CEC guarantees not been improperly removed, CEOC's filing would have had no impact on CEC's liability under the guaranties.

The court also rejected CEC's argument that the plaintiff noteholders could not pursue their suit because of "no action" clauses in the indentures. No-action clauses generally require individual bondholders to satisfy conditions precedent before initiating suit to enforce the indenture, including having the holders of a minimum percentage make demand upon the indenture trustee. However, the district court explained that when a claim is brought under the TIA, section 316(b) preempts inconsistent indenture provisions, including no-action clauses, and thus no-action clauses do not bar claims seeking to enforce the right to payment of principal and interest. The court also rejected CEC's argument that the noteholders could bring their claims only after an actual payment default. The court noted that the provisions in the indentures granting holders the unconditional right to receive payment of principal and interest, which tracked language of the TIA, omitted the TIA's modifying clause limiting that right only to suits for past due payments, and therefore did not prohibit plaintiffs from bringing the claims prior to an actual default.

Prepayment Premiums / "Make-Whole" Amounts:

***Delaware Trust Co. v. Energy Future Intermediate Holding Co. LLC (In re Energy Future Holdings Corp.)*, 527 B.R. 178 (Bankr. D. Del. 2015)**

A Delaware bankruptcy court holds that the repayment in full of certain senior secured notes did not trigger an obligation by the debtors to pay a make-whole premium, where the right to payment of a make-whole premium was not clearly stated in the applicable indenture. Specifically, the indenture did not state that such payment is due and owing following a default and an acceleration of the underlying notes caused by the commencement of a bankruptcy case.

At the time the bankruptcy petition was filed, certain of the debtors were obligated under a series of 10% first lien notes issued by Energy Future Intermediate Holding Company ("EFIH"). Under the indenture governing the notes, EFIH's bankruptcy filing caused the automatic acceleration of the notes.

The indenture trustee for the noteholders argued that the acceleration of the notes and repayment of principal and accrued interest though the debtors' debtor-in-possession financing constituted an "Optional Redemption" under the indenture, and that such a redemption gave rise to a secured claim under the indenture for the make-whole premium.

The indenture trustee further argued that it could retroactively decelerate the notes, so that they would not have been due and owing when they were repaid with the proceeds of the debtor-in-possession financing, thus bringing the EFIH repayment clearly within the ambit of an Optional Redemption. The trustee also contended that the deceleration of the notes would not violate the automatic stay (or alternatively, that cause existed to lift the automatic stay). The trustee's complaint additionally stated that the make-whole premium should be payable because EFIH's bankruptcy filing constituted an "intentional" default in order to avoid paying the make-whole premium, and asserted additional causes of action based alleged breaches of the indenture and the "perfect tender" rule under New York law.

EFIH argued that no Optional Redemption had occurred because of the automatic acceleration under the indenture based on its bankruptcy filing. Instead, once the automatic acceleration occurred, the notes were due and owing, such that the repayment of the notes could not constitute an Optional Redemption.

The bankruptcy court granted summary judgment to EFIH on most counts. Relying on *In MPM Silicones, LLC*, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014) ("*Momentive*"), it held that "[u]nder New York law, an indenture must contain express language requiring payment of a prepayment premium upon acceleration; otherwise, it is not owed." 527 B.R. at 192. Looking at the plain language of the indenture, the bankruptcy court found it to be indistinguishable from the language in the *Momentive* indenture (and indentures in other cases), in which there was no express language specifying that a make-whole premium would be owed upon automatic acceleration arising from the commencement of a bankruptcy proceeding.

In addition, the bankruptcy court focused on the distinction between "redemption" and "acceleration." It noted that under the indenture, Optional Redemption "is an act separate and apart from automatic acceleration." *Id*. at 194. Parsing the indenture closely, the bankruptcy court found that (i) the make-whole premium was due only upon an Optional Redemption, and (ii) repayment following acceleration did not constitute an Optional Redemption.

The bankruptcy court also concluded that the Optional Redemption contemplated a voluntary action by EFIH, and that under New York law, "'a borrower's repayment after acceleration is not considered voluntary.'" *Id*. at 195 (quoting *In re South Side House LLC*, 451 B.R. 248, 268 (Bankr. E.D.N.Y. 2011)). The plain language of the indenture therefore did not require the payment of the make-whole premium when EFIH repaid the notes following the automatic acceleration caused by the bankruptcy filing.

The bankruptcy court rejected the trustee's argument that the make-whole premium should be paid because the bankruptcy filing was an intentional default aimed at avoiding it. Noting that there was no provision in the indenture stating that the make-whole premium would be owed if there were an intentional default, the court held that even though there was substantial evidence prior to the bankruptcy that EFIH intended to avoid paying the make-whole once it filed, EFIH and the debtors had ample grounds to file bankruptcy due to their unsupportable capital structure and a liquidity crisis. Once in bankruptcy, EFIH was free to use whatever rights it had at its disposal to minimize estate liabilities.

The bankruptcy court found that there was no violation of the "perfect tender" rule or "no-call" provision of the indenture under New York law for the same reason that there was no Optional Redemption—the notes had already been accelerated.

Nonetheless, the bankruptcy court did agree with the trustee that it had a qualified right under the indenture to waive the automatic default arising from the debtors' bankruptcy filing and rescind the acceleration of the notes. Although the debtors attempted to argue that the indenture barred this right based on language in the indenture extinguishing that right if rescission would "conflict with any judgment of a court of competent jurisdiction," the bankruptcy court found that the automatic stay under Bankruptcy Code section 362 is not a "judgment of a court." *Id*. at 193. However, the court determined that the trustee's attempt to waive the default and decelerate the notes by sending a notice, was barred by the automatic stay under section 362(a)(3) and (6).

Accordingly, the court determined that if it were to lift the automatic stay, nunc pro tunc to a date on or before the repayment of the notes, to allow the trustee to waive the default and decelerate the notes, the debtor's refinancing would be an Optional Redemption under the Indenture and the make-whole premium would be due and owing.

The bankruptcy court therefore denied the debtors' motion for summary judgment on this issue, and stated that a trial would need to be held on the merits of whether the trustee could establish cause to lift the automatic stay to allow the trustee to retroactively waive the default and decelerate the notes.

***U.S. Bank Trust Nat'l Ass'n v. AMR Corp. (In re AMR Corp.)*, 730 F.3d 88 (2d Cir. 2013), *cert. denied,* 134 S. Ct. 1888 (2014)**

The Second Circuit holds that debtors could use funds borrowed postpetition to redeem secured notes issued prepetition, without having to pay any "make-whole" amounts required under the indentures to the prepetition notes.

Prior to filing for bankruptcy, American Airlines ("American") issued notes secured by its aircraft ("Notes") in three separate financing transactions. The Notes were issued pursuant to substantially similar indenture agreements that were governed by New York law ("Indentures"). After commencing its case, American and certain affiliated debtors filed a motion to obtain postpetition financing at an interest rate significantly lower than the Notes, and to use the proceeds to repay the Notes in full.

U.S. Bank, as trustee under the Indentures, objected to the debtors' motion and contended that the debtors could not repay the Notes without also paying certain make-whole amounts specified in the Indentures.

The Indentures provided that a make-whole amount was payable upon a voluntary redemption of the Notes. However, a separate section of the Indentures, which applied in the event of certain defaults (including the filing of a bankruptcy), provided that upon such a default, all principal and interest due on the Notes would be automatically accelerated, but that no make-whole amounts would be due.

On appeal from a bankruptcy court decision granting American's motion, the Second Circuit concluded that the default provision of the Indentures, not the voluntary redemption provision, applied following American's chapter 11 filing. That provision, the Second Circuit held, was clear that the Notes were automatically accelerated upon the filing and, under those circumstances, "the Indentures provide that no Make Whole Amount is due."

The Second Circuit found U.S. Bank's arguments to the contrary to be unavailing. First, in response to U.S. Bank's argument that "[u]nder New York law, acceleration is a remedy that affirmatively must be chosen by lenders and cannot be invoked by borrowers," the Second Circuit found that nothing in New York law prohibits self-operating acceleration provisions. The court noted that automatic acceleration provided mutual benefits to both sides: for instance, U.S. Bank benefited from the acceleration of its debt while American benefited from the exclusion of the make-whole amount from its obligations. The Second Circuit also rejected U.S. Bank's suggestion that this was an appropriate "rare circumstance" where enforcement should be refused notwithstanding the "clear and unambiguous terms" of the contract.

Second, the Second Circuit further agreed with the bankruptcy court that U.S. Bank could not enforce a provision in the Indentures that would have allowed it to waive American's default and decelerate the Notes. The Second Circuit stressed:

> As of the filing of its bankruptcy petition . . . American had the contractual right, pursuant to the Indentures, to repay its accelerated debt without Make-Whole Amount. We therefore agree with the bankruptcy court that any attempt by U.S. Bank to rescind

> acceleration now – after the automatic stay has taken effect – is an effort to affect American's contract rights, and thus the property of the estate.

Because de-acceleration would only increase U.S. Bank's claim to the detriment of American's estate and its creditors, the Second Circuit also found that the bankruptcy court did not abuse its discretion in denying U.S. Bank relief from the automatic stay.

Third, emphasizing that "prepayment can only occur prior to the maturity date," the Second Circuit also rejected U.S. Bank's argument that American's postpetition repayment of the debt constituted a "voluntary redemption," regardless of whether the debt was automatically accelerated under the Indentures.

Fourth, the Second Circuit rejected U.S. Bank's argument that the automatic acceleration provision was an ipso facto clause that was unenforceable under section 365(e) of the Bankruptcy Code. Citing prior case law, the court concluded that such clauses are only impermissible if the underlying agreement remains executory between the parties; since both parties admitted that the Indentures were not executory contracts, the acceleration provision was not an unenforceable ipso facto clause.

Finally, the court held that chapter 11's special provisions for aircraft financing and leases (in section 1110 of the Bankruptcy Code) did not alter the result.

Section 1110 generally requires a debtor under an aircraft financing to cure and perform its obligations during the case, or face stay relief in favor of the lender. American's election to perform its obligations under the Indenture did not require payment of the make-whole amounts, however, because as noted, the make-whole amounts were not owing due to the automatic acceleration upon the bankruptcy filing. Nor did section 1110 require American to pay off the entire accelerated debt immediately, since the acceleration was based upon "a default of a kind specified in section 365(b)(2)"—American's own bankruptcy filing—which was exempted from the cure and performance requirements in section 1110.

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

The Fifth Circuit held that a debtor was not required to pay a prepayment penalty in the event of an acceleration when the plain language of the note did not provide for payment of a prepayment penalty unless there was an actual prepayment. The decision affirms a decision by the Northern District of Texas bankruptcy court.

Prior to its bankruptcy filing, GC Merchandise Mart LLC ("GCMM") executed a promissory note in favor of the lender in exchange for a $30 million loan. The note contained clauses involving default, acceleration, and prepayment. GCMM failed to make payments on the note, resulting in a default under the terms. After GCMM failed to cure defaults and failed to make an additional payment, the lender issued a notice of default and eventually obtained an order appointing a receiver; at which point, GCMM filed for bankruptcy.

During the bankruptcy, the lender sought allowance of the prepayment penalty, notwithstanding the fact that GCMM never made a prepayment under the note. The bankruptcy court disallowed the claim for the prepayment penalty, and the district court affirmed. The Fifth Circuit affirmed the lower courts' decisions. The only issue before the Fifth Circuit was whether GCMM was liable for a prepayment penalty upon the prebankruptcy acceleration of the note. The Fifth Circuit looked to Colorado state law, which requires a court to look at the plain language of a contract to interpret the terms of the note.

Under the default clause of the note, if GCMM failed to make a payment according to the terms of the note, the debt accelerated and certain amounts became due immediately. In relevant part, these amounts included "all other money agreed or provided to be paid by Borrower in this Note, the Security Instrument or the Other Security Documents." The promissory note also provided that in the event of a prepayment, the debtor was obligated to pay a prepayment penalty.

The court found that there were several conditions that would trigger the payment of the penalty, but none of these conditions required payment of the prepayment penalty when no prepayment had occurred. Under the note, the debtor was obligated to pay the prepayment penalty "in the event of a Default Prepayment, which is defined as a prepayment occurring during a default or acceleration 'under any circumstances.'" However, the plain language of the note required that an actual prepayment occur before the prepayment penalty obligation was triggered.

The Fifth Circuit concluded that under general Colorado law, the lender was not entitled to prepayment penalties when it accelerated a note. Moreover, the Court found there was no language in the note that would deem that a prepayment to have occurred in the event of an acceleration. Thus, absent evidence of a clear contractual clause that provided for payment of a prepayment penalty upon acceleration, the lender did not have a valid claim for the prepayment penalty.

***U.S. Bank Nat'l Ass'n v. S. Side House, L.L.C.*, 2012 WL 273119 (E.D.N.Y. Jan. 30, 2012)**

A New York district court holds that a secured creditor is not entitled to a prepayment premium where the loan agreement did not explicitly provide for the premium to be paid in the event the debt was automatically accelerated upon the debtor's filing for bankruptcy.

In this single asset real estate case involving a solvent debtor, the bankruptcy court denied the secured creditor a claim for a prepayment penalty because: (i) the documents did not unambiguously provide for the prepayment penalty to be paid upon the automatic acceleration of the debt as a result of the bankruptcy filing; and (ii) the debtor was not prepaying the debt all at once (the only time a prepayment penalty was due under the loan documents), but instead prepaying the debt over time pursuant to a plan.

On appeal, the district court affirmed. The court explained that "a prepayment consideration provision derives from 'well-settled law' and serves the goal of protecting the lender from the losses associated with a borrower prepaying its loan prior to the loan's maturity date." Generally, however, "a lender forfeits the right to a prepayment consideration by accelerating the balance of the loan. . . . Courts recognize two exceptions to this rule: (1) where the debtor intentionally defaults in order to trigger acceleration and evade the prepayment premium; and (2) when a 'clear and unambiguous clause . . . calls for payment of the prepayment premium.'" Here, "[b]ecause the Loan Documents lacked an unambiguous clause stating that a right to prepayment consideration arises in the event of a default and acceleration, the bankruptcy court correctly disallowed [the secured creditor's] claim for prepayment consideration."

***Kimbrell Realty/Jeth Court, L.L.C. v. Fed. Nat'l Mortgage Ass'n (In re Kimbrell Realty/Jeth Court, L.L.C.)*, 483 B.R. 679 (Bankr. C.D. Ill. 2012)**

An Illinois bankruptcy court holds that a loan agreement imposing both a prepayment penalty and default interest following the lender's acceleration upon the debtor's default was enforceable according to its terms.

The debtor owned and operated an apartment complex in Illinois. Before filing its chapter 11 case, the debtor obtained a commercial loan evidenced by a note (the "Note") and secured by a mortgage on the complex; the Note and mortgage were later assigned to the Federal National Mortgage Association ("FNMA"). After the debtor defaulted under the Note, FNMA exercised its contractual right to accelerate the entire unpaid principal balance under the Note and moved to foreclose the mortgage. The debtor subsequently commenced its bankruptcy case.

FNMA filed a claim in the debtor's case seeking to recover unpaid principal and accrued interest, plus a prepayment penalty and default interest at 4% above the non-default rate. The debtor did not dispute that the Note provided for both the prepayment penalty and default interest to be assessed following the lender's acceleration of the debt upon the debtor's default. Rather, the debtor challenged the enforceability of those remedies under applicable law and claimed that, even if default interest was otherwise permissible, it was impermissibly duplicative of the prepayment penalty in this case.

Because the Note provided that Illinois law governed, the court applied Illinois law in determining whether the prepayment penalty and default interest were enforceable. First, the court noted that prepayment penalty provisions "are routinely upheld and enforced where the mortgagor voluntarily elects to pay the loan prior to maturity." The more challenging question before the court was whether "payment after acceleration can [ ]ever be a 'prepayment,' since the loan matured by election of the lender." After parsing the limited and non-uniform case law on point, the court concluded that parties are free to define a lender's rights and remedies by contract under Illinois law, and since the Note was "clear and unambiguous" in requiring the debtor to pay the prepayment penalty following default and the lender's acceleration, FNMA's claim for the prepayment penalty was allowed.

Turning to the enforceability of FNMA's default interest claim, the court found that under Illinois law: (1) "default interest provisions are generally valid and enforceable so long as the higher rate is reasonable in light of the anticipated or actual loss caused by the breach and the difficulty of proving the loss," and (2) "there is no statutory ceiling on the rate of interest that may be charged on mortgage loans." The debtor did not argue that default interest of an additional 4% was inherently unreasonable; rather, it claimed that "allowance of default interest on top of the prepayment premium would amount to 'an unreasonable and impermissible double recovery.'" Rejecting this argument, the court found evidence in the Note that the prepayment premium and the default interest addressed two different kinds of loss – the prepayment premium compensated FNMA "for the loss of its income expectancy due to the early payoff," while the default interest compensated FNMA for "the increased risk of nonpayment and the extra expenses involved in servicing a delinquent loan." The court concluded, "[a]lthough the period of default interest partially overlaps with the discount period of the prepayment premium, that does not mean that the amounts are double compensation for the same loss. By the terms of the Note, they cover separate losses."

Finally, because FNMA was oversecured, the court held that it was entitled to postpetition interest at the default rate under section 506(b) of the Bankruptcy Code.

***In re School Specialty, Inc.*, 2013 WL 1838513 (Bankr. D. Del. Apr. 22, 2013)**

A Delaware bankruptcy court upholds a make whole prepayment premium, finding it did not constitute disallowable unmatured interest under Bankruptcy Code section 502(b)(2).

The debtors entered into a credit agreement that would mature in 18 months unless the debtors refinanced certain notes, in which event the agreement would mature in 31 months (the "Conditional Maturity Date"). The agreement provided that upon prepayment or acceleration, the debtors were required to pay an "Early Prepayment Fee." If the prepayment or acceleration occurred during the first 18 months, the Early Prepayment Fee was equal to the "Make Whole Payment," calculated by discounting the future stream of interest payments through the Conditional Maturity Date, using the Treasury rate plus 50 basis points as the discount rate.

The debtors subsequently breached a liquidity covenant, triggering acceleration during the first 18 months and obligating them for the Make Whole Payment. Not long thereafter, they filed for bankruptcy and entered into a DIP financing arrangement with the same lender. As part of the order approving the DIP financing, the debtors stipulated that they were liable to the lender for the Make Whole Payment.

The creditors committee objected, arguing that the Make Whole Payment was: (i) unenforceable as liquidated damages because it was "grossly disproportionate" to the lender's probable loss; (ii) not "reasonable" as required by Bankruptcy Code section 506(b); (iii) unmatured interest disallowed under section 502(b)(2); and (iv) objectionable because it did not provide for mitigation of damages. The bankruptcy court overruled each objection.

First, the court explained that "[t]he inquiry into whether a prepayment provision will be enforced in bankruptcy begins with whether the prepayment provision is enforceable under applicable state law." Turning to New York law, the court held that the Make Whole Payment was not plainly disproportionate to the lender's probable loss, and rejected the committee's contention that the calculation should have included interest for only the first 18 months. "The Committee's argument that [the refinancing] extension was unlikely is irrelevant. The Term Loan Credit Agreement required [the lender] Bayside and its investors to keep adequate funds available through [the Conditional Maturity Date of] December 2015. The Court cannot, with the benefit of hindsight, alter the agreement based on subsequent operational results and managerial decisions." The court also found that a discount rate tied to Treasury Note performance was not plainly disproportionate.

Second, the court observed that since it had determined that the Make Whole Payment was not disproportionate to the lender's probable losses, "even assuming § 506(b) applies, the Make Whole Payment meets the § 506(b) reasonableness standard."

Third, the court joined the majority view that "a claim for a make whole premium [is] akin to a claim for liquidated damages, not a claim for unmatured interest."

Therefore the Make Whole Payment could not be disallowed as unmatured interest under section 502(b).

Finally, the court noted that, "under New York law, a valid liquidated damages claim obviates the duty to mitigate."