Business Track

Substantial Contribution Claims

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SUBSTANTIAL CONTRIBUTION CLAIMS FOR BIDDERS UNDER 11 U.S.C. § 503(b)(3)(D)

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In the last ten years, debtors have, in large part, eschewed efforts to rehabilitate pursuant to traditional plans of reorganization. Instead, debtors have focused their efforts on sales of substantially all of their assets under section 363 of the Bankruptcy Code in an attempt to maximize value while capitalizing on the perceived efficiencies of a quick sales process. As part of the sales process, debtors typically attempt to identify a stalking horse bidder in order to establish a baseline bid for the assets while bringing an increased level of certainty to the sales process. In exchange for their efforts, stalking bidders request, and courts frequently approve, a break-up fee and/or an expense reimbursement as consideration for their diligence, including negotiation of the terms of sale.

As a byproduct of asset sales, third party, non-stalking horse bidders have sought to recover the fees and expenses incurred in connection with their efforts related to sales. These third party bidders assert what could be described as a "reverse breakup fee" by requesting allowance of an administrative expense for a substantial contributions to the estate under section 503(b)(3)(D). To date, these requests for substantial contribution claims have met with mixed results.[1]

The majority of courts that have been confronted with the issue have declined to award an administrative expense to a bidder for their efforts related to asset sales. These courts generally reason that such bidders acted in their own economic interests by seeking to purchase a debtor's assets, or conclude that section 503(b)(3)(D) was not intended to encompass parties beyond those

[1] For a discussion of two recent decisions regarding requests for administrative expenses for substantial contributions by non-stalking horse bidders, *see* William L. Medford and Bruce H. White, *The Wildcard of Competing-Bidder Break-Up Fees and Substantial Contribution Claims*, Am. Bank. Inst. J. (Feb. 2011).

expressly listed in the statute. However, a minority of courts have awarded administrative expenses for the substantial contributions of bidders. These courts have done so where a bidder demonstrates extraordinary efforts that resulted in a direct and significant benefit to the debtor's estate.

Section 503(b) sets forth nine examples of administrative expenses that may be paid from the assets of a debtors' estate. 11 U.S.C. § 503(b). Any request for an administrative expense must be strictly construed because administrative expenses reduce funds available for distribution to creditors. *See*, *e.g.*, *City of White Plains, New York v. A & S Galleria Real Estate, Inc. (In re Federated Dep't Stores, Inc.)*, 270 F.3d 994, 1000 (6th Cir. 2001) (citations omitted). A party requesting an administrative expense bears the burden of proof by a preponderance of the evidence. *See*, *e.g.*, *McMillan v. LTV Steel, Inc.*, 555 F.3d 218, 226 (6th Cir. 2009) (citations omitted). Such determinations are questions of fact left to the sound discretion of the bankruptcy court. *Haskins v. United States (In re Lister)*, 846 F.2d 55, 56 (10th Cir. 1988) (citing *Pierson & Gaylen v. Creel & Atwood (In re Consolidated Bancshares, Inc.)*, 785 F.2d 1249, 1252 (5th Cir. 1986)).

Section 503(b)(3)(D) and (b)(4) provide administrative expenses to certain persons and their professionals who have made substantial contributions to bankruptcy estates. Section 503(b)(3)(D) provides, in pertinent part, that "[a]fter notice and a hearing, there shall be allowed, administrative expenses . . . including the actual, necessary expenses . . . incurred by a creditor . . . or, a committee representing creditors . . . in making a substantial contribution in a case under chapter . . . 11 of this title." Section 503(b)(4) is often considered a tag along to section 503(b)(3)(D) and provides that "reasonable compensation for professional services rendered by an attorney or account of an entity whose expense is allowable under . . . [section 503(b)(3)(D)] . . . based on the time, the nature, the extent, and the value of such services, and the cost of comparable

services other than in a case under [the Bankruptcy Code], and reimbursement for actual, necessary expenses incurred by such attorney or accountant."

Section 503(b)(3)(D) is intended to promote meaningful participation in the reorganization process, but not to encourage "mushrooming" administrative expenses. *In re S&Y Enterprises, LLC*, 480 B.R. 452, 459 (Bankr. E.D.N.Y. 2012) (citation omitted). Compensation should instead be preserved for those instances where a party's involvement truly fosters and enhances the administration of the estate. *Id*. As such, administrative expenses for substantial contributions are the exception, not the rule. *Id*. at 461. Courts generally seek to limit administrative expenses for substantial contributions to extraordinary actions which lead directly to tangible benefits to the debtor, the debtor's estate, and its creditors. *In re Best Prods. Co*., 173 B.R. 862, 866 (Bankr. S.D.N.Y. 1994); *see In re Lister*, 846 F.2d at 57 (requiring actual, demonstrable benefit to estate). Courts have considered, among other things, whether the services of the party requesting the administrative expense were duplicative of the services rendered by others, and whether the alleged benefit to creditors outweighs the amount of the administrative expense sought.

The courts are split as to whether the party seeking the administrative expense must have taken actions solely for the benefit of the estate and its creditors, or whether it is sufficient to have taken actions in self-interest that resulted in a benefit to the estate. *Compare Hall Fin. Grp., Inc. v. DP Partners Ltd. P'ship (In re DP Partners Ltd. P'ship)*, 106 F.3d 667, 673 (5th Cir. 1997) (creditor not required to have "self-deprecating, altruistic intent as a prerequisite to recovery of fees and expenses") *with Lebron v. Mechem Fin. Inc*. 27 F.3d 937, 944 (3d Cir. 1994) (citation omitted) (creditor must show that its efforts "transcended self-protection"); *In re Lister*, 846 F.2d at 57 (citation omitted) (efforts undertaken by creditor solely to further own self-interest not compensable, notwithstanding any benefit to estate).

Courts also diverge on whether a bidder seeking to purchase a debtor's assets has standing to seek a substantial contribution administrative expense. A party seeking an administrative expense must have standing to proceed under section 503(b). Several courts have held that because section 503(b) uses "includes," it is not limiting in nature. *See*, *e.g.*, *Mediofactoring v. McDermott (In re Connolly North America, LLC)*, 802 F.3d 810, 815-16 (6th Cir. 2015) (because section 102(3) provides that term "includes" is not limiting, creditor in Chapter 7 case who made requisite showing of substantial contribution entitled to administrative expense despite language in section 503(b)(3)(D) stating such expenses to be granted in a case "under chapter 9 and 11"). According to these courts, a non-stalking horse bidder has standing to seek an administrative expense for a substantial contribution. *See, e.g.*, *In re S & Y Enter., LLC*, 480 B.R. 452. Other courts, however, hold that because a non-stalking horse bidder is not included in section 503(b), they lack standing to seek an administrative expense for a substantial contribution. *See, e.g.*, *In re Dorado Marine, Inc.*, 332 B.R. 637 (Bankr. M.D. Fla. 2005); *In re S.N.A. Nut Co*., 186 B.R. 98 (Bankr. N.D. Ill. 1995).

The case summaries that follow highlight the extent to which courts have strictly construed section 503(b)(3)(D) to accomplish the section's objectives—encouraging meaningful participation by parties in a bankruptcy case while limiting compensation to only the bidders that demonstrate extraordinary efforts in support of the bankruptcy process.[2]

A. Cases Allowing Substantial Contribution Administrative Expenses for Bidders

Very few cases have permitted a bidder to obtain an administrative expense for a substantial contribution. Where courts have allowed such expenses, the bidder demonstrated that

[2] The case summaries are not intended to be an exhaustive list of cases related to section 503(b)(3)(D), but rather a sampling of cases in which courts discussed a bidder's pursuit of a substantial contribution administrative expense.

its efforts caused a significant improvement in the amount to be paid to creditors and that its expenses would not eclipse that benefit to the estate. Even so, some of these courts have denied compensation associated with the bidder's attempts to acquire a debtor's assets and limited the reimbursement of expenses to only those costs incurred that actually resulted in an improved result for the estate.

1. *In re Pow Wow River Campground, Inc.*, 296 B.R. 81 (Bankr. D. N.H. 2003).

A proposed buyer pursuant to a plan sought an administrative expense for a substantial contribution alleging that its involvement in the case resulted in an increase in the dividend to be paid to unsecured creditors from fifty percent to one hundred percent plus interest. The court noted that the buyer's participation in the formulation and confirmation of a plan rapidly increased the dividend from the amount originally proposed. The court found that portions of the services rendered prior to the formulation of the plan related to the buyer's self-interest in acquiring the debtors' assets and were not substantial contributions. The court did however, find that the buyer's plan formulation efforts did confer a substantial benefit on the estate, especially in the absence of an active creditor's committee, and should be allowed as an administrative expense.

2. *In re Kidron, Inc.*, 278 B.R. 626 (Bankr. M.D. Fla. 2002).

An unsuccessful bidder sought a substantial contribution administrative expense for its efforts in the sale process that ultimately resulted in a sale to an insider of the debtors at a price $2 million higher than originally proposed. The bidder acquired an unsecured claim from a creditor of the debtors and made concrete suggestions to resolve issues of non-disclosure of due diligence by the debtors to itself and other non-insider bidders that resulted in the court ordering the debtors to produce certain documents on a specific timetable. The court concluded that the bidder's expenses incurred in participating as a bidder were not compensable, even if such bidding resulted

in a higher sale price. The court held, however, that the bidder's expenses incurred in connection with the sale process that directly and materially contributed to a successful sale for the benefit of creditors were a substantial contribution. The court explained that in the unusual circumstances of the case, the extraordinary efforts of the bidder helped to "even the playing field" for other bidders so that an auction could proceed.

3. *In re Diamonds Plus, Inc.*, 233 B.R. 829 (Bankr. E.D. Ark. 1999).

A stalking horse bidder sought payment of a break-up fee or, alternatively, a substantial contribution claim for coordinating a going-out-of-business sale for the debtor's business. The court concluded that the bidder was not entitled to a break-up fee because the agreement had not been executed by the debtor or approved by the court. Nevertheless, the court did conclude that the bidder was entitled to a substantial contribution claim because its assistance to the debtor in coordinating its going-out-of-business sale and making the initial bid resulted in an increase of approximately $120,000 in the purchase price to the eventual winning bidder. The court therefore granted an administrative expense under section 503(b)(3)(D) for the bidder's expenses incurred in conducting the sale and its attorneys' fees.

4. *Hall Fin. Grp., Inc. v. DP Partners, Ltd. P'ship (In re DP Partners Ltd. P'ship)*, 106 F.3d 667 (5th Cir. 1997).

A competing bidder that discovered that the debtor had undervalued its assets purchased three small unsecured claims and proposed a competing plan that set off a bidding war. The bidder sought an administrative expense for making a substantial contribution. After several amendments to the plan, the debtor's proposed plan was confirmed, providing approximately $3 million more for creditors than the prior version. On appeal, the court of appeals held that both lower courts erred in requiring the competing bidder to give advance notice of its intent to seek an administrative expense. The court found, however, that the bankruptcy court correctly concluded that the bidder

was entitled to a substantial contribution claim for its efforts. The court noted that the competing bidder was not required to have an altruistic intent in order to obtain a substantial contribution claim. The bidder discovered a potential fraudulent conveyance action which would benefit the secured creditor, caused the exclusivity period to be terminated, and caused the debtor to change its proposed plan for the better.

B. Cases Denying Substantial Contribution Administrative Expenses for Bidders

Far more cases have declined to allow an administrative expense for a substantial contribution to a bidder. These courts have closely examined the bidder's alleged substantial contribution to determine whether the bidder actually improved the outcome for the estate, whether the improved outcome would have occurred without the bidder's efforts, whether the amount of the administrative expense exceeds the alleged benefit to the estate, and whether the bidder was acting solely in its own economic self-interest.

1. *In re S & Y Enter., LLC*, 480 B.R. 452 (Bankr. E.D.N.Y. 2012).

The bankruptcy court held that an unsuccessful bidder for the debtors' assets did have standing to apply for a substantial contribution expense under section 503(b)(3)(D), even though it was not one of the parties expressly listed in the statute. The court explained that the use of "includes" in section 503(b) was illustrative and not limiting and the purpose of section 503(b) is to encourage active participation by parties in the case, particularly where estate-compensated parties are failing to act. Nevertheless, the court found that the bidder could not satisfy the steep burden to show its activities (drafting and defending an amended plan and disclosure statement encompassing its proposed sale transaction) constituted a substantial contribution. The court noted that efforts by bidders are often self-interested and where such efforts are undertaken solely in self-interest, substantial contribution claims will not be granted. The court explained that its focus

was on the nature of the bidder's contribution to the overall success of the Chapter 11 case. The court found that the bidder could not meet the standard, because its efforts, were self-interested and provided at most an indirect benefit to the estates in causing the original bidder to increase the purchase price.

On appeal, the district court held that the bankruptcy court did not err in declining to grant a substantial contribution administrative expense because it did not find that the bidder's efforts led to a direct and significant benefit to the estate. *Bedford JV, LLC v. Sky Lofts, LLC*, 2013 WL 4735643 (E.D.N.Y. Sept. 3, 2013). According to the district court, the bankruptcy court did not err in considering the bidder's self-interested motive, as it did not give the factor too much weight, expressly noting that a party need not establish that it acted in an altruistic manner to only benefit the estate and not its own interests. The bankruptcy court also correctly required the bidder, as an entity not expressly listed in section 503(b)(3)(D), to make a substantial showing that its efforts led to a benefit to the estate. The district court explained that prospective buyers are "less able or willing to undertake special or extraordinary actions that advance the entire bankruptcy process."

2. *In re ASARCO LLC*, 2010 WL 3812642 (Bankr. S.D. Tex. Sept. 28, 2010).

Plan proponents alleged that their proposed plan caused a bidding war between two other proposed acquirers, resulting in an increased dividend under a parent company's plan that was ultimately confirmed. The court noted that substantial contribution claims are to be granted in only unusual or rare circumstances in order to preserve the estate for the benefit of creditors. The court found that the movants failed to meet the high threshold, as they could not establish that there was a causal link between the movants' actions and the parent company's decision to amend its plan to provide full payment. The court explained that the movants' evidence on a causal connection was speculative and relied only on the temporal proximity of actions of the movants

and the parent company's amendments. The parent company's decision to submit the amended plan was not driven by the movants' filing of a plan, participation in the failed auction, or objections to the parent's plan. Rather, the parent's decision to amend its plan was driven by other factors such as a rise in copper prices, a judgment entered against it in collateral litigation, and its desire to end asbestos litigation and consolidate its global operations with its U.S. operations.

3. *In re Dana Corp.*, 390 B.R. 100 (Bankr. S.D.N.Y. 2008).

A competing bidder alleged that its multiple counteroffers and objections to the proposed equity investment resulted in an increase of the guaranteed investment in the debtors of $290 million. The court concurred with an ad hoc committee and the United States Trustee that the efforts of other parties were more responsible for the improved treatment and that the company was nothing more than a losing bidder acting in its own self-interest. The court found that although the bidder's efforts may have played a role in the alternative investment procedures implemented under a global settlement, those procedures served the bidder's interests in making an alternative investment proposal. Moreover, the court noted that other parties insisted on an opportunity for competitive investment offers. Finally, the court reasoned that the bidder's proposals, unlike the investment proposal ultimately selected by the debtors, were unlikely to result in a successful reorganization because they were conditional and lacked the support of labor unions whose consent was essential.

4. *Ideal Aerosmith, Inc. v. Carco Electronics (In re Carco Electronics)*, 346 B.R. 377 (Bankr. W.D. Pa. 2006).

An original bidder for the debtor's assets asserted that it was entitled to administrative expense for its costs incurred operating the debtor's business after it signed an APA, but without court approval. Upon learning of the bidder's unauthorized operation of the business, the court prohibited such operation and provided for a competitive auction of the debtor's assets, which the

bidder ultimately lost. The bidder asserted that its operation of the business conferred a benefit on creditors by maintaining the going concern value of the debtor's assets. The court held that the bidder was not entitled to an administrative expense under section 503(b)(1)(A) and found the bidder's belated substantial contribution argument unconvincing. The court concluded that the bidder's actions in operating the business did not enhance the value of the debtor's assets, as it could not establish that its actions directly caused the increase in purchase price. Likewise, the court held that the bidder's actions were motivated by its own interest because it believed court approval was a mere formality and its alleged "substantial contribution" was a mere contrivance invented after it failed to acquire the debtor's assets.

5. *In re Dorado Marine, Inc.*, 332 B.R. 637 (Bankr. M.D. Fla. 2005).

A stalking horse bidder sought an administrative expense for a substantial contribution where it had negotiated a break-up fee with the Chapter 7 trustee that had not been preapproved by the court. The court concluded that it was not bound by the trustee's agreement to provide the break-up fee, as it had not previously approved the fee. The court also found that the bidder was not a party eligible to receive a substantial contribution claim, as it was not a creditor or other entity specified in section 503(b)(3)(D). In addition, the court noted that the fees and expenses were incurred by the bidder after the case converted from Chapter 11 to 7 and therefore were not within section 503(b)(3)(D)'s coverage, as that section requires a substantial contribution to be in a case under Chapter 9 or 11. The court did, however, permit the bidder to obtain a portion of its requested administrative expense pursuant to section 503(b)(1)(A) as the bidder conducted the due diligence and served as a catalyst for the eventual sale of the debtor's assets.

6. *Pacificorp Kentucky Energy Corp. v. Big Rivers Elec. Corp. (In re Big Rivers Elec. Corp.)*, 233 B.R. 739 (W.D. Ky. 1998).

An initial proposed purchaser of the debtor's assets sought an administrative expense for a substantial contribution where the later winning bid exceeded the initial buyer's bid by $50 million. The court noted that the initial buyer included an onerous no-shop clause in its purchase agreement and refused to participate in an auction when the bankruptcy court required one to be conducted. The initial buyer also litigated at every turn, filing a motion to withdraw the reference, a motion for recusal of the bankruptcy judge, a writ of mandamus for recusal of the bankruptcy judge, and an appeal of the confirmation order of the amended plan. The district court on appeal concluded that a proposed buyer's self-interest is not a *per se* bar to a substantial contribution administrative expense, but that the bankruptcy court did not err in considering whether the interests of the initial buyer transcended its own self-interest. The district court also agreed that the initial buyer failed to enhance in any way the reorganization of the debtor, and in fact, worked hard to prevent the debtor from marketing its assets and obtaining the highest value for the estate.

7. *In re S.N.A. Nut Co.*, 186 B.R. 98 (Bankr. N.D. Ill. 1995).

An unsuccessful bidder sought an administrative expense for its efforts in bidding on the debtor's assets and luring in other bidders. Although two other bids were received, none of the bids, including the initial bidder's, were adequate and thus no sale occurred. The court found that the initial bidder, although it did induce other bids, did not render any benefit to the estate by its bid because even if higher bids occurred, no sale was consummated. The court explained that the bidder should be required to bear its costs associated with the auction, rather than the creditors who received nothing as a result of the auction, because it voluntarily entered the bidding process and was able to bid for a company with free and clear title. In addition, the court found that the

bidder did not have standing to pursue a substantial contribution claim because it was not one of the parties denominated in section 503(b)(3)(D).

8. *In re Public Serv. Co. of New Hampshire*, 160 B.R. 404 (Bankr. D. N.H. 1993).

A competing utility company that participated in the bidding process for the acquisition of the debtor's assets sought an administrative expense for making a substantial contribution because it alleged that its participation was responsible for substantial increase of approximately $300 million in total value to creditors from the initial to the final confirmed plan. The court found that the benefit to the estate from the company's bid was at best indirect and incidental and that the company's actions were ultimately in pursuit of its own economic self-interest. In addition, the court noted that the procedures established for the sale process required all bidding parties to submit disclosure statements and plans and the company failed to alert parties and the debtor that it intended to seek reimbursement of its expenses in its disclosure statement.

9. *In re FRG, Inc.*, 124 B.R. 653 (Bankr. E.D. Pa. 1991).

A competing bidder sought an administrative expense for making a substantial contribution for agreeing to a settlement not to continue to pursue its competing plan. The bidder alleged that its competing plan had caused the purchase price in the debtor's plan to increase from $2.35 to $3.15 million. The court found that the bidder did not have standing to seek a substantial contribution administrative expense because although it had acquired a claim against the debtor's estate, the transfer of the claim had not been approved by the court and therefore it was not a "creditor" as required by section 503(b)(3)(D). Moreover, the court concluded that the services provided by the bidder did not benefit the estate and the purpose of the debtor's stipulation to provide compensation to the bidder was to induce the bidder to cease its litigation activities which were arguably a detriment to the estate.

10. *In re Am. 3001 Telecomm., Inc.*, 79 B.R. 271 (Bankr. N.D. Tex. 1987).

A rival telecommunications company that filed a competing plan of reorganization providing for its acquisition of the debtor's assets sought an administrative expense for a substantial contribution. The court found that the rival company's efforts provided no benefit to the estate. The rival made a business judgment to acquire a distressed company at a bargain price. When it discovered that its plan was not confirmable and other parties were willing to pay more for the debtor's assets, the rival abandoned its efforts. Because the rival's efforts, if successful, would have benefitted only itself and not the estate, the court found that the rival had not made a substantial contribution.

11. *In re Baldwin-United Corp.*, 79 B.R. 321 (Bankr. S.D. Ohio 1987).

Several banks and companies who served as indenture trustees for debentures associated with one of the debtor's myriad affiliates sought administrative expenses for alleged substantial contributions, asserting that as members of the creditor's committee, they were influential in garnering approval among debenture holders for a proposal to buy various partnerships and retire the debentures. The court found that the evidence did not support the parties' assertions that they were instrumental in the many settlements reached, but rather that they engaged in the typical activities of a committee member and were by no means the leading participants. The court noted that while the parties were significantly involved in negotiations with the committee and debtors, they did not engage in any activities beyond that expected of a committee member and therefore did not merit administrative expenses for a substantial contribution.

12. *In re The Frog and Peach, Ltd.*, 38 B.R. 307 (Bankr. N.D. Ga. 1984).

An unsuccessful purchaser of the debtor's assets sought an administrative expense for a substantial contribution, alleging that its preparation and submission of a sales contract provoked

competitive bidding and a higher sales price. The court emphasized that the bidder was not a creditor of the debtor's estate and therefore did not fall within the statutory requirements of section 503(b)(3). The court explained that the purpose of section 503(b) was to encourage meaningful creditor participation in bankruptcy cases, which would not be advanced by granting an administrative expense to a bidder acting in its own self-interest who was not a creditor and therefore had no interest in increasing the dividend to the estate.

C. Conclusion

As the foregoing case summaries illustrate, courts have been reluctant to allow administrative expenses for substantial contribution to bidders, either because the bidders do not fall within the statutory framework of section 503(b)(3)(D) or because the bidders have been unable to make the requisite showing that their efforts were in fact responsible for a significantly improved outcome in a debtor's bankruptcy case. Although many bidders can certainly argue that their efforts resulted in an increased sale price for a debtor's assets, the courts have limited the allowance of substantial contribution administrative expenses to the truly extraordinary cases.

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Section 503(b)(9) Claims Continue to Create Controversy

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Lenders' Claims, Under Make-Whole Provisions, Under Attack

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LENDERS' CLAIMS UNDER MAKE-WHOLE PROVISIONS UNDER ATTACK

Lenders' claims arising under make-whole provisions, prepayment penalties, prepayment premiums and early redemption premiums (collectively "Premiums"), have provided a fertile field for litigation in bankruptcy courts. Recent decisions in Delaware and New York have caused significant consternation for lenders seeking to protect their sacred bargained for yields. Lenders have found that the automatic acceleration provisions in their own indentures have resulted in proverbial shots to their respective feet. Debtors have used these loan provisions, together with Sections 506 (b), 502 (b)(2) and 362 of the Bankruptcy Code (the "Code") to appeal to bankruptcy courts which already seem inclined to interpret these provisions away, under general equitable principle, in order to preclude a perceived windfall to the lenders. This is especially the case with respect to insolvent estates. These materials will give a brief overview of the law and will then review recent New York and Delaware cases which are now before the Second and Third Circuit Courts of Appeal. The first is a case arising in the Momentive Performance Materials, Inc. bankruptcy case, *In re MPM Silicones, LLC*, 2014 Bankr. LEXIS 3926, 2014 WL 4436335 (Bankr. D. Del. 2015) aff'd *In re MPM Silicones, LLC*, 531 B.R. 321 (S.D. N.Y. 2015)(hereinafter referred to as "*Momentive*"). The second arises from two reported cases in the Energy Future Holdings Corp. bankruptcy. They are *Del.Trust Co. v Energy Future Intermediate Holding Co. LLC.* 527 B.R. 178 (Bankr. D. Del. 2015)*; Del. Trust Co. v Energy Future Intermediate Holding Co. LLC.* 533 B.R. 106 (Bankr. D. Del. 2015)(hereinafter referred to "Energy Future Holdings").

I. The Genesis of Make-Whole Premiums.

Make-whole provisions have evolved from the early common law perfect tender rule, which is still the law in New York. This is important because many complex loan documents and indentures originate in New York or designate New York law in their choice of law provisions. The perfect tender rule prohibits a borrower from prepaying a note, absent a specific provision permitting prepayment. The purpose of the rule is to protect the lender's bargained for stream of payments and yield. There is an exception to the rule where the lender accelerates the note and thereby elects to change the maturity date. In such event, under the common law, no prepayment damages are available because there is no prepayment since the maturity has been accelerated. This exception was inapplicable if the borrower triggered the default and acceleration with the intention of avoiding the perfect tender rule.

Damages for violation of the perfect tender rule are generally determined calculating the present value of the bargained for income stream and subtracting the principal balance to find the lost bargained for yield upon prepayment. This is harder than it sounds and involves the court determining the appropriate discount rate and other variables in determining the present value of the installments of principal and interest. Therefore, lenders and borrowers attempted to eliminate uncertainty by agreeing in advance, in the loan documents or indenture, to the measure of damages. These provision can take many forms but there are generally two types, (i) a fixed fee which is generally a percentage of the unpaid amount or (ii) a yield maintenance formula

designed to compensate the lender for its lost yield. Fixed fees are generally found in floating rate loan documents and yield maintenance formulas are generally utilized in fixed interest rate documents where the yield maintenance is most important. These make-whole provisions are generally considered to be claims for liquidated damages and not unmatured interest. Make-whole provisions should be distinguished from no-call provisions which simply prohibit prepayment, essentially a contractual acknowledgement of the perfect tender rule. Breach of no-call provisions simply gives rise to either a suit for specific performance by the lender or a claim for damages with the same analysis as breach of the perfect tender rule.

When a borrower files bankruptcy, the interpretation of Premium provisions and no-call provisions implicates both state law and bankruptcy law. The bankruptcy court will usually look first to the indenture or loan documents to determine if the applicable provisions are enforceable under state law. This may include consideration of whether there is a preclusion of such provisions under state law. If the provision is not enforceable under state law, the examination ends. If the provision is enforceable under state law, the bankruptcy court will then examine whether the provisions are enforceable under the Code. For the general principals set forth in this Part I of the materials, see Donald Lee Rome, Matthew W. Kavanaugh & Randye B. Soref, *Make-Whole and No-Call Provisions Caveat Lender*, Business Workouts Manual, (2015) and Scott K. Charles & Emil A. Kleinhaus, *Prepayment Clauses in Bankruptcy*, 15 AM. Bankr. Inst. L. Rev. 537, 556 (2007).

II. The Impact of Sections 502(b)(2) and 506(b) of the Code on Premiums.

A) Premiums and Section 502(b)(3) of the Code.

As an initial matter, bankruptcy courts have addressed why "make whole provisions" are allowable at all under 11 USC § 502(b)(2). This section of the Bankruptcy Code precludes claims for unmatured interest. Premiums certainly are designed to protect the expected future interest stream under the indenture; however, courts are split on whether and when Premiums are allowed for undersecured creditors under this section of the Code. Most courts, especially when applying New York law, have held that these are not claims for future interest but are liquidated damages claims. See *GMX Resources*, Case No. 13-11456 (Bankr. W.D. Okla. Aug. 27, 2013), *In re Sch. Specialty, Inc.*, 2013 WL 1838513 (Bankr. D. Del. April 22, 2013); *In re AMR Corp.*, 730 F. 3d 88 (2d Cir. 2013); and *In re Chemtura Corp.*, 439 B.R. 561, 598 (Bankr. S.D.N.Y. 2010); *In re Skyler Ridge*, 80 B.R. 500,508 (Bankr. C.D. Cal. 1987); *Noonan v Fremont Fin. (In re Lappin Elec. Co.) , 245 B.R. 326* (Bankr. E.D. Wisc. 2000); *In re Outdoors Sports Headquarters, Inc.*, 161 B.R. 414, 424 (Bankr. S.D.Ohio 1993)*; In re Trico Marine Servs., Inc.*, 450 B.R. 474,476,477 (Bankr. D. Del. 2011) The court in *In re Trico Marine Servs.,Inc.* is often cited for the proposition that Premiums are liquidated damages because this court provides a survey of cases and takes the position that this is the majority view. Under New York law, a liquidated damages provision is enforceable where (i) actual damages are difficult to determine and (ii) the premium is "not plainly disproportionate" to the possible loss as determined on the date of the indenture. A Premium is "not plainly disproportionate" where (i) the prepayment fee was calculated so that the lender would receive its bargained-for yield and (ii) the fee resulted from an arm's length transaction between sophisticated parties. See *In re Sch. Specialty, Inc.*,

denying a committee's claim that a Premium was not an enforceable liquidated damages and was disproportionate.

Other courts have held that Premiums are not always liquidated damages with respect to undersecured creditors. Courts have prohibited Premiums under Section 502(b)(2) of the Code where the obligations were not accelerated until after the bankruptcy so that the Premium was not due on the petition date and was therefore unmatured. See *In re Doctor's Hospital of Hyde Park, Inc.*, 508 B.R. 697 (Bankr. N.D. Ill. 2014) ("Doctor's Hospital"). In that case, the court looked to the "economic substance" of a Premium and found that it was both a claim for unmatured interest because it was a yield maintenance formula, and liquidated damages because it was an agreed calculation to establish damages for failure to make all payments through the term of the loan. In this case, the loan was not accelerated until sometime after the bankruptcy petition and the lender was undersecured. The court held that the claim was therefore barred by Section 503(b)(2) of the Code because the Premium had not yet matured. The court cited the Seventh Circuit in *In re Chicago Milwaukee, St. Paul & Pac. R.Co,* 791 F.2d. 524 ,529 (7th Cir. 1986) for the proposition that a bankruptcy court can refuse interest to undersecured creditors under Section 502(b)(2) where unsecured creditors are not receiving all of their principal. The court expressed its disagreement with the *Trico Marine Servs., Inc.* reasoning which, the *Doctor's Hospital* court thought, rested on a "false dichotomy between unmatured interest and liquidated damages". Further, it questioned the assertion by the *In re Trico Marine Servs., Inc.* court that the majority of courts found Premiums to be liquidated damages in all cases. The *Doctor's Hospital* court distinguished several of the opinions cited by *Trico Marine Servs., Inc.* in support of its holding. These included: (i) *In re Outdoors Sports Headquarters, Inc.*, which upheld the premium because the lender had accelerated upon default and the Premium was due and no longer unmatured; (ii) *In re Skyler Ridge* where the court held that the liquidated damages fully matured at the time of breach and therefore did not represent unmatured interest; and (iii) *In re Lappin Elec. Co.*, which concluded the Premium was just an agreed upon settlement unrelated to the lost yield and therefore not unmatured interest. Almost all of the cases cited under this section II are decided applying New York law, however, there appears to be no consistency with respect to when the Premium was upheld as liquidated damages and when it will be prohibited as unmatured interest with respect to claims of undersecured creditors. It does appear that if the Premium is matured because of default, it is much more likely that it will not be prohibited under Section 503(b)(2).

B) Premiums and Section 506(b) of the Code.

At least with respect to the application of 11 USC § 506(b), there does appear to be some degree of certainty. If the loan agreements provide for an enforceable premium under the documents and state law, most courts have held that premiums are charges, allowable to the extent of the lender's security, under 11 USC § 506(b), which provides that a secured claim may include principal, interest and "any reasonable fees, costs or charges provided for under the agreement…". Therefore, where the "make whole claims" are enforceable and the creditor is fully secured, it does not matter whether the court holds that such charges are "liquidated damage" or claims for unmatured interest.

III. Automatic Acceleration and Premiums.

A) The Ipso Factor Clause. Much of the litigation in bankruptcy regarding Premiums involves the impact of "ipso facto" clauses, and resulting automatic acceleration, upon the rights of the lender thereafter. Many indentures contain provisions for automatic default and acceleration of the obligations when a borrower files bankruptcy. When this happens, the maturity of the obligations is accelerated to the bankruptcy petition date and unless a Premium in the loan documents expressly provides that it is effective upon acceleration, it will not be enforced. As an initial matter, lenders have argued that such "ipso facto" clauses are void; however, "ipso facto" clauses are only void under certain sections of the Code; 11 USC § 365(e)(1) in executory contracts, 11 USC § 541(c)(1)(b) terminating a debtors interest in property and 11 USC § 363(1) giving the trustee the right to use, sell or lease property despite an "ipso facto" clause. Almost all courts have held that loan documents or indentures are not executory contracts and therefore these ipso factor acceleration clauses have been enforced against the debtor, to the detriment of the lender. The Second Circuit discussed the "ipso facto" clause issue at length in *In re AMR Corp*. and affirmed the lower court in the enforcement of such clauses under an indenture.

B) The Language Allowing Premium Upon Acceleration Must Be Explicit. Where the filing of the bankruptcy has automatically accelerated the maturity date of the indenture, bankruptcy courts have been loath to allow claims for Premiums. Under New York law, the loan documents must expressly provide that a Premium is due upon acceleration or it will not be enforced. See *Northwestern Mut. Life Ins. Co. v Uniondale Realty Assoc.*, 816, N.Y.S. 2d 831, 835 (N.Y. Sup. Ct. 2006)*; In re South Side House, LLC,* 451 B.R. 248, 268 (Bankr. E.D.N.Y. 2011), aff'd *'U.S. Bank Nat'l Ass'n v. South Side House, LLC,* No. 11-4135, 2012 WL 273119 (E.D.N.Y. Jan. 30, 2012) and *In re Premier Entm't Biloxi LLC,* 445 B.R. 582, 626. A minority of courts have sided with the lender and ruled that the acceleration itself qualifies as a prepayment which triggers the Premium and requires no language expressly tying the Premium to acceleration. That minority includes, *In re Skyler Ridge*, 80 B.R. 500, 1987 Bankr. LEXIS 1935, Bankr. L. Rep. (CCH) P72,167, 16 Bankr. Ct. Dec. 1122 (Bankr. C.D. Cal. 1987) and *In re Imperial Coronado Partners, Ltd*., 96 B.R. 997, 1989 Bankr. LEXIS 269 (B.A.P. 9th Cir. 1989). To be clear, all courts have held that if the language of the indenture explicitly provides for payment of a Premium in the event of acceleration of the loan, courts will enforce them and allow those claims. Unfortunately, that is where the clarity ends. The examples of holdings where the language is express or clear enough to allow such a claim are few and far between. Two cases in the Seventh Circuit have found that the express language of the indenture provided for a premium upon acceleration. The case of *In re Schaumburg Hotel Owner Limited Partnership*, 97 B.R. 943, 1989 Bankr. LEXIS 416 (Bankr. N.D. Ill. 1989) enforced the premium because the language specifically provided that the premium would be payable upon acceleration. In the case of and *In re AE Hotel Venture*, 321 B.R. 209, 2005 Bankr. LEXIS 166, 44 Bankr. Ct. Dec. 92 (Bankr. N.D. Ill. 2005), the court acknowledged the general rule that a lender waives its right to a prepayment premium upon acceleration but found that the language,

while not mentioning acceleration, expressly provided for the payment even after the lender exercised its remedies, including foreclosure. Other cases which may be helpful in determining what language is sufficient to clearly tie the premium to the acceleration of the debt include: *In re Madison 92nd Street Associates, LLC,* 472 B.R. 189, 2012 Bankr. LEXIS 2515, 56 Bankr. Ct. Dec. 170, 2012 WL 1995129 (Bankr. S.D.N.Y. 2012)*; In re CP Holdings, Inc.*, 332 B.R. 380, 2005 U.S. Dist. LEXIS 24461 (W.D. Mo. 2005); *In re United Merchants & Mfrs., Inc.*, 674 F.2d 134, 6 Collier Bankr. Cas. 2d (MB) 321, Bankr. L. Rep. (CCH) P 69005 (2d Cir. 1982); *Parker Plaza W. Partners v Unum Pension & Ins. Co.*, 941 F.2d. 349, 355-356 (5th Cir. 1991); *Teachers Ins. & Annuity Ass'n v Butler,* 626 F. Supp. 1229, 1230 (S.D.N.Y. 1986); *In re AMR Corp.*, 485 B.R. 279 (Bankr. S.D.N.Y. 2013); and *In re Chemtura Corp*., 439 B.R. 561 (Bankr. S.D. N.Y. 2010). In *In re Chemtura Corp.*, Judge Gerber, in the context of approving a settlement between the debtors and the lender, upheld a premium where the language of the indenture provided that the premium was due if the loan was paid prior to the "original maturity date" (emphasis added). While Judge Gerber had only to approve the settlement based upon the business judgment rule, this ruling was cited favorably in *Momentive*, in the context of denying enforcement with respect to other language in that case.

Unfortunately for lenders, the majority of cases have found that there is insufficient express language in the indentures to overcome the waiver of the Premiums upon acceleration, whether by the actions of the lender or the automatic acceleration as a result of a bankruptcy filing or other default. See the Fifth and Seventh Circuits, respectively, in *In re Denver Merchandise Mart, Inc.*, 740 F.3d 1052, 58 Bankr. Ct. Dec. (DRR) 274 (5th Cir. 2014) and In re LHD Realty Corp., 726 F.2d 327 (7th Cir. 1984). Again, many of the indentures reviewed by bankruptcy courts across the country are reviewed under New York law, as that is the choice of law in the documents. Therefore, many of these courts look to New York decisions in making their rulings. New York courts have been exacting in the requirement that the preservation of the Premium must be directly tied to the acceleration provisions, in order to enforce the Premium. In *In re Premier Entm't Biloxi, LLC,* 445 B.R. 582 (Bankr. S.D. Miss. 2010), the court rejected the indenture trustee's claim for a Premium after automatic acceleration finding that there was no clear contract language preserving the Premium after maturity as is required under New York case law. Other recent cases finding the language insufficient to enforce the Premium include: In *HSBC Bank USA, N.A. v. Calpine Corporation,* 2010 U.S. Dist. LEXIS 96792, 2010 WL 3835200 (S.D.N.Y. Sept. 14, 2010) *("Calpine II")*, and *In re Solutia,* 379 B.R. 473, 2007 Bankr. LEXIS 3921, 49 Bankr. Ct. Dec. 38 (Bankr. S.D.N.Y. 2007) where, at 488, the court held that the language was negotiated by sophisticated parties and could have expressly provided for a Premium on acceleration. It should be noted that the acceleration provisions in both *Solutia* and *In re Calpine Corp.*, No. 05-60200 (Bankr. S.D. N.Y. 2007)(Dkt. No. 3481-4) *("Calpine I").* contained acceleration language which provided that "principal of and premium, if any, ... would be immediately due and payable…". Both courts held that this language simply sends the reader back to the indenture to see if a Premium is provided upon acceleration. These courts contrasted this language with other cases where the acceleration clause provided that, upon acceleration, the debtor shall pay the Premium. In many of these cases the Premium provisions in the indentures are separate from the default and acceleration provisions and the courts have treated them separately, distinguishing the Premiums as voluntary prepayments and therefore different than

the automatic acceleration provisions. The courts go to great length to assert that they are reviewing the document as a whole, but the analysis focuses first on those provisions which the courts believe are the most appropriate part of the indenture, the automatic acceleration provisions. If there is no incorporation of the make-whole provision into the acceleration provisions or express terms providing for the Premium in the acceleration provisions, the premium will not be enforced. See *In re Solutia, Calpine I* and *II*.

Two cases indicate just how carefully courts parse language to disallow these Premiums. In *In re Denver Merchandise Mart,* the Fifth Circuit upheld a decision which denied a Premium because the acceleration clause language provided that the Premium was due upon payment after acceleration, whether the payment was voluntary or involuntary, including after acceleration. The court held that since there was no payment by the debtor, no Premium was due. The court held that the lender could have drafted a provision which required that the Premium was due upon acceleration and not payment after acceleration. This is the same interpretation of substantially similar language in an earlier case in New York, *Northwestern Mut. Life Ins. Co.*

C) Intentional Default to Trigger Acceleration and Avoid the Premium. Lenders have argued that the borrower filed a bankruptcy simply to trigger acceleration and destroy the Premium. These arguments are rarely successful because there is generally some evidence of cashflow issues or catalyst other than an intent to defeat the Premium.

D) The Automatic Stay and Lender Waiver of Default and Rescission of Acceleration. Many indentures contain rights of rescission and waiver of defaults. Lenders have delivered rescission notices to debtors after bankruptcy default automatic acceleration in order to decelerate the loans and reinstate the Premiums. The efforts have not been successful and virtually every court has found that such rescission notices violate the automatic stay as an action to collect a debt or modify contract rights. See *In re Solutia* and *In re AMR Corp., Calpine I and Calpine II.* Lenders have also sought to lift the stay to rescind for cause. Courts have applied the Sonnax factors, *In re Sonnax Indus.,* 907 F.2d 1280 (2d Cir. Vt. 1990) and refused to do so.

IV. Recover Under No-Call Provision or the Perfect Tender Rule

Lenders have also argued that, if there is no enforceable Premium, they may still recover under the perfect tender rule or the no-call provisions. As a general rule, bankruptcy courts will not specifically enforce no-call provisions because "the essence of bankruptcy reorganization is to restructure debt…" and this would mean that the lender could contractually prohibit the debtor from reorganizing. See *In re Chemtura Corp., Calpine I* and *Calpine II*. However, lenders have argued that they are entitled to unsecured damage claims for breach of the perfect tender rule or a no-call provision. Many recent courts have held that in absence of a fee, charge or formula for determining damages in the event of breach of a no-call provision, there can be no recovery. This is because if there is no agreement with respect to damages, there are no liquidated damages. The measure of damages would therefore be the based upon the interest which would have been paid, but for the bankruptcy. Such claims would violate 11 USC § 502(b)(2) which precludes claims for unmatured interest. Further, pursuant to 11 USC § 506(b), secured lender are not

entitled to include fees or charges in their secured claims unless they are provided for in the loan documents.

Generally, indentures do not provide for a charge in the event of breach of the no-call provision. Further, courts have held that the perfect tender rule is inapplicable if the documents modify the common law rule with premium provisions. The result may be different if the debtor is solvent. In *In re Premier Entm't Biloxi, LLC*, the court found that while there was no claim under Section 506(b), there might be a claim for a loss of a stream of payments under Section 502(b)(2). Because the indenture provided that all remedies were cumulative, the court held that the lender was entitled to an unsecured claim for common law damages under the no-call provision. The measure of damage was the difference between the market rate of interest and the contract rate of interest at the date of payment. Because the debtor was solvent, equitable grounds supported allowing the claim despite Section 502(b)(2) of the Code. This reasoning was followed in *Calpine I* where the debtor was insolvent, but was reversed in *Calpine II.* In reversing *Calpine I,* the district court in *Calpine II*, nevertheless agreed with the reasoning in *In re Premier Entm't Biloxi, LLC* where the debtors were solvent, under general equitable principles contained in the legislative history of 11 USC § 1124 or under the best interest test under 11 USC § 1129(a)(7).

V. *Momentive* and *Energy Future Holdings*.

As stated above, two cases have been decided which may have far reaching consequences with respect to the application of Premiums, *Momentive* and *Energy Future Holdings*, with claimed Premiums of $200 million and $451 million Premiums, respectively. These cases, which have now been affirmed by their respective district courts and are on their way to their respective Circuit Courts of Appeal, have struck fear in the hearts of lenders.

A. ***Momentive.*** In *Momentive*, the court, in a lengthy bench opinion, demolished every argument which the lenders made to preserve a secured claim arising from the Premiums in the loan documents. The decision was in the context of a contested plan confirmation. The debtors were obligated pursuant to prepetition indentures and notes. The notes had an interest rate of 10% per annum, were due on October 15, 2020 and contained Premiums in the event of prepayment prior to October 15, 2015; however, the indenture contained the dreaded acceleration clause which was triggered by the commencement of a bankruptcy proceeding . Section 6.01(f) provided for default if the debtors filed a voluntary bankruptcy proceeding ("Bankruptcy Default"). Section 6.02 of the indenture contained the acceleration provisions ("Acceleration Provisions") which provided for discretionary acceleration by the lenders for all defaults except a Bankruptcy Default. In the event of a Bankruptcy Default, the Acceleration Provisions provided that "the principal of, premium, if any, and interest on all Notes shall ipso facto become and be immediately due and payable". The Acceleration Provisions also provided the lenders with an elective right to rescind and decelerate.

The debtors commenced Chapter 11 on April 13, 2014. Thereafter they filed a plan which gave the lenders the option to vote for the plan and be paid all principal and interest on the effective date of the plan, with no Premium, or to vote against the plan and receive replacement

notes equal to the allowed amount of the lenders' claims, which could, at the discretion of the bankruptcy court, include a Premium. The lenders objected to their plan treatment and argued that the commencement of the bankruptcy constituted a redemption of the notes, entitling them to the Premium contained in the notes. The debtors argued that the acceleration provision was triggered by the bankruptcy, the maturity date was moved to the date of the petition and therefore, no Premium was due. The court agreed with the debtors, finding that the interpretation of the indenture provisions was a matter of basic contract law, citing *In re AMR Corp.* The parties agreed that New York law was applicable. The court noted that under New York law, a lender generally forfeits the right to a premium by accelerating the obligation unless a "clear and unambiguous clause … calls for payment of the prepayment premium" citing *U.S. Bank Nat'l Ass'n, v South Side House LLC* at 4-5. Parsing through the documents, the court focused on the language of the two sections of the agreement which it believed were material to its determination, the Acceleration Provisions and the Premium Provisions. The court found that these were two distinct and independent provisions and treated as such throughout the loan documents. The Premium Provisions dealt with a voluntary redemption of the notes, which required the debtors to go through a process in order to redeem the notes prior to October 15, 2015. Notices and other actions were required by both parties. Conversely, the Acceleration Provisions dealt with an involuntary modification of payment terms and required no action or notice. Neither the Premium Provisions nor the Premium were incorporated by reference or otherwise into the Acceleration Provisions nor were the Acceleration Provisions incorporated into the Premium Provisions of the notes. The court then looked to the provision which it believed most relevant, the Acceleration Provisions, to see if a Premium was required in such event. The court found that the Acceleration Provisions did not expressly call for the payment of a Premium upon acceleration and found the language that provided for payment of "a premium, if any," upon acceleration, not sufficiently explicit to require payment of a Premium upon acceleration. Citing *In re La Guardia Associates, L.P.*, 2006 Bankr. LEXIS 4735, 2006 WL 6601650 (Bankr. E.D. Pa. Sept. 13, 2006), the court finds that this language in an acceleration provision simply sends the reader back to the Premium Provisions to see when one is due, it does not establish the obligation upon acceleration. In this case it is only due upon a voluntary redemption. The court contrasted this language with the language in *U.S. Bank Nat'l Ass'n v South Side House LLC,* which provided that 'upon Lender's exercise of any right of acceleration…Borrower shall pay to Lender ….the prepayment premium'.

The lender argued that, regardless of the acceleration of the debt due to the Bankruptcy Default, the early payment of the debt constituted a redemption prior to October 15, 2015, requiring the Premium under the Premium Provisions in the notes. The court again rejected this argument and held that the automatic acceleration, under the Acceleration Provisions changed the maturity date from some point in the future to the petition date. This was separate and independent from the Premium Provisions which contemplated a voluntary payment. Hence the repayment of the debt in the bankruptcy proceeding is not a redemption, citing *In re AMR Corp.* The lender further argued that because the Premium Provisions had a date certain before which redemption would trigger the payment of the Premium, the explicit requirement is satisfied. The lenders contrast this with a provision which triggers the Premium upon redemption before maturity, which ties the Premium to maturity. The lenders cited *In re Chemtura Corp.* in support

of their position, however the court disagreed and found that the language of the Premium provisions in *In re Chemtura Corp.* was distinguishable because it provided for a Premium if redemption occurred prior to the "original" maturity date (emphasis added). The court found that the *In re Chemtura Corp.* language was clear and unambiguous enough and cited Scott K. Charles & Emil A. Kleinhaus, *Prepayment Clauses in Bankruptcy,* which instructs that the optimal strategy for lenders is to negotiate a Premium which requires the debtor to pay the Premium whenever the loan is repaid prior to its original maturity. The court found that the Premium Provisions and the Acceleration Provisions did not accomplish that. Lender finally argues that this makes no commercial sense and is contrary to the reasonable expectation of the parties. Quoting language from *In re LHP Realty Corp.,* 726 F2d 327, 331 (7th Cir. 1984), the court found that this was exactly what the lenders bargained for in the Acceleration Provisions, establishing that they "preferred, sensibly no doubt, accelerated payment over the opportunity to earn interest from the …loan over a period of years".

The lender next argued that since the automatic stay cancelled its right to rescind, that it should be entitled to damages for breach of the rescission provisions. The court agreed with debtor that the loans were negotiated in the context of the possibility of a bankruptcy and the automatic stay was part of the bargain. The court found that the lender bargained for the acceleration of debt and must live with the consequences.

The lender also sought to rescind the acceleration, pursuant to the elective rescission provisions in the Acceleration Provisions. The court, consistent with *In re AMR Corp.* and *In re Solutia*, denied the right to rescind, holding that the automatic stay did bar rescission and deceleration of the obligations because it would increase the lenders' claim by $200 million. The court held that this is an attempt to exercise control over the estate by exercising a contract right, in violation of Sections 362(a)(3) and 362 (a)(6). Judge Drain further held that such rescission and deceleration was not an exception to the stay, under Section 555(iii) of the Code for recession of a securities contract, because the notes were not securities. Further, the court refused to lift the stay nunc pro tunc for cause because deceleration would significantly impact the other creditors and the estate, citing the twelve factors in *In re Sonnax Indus*.

The Court also denied a claim for damages in the amount of the Premium based upon breach of the a no-call provision which the lenders argue was contained in the notes Premium Provisions. The purported no-call provision was the introductory language to the Premium Provisions and provided "except as set forth in the following two paragraphs (which referenced the Premium), the Note shall not be redeemable at the option of *Momentive,* prior to October 15, 2015." The court held that this language was simply a framing device for the elective redemption provisions and the Premium and not a no-call provision. The lender also argued that, under the general reservation of common law rights and remedies in the indenture, it had a common law claim for breach of the perfect tender rule. First, the court held that, while breach of the perfect tender rule under New York law may result in a claim, at least for specific performance, under the two step approach, the analysis requires application of the Code to ascertain if such claim is precluded in bankruptcy, citing *Ogle v. Fidelity & Deposit Company of Maryland,* 586 F. 3d 143 (2nd Cir. 2009) at 147-48. The court first held that there can be no claim for specific performance

of the perfect tender rule in bankruptcy because of the "non-contractual acceleration of debt for claim determination purposes" citing *Calpine I* at 11-14 and Scott K. Charles & Emil A. Kleinhaus, *Prepayment Clauses in Bankruptcy,* supra at 563-64. Next, the court held that the loan documents did not contain a fee or charge for breach of the perfect tender rule and therefore such damages are not allowable under Section 506(b) of the Code, citing *Calpine I* and *II*. Finally, the court recognized the split in authority with respect to whether claims for lost yield expectations are liquidated damages or claims for unmatured interest, citing *In re Trico Marine Servs.,Inc.* (finding liquidated damages) and *In re Doctors Hospital of Hyde Park, Inc.*, 508 B.R. 596, 605-06 (Bankr. N.D. Ill. 2014) (finding unmatured interest). The court concluded that, under New York law, where there is no liquidated damages provision for breach of the perfect tender rule in the documents, the measure of damages is the present value of the interest under the under the original notes less the present value of the interest under the replacement notes, citing Scott K. Charles & Emil A. Kleinhaus, *Prepayment Clauses in Bankruptcy,* at 541-42. The court characterized this as unmatured interest. The court found no such liquidated damages provision related to breach of the perfect tender rule so it held that any such claim by the lenders would be for unmatured interest and therefore prohibited under Section 502(b)(2) precluding claims for unmatured interest. With respect to two cases cited by the lenders, *In re Premier Entm't Biloxi, LLC* and *In re Chemtura Corp.*, the court agreed that these cases were properly decided because both estates were solvent and therefore the claims were subject to an exception to Section 502(b)(2) under equitable principles as set forth in the legislative history of Section 1124 of the Code (citing 140 Cong. Rec. H 10 768 (October 4, 1994) or because of the "best interests test" in Section 1129(a)(7).

The nightmare for the lenders intensified when they sought to enter parol evidence to establish the intentions of the parties, in the form of the risk disclosures in the prospectuses issued in conjunction with the bonds. The lenders pointed out that the risk of disallowance of the Premium upon acceleration is not among the risks disclosed in the prospectuses. The court goes to great length to say that his opinion is based upon well settled law and that there is nothing new here and everyone should have known that the Premium was going to be disallowed in a bankruptcy acceleration. It found the lack of disclosure unpersuasive.

The lenders were therefore denied any Premium or damages. This case was affirmed by Judge Briscotti in a lengthy written opinion in *In re MPM Silicones, LLC,* 531 B.R. 321 (S.D. N.Y. 2015). Apparently not satisfied that there were not enough nails in the lender's coffin, the District Court added a ground for denying the lenders claims under the perfect tender rule, holding that the Premium Provisions and the Acceleration Provisions modified the perfect tender rule so that it was no longer available, citing *U.S.Bank Nat. Ass.n,* and Scott K. Charles & Emil A. Kleinhaus, *Prepayment Clauses in Bankruptcy,* at 543. *Momentive* is currently on appeal before the Second Circuit Court of Appeals.

B. *Energy Future Holdings.* The Delaware bankruptcy court addressed similar issues in *Energy Future Holdings*. *Energy Future Holdings* was also determined under New York law. The dispute arose in the context of the debtors' requested approval of post-petition financing which would refinance the prepetition lenders' obligations. The indenture of the prepetition

lenders contained an "Optional Redemption Clause" which provided that the debtors could redeem all or a part of the notes prior to December 1, 2015 if the debtors paid the "Applicable Premium". The indenture also contained default provisions, under which certain defaults, including a bankruptcy filing, automatically accelerated the loans with the following language "all outstanding Notes shall be due and payable immediately, without further action or notice." Most of the notes accrued interest at the rate of 10% per annum. The debtors filed bankruptcy on April 29, 2014 and immediately sought approval for financing to repay all of the outstanding prepetition notes and to settle certain noteholders' claims. The debtors did not propose to pay any Premium, other than the settlement proposed to the settling noteholders. The refinancing would have saved $13 million per month in interest and a total Premium of $431 million. Those lenders who had not settled objected to the financing on May 13, 2014, asserting (i) their rights to the Premium because an Optional Redemption would occur when the notes were repaid, (ii) that the debtors had intentionally triggered the bankruptcy default to avoid payment of the Premium, and (iii) the repayment would be a violation of the lenders right to rescind the acceleration of the notes. The lenders also filed an adversary proceeding on May 15, 2014, alleging the same issues raised in the objection as well as an unsecured claim for breach of the no-call provision, in the indenture. The lender also filed a motion to determine that it could decelerate the notes without violating the automatic stay. The court approved the financing on June 6, 2014 and the settling noteholders were paid their interest, principle and settlement amount. The objecting lenders also received interest and principle and continued to prosecute their claims under the adversary proceeding. The court bifurcated the trial. Phase I of the trial was to determine whether the lenders were entitled to any claim under non-bankruptcy law for what the court called a "Redemption Claim", whether for a Premium, violation of a no-call provision, right to decelerate, or other claim. The court would also determine if the debtors had intentionally triggered the acceleration to avoid the Premium. The debtors would be presumed solvent for this phase of the hearing, except with respect to the intentional acceleration issue. If the Court found that there was a Redemption Claim and the debtors contest their solvency, Phase II would determine if the debtors were insolvent and if that insolvency gave rise to any defenses to or bars the Redemption Claim under the Code.

After full discovery, the parties filed cross motions for summary judgment. In rendering its decision, the court reviewed the indenture for key provisions of the notes and indenture. It found that key provisions were the "Optional Redemption" in Section 3.07, the "Events of Default" in Section 6.01, " Acceleration" in Section 6.02 and the Applicable Premium definition in Section 1.01 under "Definitions". The Optional Redemption provided that at any time before December 1, 2015, the debtor could redeem the notes by paying the principal and the Applicable Premium. The Applicable Premium provided a formula approach, the Events of Default included a bankruptcy filing and the Acceleration provided that, upon a bankruptcy default, the notes would be due and payable immediately without further action or notice. The court contrasted automatic acceleration with the Acceleration provisions in the event of non-bankruptcy defaults, which were discretionary with the lender.

The court held that, under New York law, it need not look outside the "four corners" of the document and noted that a document is not ambiguous simply because the parties offer

different constructions of the same terms. The court found the document was not ambiguous. The court then begins its analysis with the most relevant provision. Like the court in *Momentive*, the court selects the Acceleration provision. The Acceleration provision accelerates all notes in the event of bankruptcy, there is no mention of the Applicable Premium upon automatic acceleration and no incorporation of the Optional Redemption section in the Acceleration provision. Based upon this language and New York law, which requires that the indenture contain express language providing for a Premium upon acceleration or none will be allowed, the court finds that the lenders have no right to the Applicable Premium in the event of acceleration, citing *Northwestern Mut. Life Ins. Co. v Uniondale Realty Assocs.*; *In re South Side House, LLC*, aff'd *U.S.Bank Natl Ass'n v South Side House LLC*; *In re Premier Entm't Biloxi, LLC* and *Momentive*. The court commented that, prior to the date this indenture was negotiated, many cases had been decided upholding language providing for Premiums in the event of acceleration, citing *In re United Merchs. & Mfrs, Inc.*, at 141-143*; Parker Plaza W. Partners v Unum Pension & Ins. Co.* and others. The court said that the lender could have bargained for such a provision. The court held that the indenture was negotiated at arms-length, by sophisticated parties who were represented by counsel and the court was unwilling to read into the documents provisions which are not there. The court then emphasized the correctness of its analysis under New York canons of construction which provide that a specific provision governs the circumstances to which it is directed, even if it contradicts a more general provision, citing *In re AMR Corp.* The court concludes that nowhere in Section 6.02, the Acceleration Provisions, is there reference to the Applicable Premium or the Optional Redemption Section 3.07 or anything that would support the lender's position. The court then reviewed acceleration provisions in four cases, decided under New York law, where the court denied enforcement of a Premium after a bankruptcy acceleration; *Calpine I*, *In re Premier Entm't Biloxi, LLC, Momentive* and *In re Solutia*. The court finds these provisions substantially similar and agrees with the holdings in those cases.

The lenders argue that the indenture must be read as a whole and that the Optional Redemption is a "wholesale bar" to any payment before December 1, 2015. The court calls this reading strained and believes it defies canons of contract construction because (i) the lender looks to the Redemption section instead of the Defaults and Remedies section to determine the remedies upon default, and (ii) the lender asks the court to hold that because the Optional Redemption does not expressly disclaim the effect of the Acceleration Provisions, the Optional Redemption section must control. It finds that such a construction is clearly contrary to New York law, requiring an explicit provision of a Premium upon acceleration. The court, as in *Momentive*, finds that the redemption provisions are wholly separate from the acceleration provisions and are distinguished in treatment throughout the indenture. As in *Momentive*, this court finds that, under the indenture, (i) there is a detailed process for voluntary redemption which is completely unrelated to acceleration; and (ii) acceleration is automatic and without notice. The court then holds that under New York law, a payment after acceleration is not considered voluntary, citing *In re AMR Corp.* at 103, rejecting the claim that an accelerated claim is a "voluntary redemption". This is because the maturity date is moved up by acceleration. Under New York law, once an obligation is accelerated, it is no longer possible to prepay it.

The court next denied the lenders secured damage claim based upon the debtors' triggering of the default with the intention of denying the Premium. It found, that this indenture did not provide that if the debtor triggered the default in order to avoid the Premium, it would receive a Premium. Therefore it was precluded by Section 506(b) of the Code. Further, the court found that the lender had the burden of proof with respect to this issue and the lender had not established the case.

This author believes that, based upon the courts finding and ruling in *Energy Future Holdings*, it would be almost impossible to prove the default by the debtor and acceleration was with the intent to evade the Premium. Here it was established that the debtor had sought refinancing for some time before the bankruptcy, the new lenders had encouraged a bankruptcy to avoid the Premium, eight months before the bankruptcy, the debtors management had represented that the debtors were solvent, the debtors filed an 8-k with the SEC disclosing the proposed post-bankruptcy filing and avoidance of the Premium, the debtor memorialized its plan and the avoidance of the Premium in a Restructuring Support Agreement and the debtor made no effort to market assets. The court found this unpersuasive in light of evidence that the debtors had cashflow problems and would have suffered significant tax consequences if they had marketed assets.

The court also denied the unsecured claim for breach of a no-call provision. The court found that the early redemption provisions in this case were almost the same as those in the *Momentive* case. The court found that, like *Momentive*, the indenture did not preclude prepayment but allowed it and called for a Premium in such event. Therefore, the perfect tender rule was modified and was inapplicable. As in *Momentive*, it also found the language in the Redemption provisions precluding payment except if paid pursuant voluntary redemption provisions to be "framing" devices and not no-call provisions. The court followed *Momentive* in denying claims under the perfect tender rule.

The court also held that there was no claim for damages for breach of the rescission clause, because Section 506(b) of the Code only provides for claims of over secured creditors for fees, costs and charges provided for "under the agreement…" The indenture did not provide for a charge or fee in the event that the lenders was precluded from exercising their rescission rights. The court, also held that there was no claim for yield expectation damages due to the lenders inability to rescind the acceleration for the reasons cited in *Momentive*, including that such damages were in violation of Section 502(b)(2) of the Code.

Finally, following *Momentive*, the court held that the automatic stay did preclude the rescission because it was "an act to assess or recover" a claim. The court decided that if the stay were lifted nunc pro tunc "for cause", the lender would be able to rescind acceleration and the Premium would be due. In determining if the stay should be lifted for cause, the court would make its determination, under the totality of the circumstances in a particular case, citing *In re Wilson,* 116 F. 3d 87, 90 (3d. Cir. 1997). It held that the factors to be considered included: (i) whether any great prejudice will result to the estate or the debtor, (ii) whether the hardship to the non-debtor outweighs the hardship to the debtor, (iii) the probability of the creditor prevailing on the merits, citing *In re Doroney Fin. Corp.*, 428 B.R. 595, 609 (Bankr. D. Del. 2010). Lenders

argued that if the debtors are solvent "cause" would exist to lift the stay because the debtors and the estate would not be prejudiced but the debtors would simply be held to their bargain. This court found that, several courts, including *Momentive* and *In re AMR Corp.*, have disagreed that this issue simply depends on whether the estate is solvent. The court held that there was a question of fact with respect to this issue and set the matter for hearing. In a subsequent hearing, the court denied the request to lift the stay nunc pro tunc to allow for rescission. The court found that the estate and other stakeholders would be greatly prejudiced and the harm to the first lienholder did not outweigh the harm to the debtors and the estate. The court found it important that the Premium was a much greater percentage of the debtors' estate than it was of the lenders portfolio.

As in *Momentive*, the Court in *Entergy Future Holdings* denied the lenders any recovery under the Premium or any no-call or perfect tender rule theories. The court was affirmed on appeal to the district court in *Del. Trust Co. v Energy Future Intermediate Holding Company LLC*, Civ. Action No. 15-620RGA (D. Del. Feb. 16, 2016) (Memorandum Order) and the cases are now pending before the Third Circuit Court of Appeals.

VI. Lessons to be Learned.

What are the lessons to be learned from this developing case law:

1. When drafting Premium provisions, review the treatise Scott K. Charles & Emil A. Kleinhaus, *Prepayment Clauses in Bankruptcy*, 15 Am. Inst. L. Rev. 537 (2007), because recent decisions have cited its drafting instructions favorably.
2. Drafters should include the covenant requiring payment of the Premium in the acceleration provisions.
3. The inclusion of the Premium in the acceleration provisions cannot simply be a passing inclusion with interest and principal, it should specifically require that, upon acceleration, the Premium is due and payable.
4. Language in the acceleration provisions can state that the Premium is due if acceleration occurs prior the "original" maturity date, but this should be a defined term and that defined term should not be confined to voluntary redemption provisions.
5. Drafters should avoid language that states that the Premium is due upon payment after acceleration because a court may hold that payment was never made so the Premium is not due. The Premium should be due upon acceleration.
6. If there are separate provisions for voluntary redemption and acceleration, do not expect these provisions to be read as a whole. Drafter should understand that recent courts have held that these are very different circumstances and the requirement of a Premium in a voluntary redemption context will not be read to apply in the event of acceleration. The Premium must be provided for in the acceleration provisions. Again, this is because, under New York law and that of other jurisdictions, a payment after acceleration is not a voluntary payment. This distinction between the interpretation of voluntary versus accelerated payment should be kept in mind in drafting each section of all of the documents.

7. Drafters should provide language in the indenture which affirmatively states that the Premium constitutes liquidated damages, is agreed to because damages are difficult to determine, and is not disproportionate in the context of the lender's bargained for yield.
8. Drafters should provide specifically for a no-call provisions in the general reservation of rights provisions, include a Premium for the violation of same, as knowledge that the Premium is a liquidated damages, necessary because damages are difficult to determine and agree that it is not disproportionate to the lender's bargained for yield.
9. Drafters should make certain that the Premium is specifically included as part of the obligations to be secured in any security agreements.
10. In the event of default before bankruptcy, where lender's counsel is faced with executed documents which provide unenforceable Premium language, the lender should try to remedy the problem in a forbearance agreement or amendment to the documents as a condition to forbearance. Debtors' should beware of language in forbearance agreements which are designed to rehabilitate the defective Premium language.
11. In the event the debtor is in default, the lender is undersecured and it appears that the Premium will be due after acceleration, the lender will want to insure the loan is accelerated prior to a bankruptcy to improve chances that the Premium will not be prohibited under Section 502(b)(2) of the Code. Conversely, the debtor will want to file prior to acceleration to reach the converse result.

In conclusion, cases involving Premiums are often difficult to reconcile, and not just because their resolution is dependent upon the specific language in the loan documents. An indenture, which a lender would believe, read as a whole, would clearly evidence an agreement to protect the lender's expected yield is parsed away by the court. After reviewing the lengths to which courts have gone to disallow Premiums, perhaps lender's counsel engaged in drafting these Premium provisions should consider a special rider to its malpractice coverage for even attempting to draft a Premium provision which will withstand bankruptcy acceleration.