Toward Understanding Make-Whole Premiums in Bankruptcy

By Patrick M. Birney[*]

I. Introduction

Loan agreements and bond indentures typically contain prepayment provisions that circumscribe a borrower's ability to prepay outstanding indebtedness before maturity. In those instances where a borrower is authorized under the documents to repay or refinance the debt prior to maturity, the contract with the lender (hereinafter "lender") routinely provides for charging the borrower fees for the early repayment, resulting in the lender's prospective loss of debt service. In bond transactions these charges are generally described as make-whole premiums. In loan transactions the fees may be referred to as prepayment penalties, prepayment premiums, yield maintenance premiums or prepayment fees. For ease of reference this article will refer to these make-whole premiums, fees and charges — regardless of whether they are provided for in the contract governing a bond or loan transaction — as "MWPs". Bankruptcy courts have had occasion to rule on the enforceability of MWPs in various situations where the borrower has sought protection under the Bankruptcy Code and the lender has sought to have the MWP treated as an allowed claim in the bankruptcy case. In ruling on the enforceability of MWPs, bankruptcy courts are called upon to interpret state law, analyze contract provisions, and scrutinize an MWPs' propriety under the provisions of the Bankruptcy Code. Part I of the article will analyze the origin of MWPs. Part II will describe the typical characteristics of an MWP. Part III will analyze the enforceability of MWPs under state law. Finally, Part IV will review the enforceability of MWPs in a case filed under the Bankruptcy Code, including exploring recent decisional law that addresses their enforceability.

II. The Evolution of Make-Whole Premiums

An MWP's family tree can be traced back, at least in part, to 1829, when the Connecticut Supreme Court in *Abbe v. Goodwin*[1] concluded that a borrower had no common law right to compel the lender to accept prepayment of two commercial mortgage notes prior to their maturity.[2] Sixteen years

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later, in *Brown v. Cole*[3] the English Chancery Court dismissed a similar action filed by a borrower seeking court authority to satisfy a mortgage debt prior to maturity.[4] By 1930 courts across the country had adopted the reasoning and conclusions reached almost 200 years ago in *Abbe* and *Brown*[5] and commentators have in unison pointed to the *Abbe* and *Brown* decisions as the alleged genesis of what is known now as the perfect tender in time rule (the "Perfect Tender Rule").[6] The Perfect Tender Rule provides that "a commercial borrower 'has no right to pay off his obligation prior to its stated maturity in absence of a prepayment clause.' "[7] The Perfect Tender Rule, thus, permits the lender to refuse a premature proffer of principal and interest.[8] The lender's economic expectations provide the predominant rationale underpinning the Perfect Tender Rule,[9] with Professor Frank S. Alexander noting four common economic justifications supporting the Rule: "(1) the creditor's transaction costs resulting from unanticipated reinvestment of the principal; (2) the need for predictable returns on investments; (3) the need for the stability provided by regular payments over time; and (4) the desire of the creditor to maximize yield beyond the contractual interest rate."[10]

While the Perfect Tender Rule is by no means jurisdictionally ubiquitous,[11] it remains viable in many states, including New York,[12] which is home to multiple money center banking institutions. In those jurisdictions, a specific provision in a loan agreement or bond indenture authorizing an entitlement to prepay before maturity is generally required to obtain relief from the Perfect Tender Rule.[13] As an alternative to remaining silent regarding the Perfect Tender Rule, a loan agreement or bond indenture in Perfect Tender Rule jurisdiction may also include a "no call" covenant, which makes plain that prepayment prior to maturity is expressly prohibited.[14] Damages for a breach of a no call provision have been found to equal "the present value of the difference between (a) the interest income the lender would have earned had the contract been performed, and (b) the interest income the lender would be deemed to have earned by timely mitigating its damages — i.e. by making an investment with similar characteristics at the time of the breach."("No Call Damages").[15] This measure of damages is intended to "put lenders in the same position as if the loan were repaid on its original schedule."[16]

Absent a provision in a loan agreement or indenture permitting early repayment, or an abrogation of the Perfect Tender Rule in the jurisdiction governing the transaction, a borrower must negotiate with the lender for the privilege of making an early tender. In that instance, a lender is free to reject a borrower's request and, "[t]ypically, the lender will agree to accept the prepayment, conditioned upon the borrower's willingness to pay a penalty."[17]

Not surprisingly, prepayment clauses typically contain a monetary prepayment provision. As noted by one author on the subject, a monetary prepayment provision "is defined as *any* charge (other than late charges, unpaid interest, or other amounts due to reimburse the lender its loan maintenance and collection expenses) imposed by the lender upon its borrower by reason of the borrower's payment of all or any portion of a loan on a date prior to

the scheduled 'due' or 'maturity' date."[18] A monetary prepayment provision generally assumes one of two principle structures, a fixed-fee prepayment or a yield maintenance prepayment,[19] Each will be discussed, in turn.

III. The Characteristics of Make-Whole Premiums

Courts have noted that an essential purpose of an MWP is to compensate lenders "for the risk that market rates of interest at the time of prepayment might be lower than the rate of the loan being prepaid."[20] That is, an MWP acts to, effectively, reimburse the lender for projected interest payments that the borrower would not make if the loan were satisfied prior to maturity.[21] "Among other things, a prepayment premium insures the lender against loss of his bargain if interest rates decline."[22]

As noted, supra, a monetary prepayment provision will generally be in the form of a fixed fee prepayment provision or a yield maintenance prepayment.[23] A fixed fee prepayment provision will permit a borrower to satisfy amounts due and owing under the debt instrument prior to maturity in consideration for payment of a sum certain.[24] "A fixed prepayment fee. . .can require payment of a specific dollar amount, or, more typically, a percentage of the outstanding loan balance."[25] The prepayment fee often decreases as the debt instrument approaches maturity[26] and is generally relied upon in floating-rate loan instruments.[27]

A second prepayment structure comes in the form of "yield maintenance" formulas,[28] intended to make the lender whole by estimating the lender's damages if the borrower seeks to satisfy the debt obligation prior to maturity.[29] One yield maintenance methodology adopts the No Call Damage formula discussed, *supra*.[30] "If enforced [this methodology] would effectively ensure that a court does not enjoin prepayment and applies the standard formula for determining expectation damages."[31] Another common yield maintenance formula fixes the lender's "reinvestment rate at the rate of interest that could be obtained through investment in U.S. Treasury notes of a maturity similar to the relevant loan."[32] Yield maintenance formulas are adopted when the underlying debt instrument provides a fixed-rate.[33]

IV. The Enforceability of Make-Whole Premiums under State Law

In discussing the enforceability of a borrower's right to prepay a commercial loan prior to maturity, the Kansas Supreme Court noted the following in *Metropolitan Life Ins. Co. v. Strnad*:[34]

> American courts have traditionally taken the view that competent adults may make contracts on their own terms, provided they are neither illegal nor contrary to public policy and, in the absence of fraud, mistake, or duress, that a party who has fairly and voluntarily entered into such a contract is bound thereby, notwithstanding it was unwise or disadvantageous to that party.[35]

Thus, a court's willingness to enforce an MWP in the first instance is inextricably linked to a determination of the contracting parties' intent from an analysis of the "four corners of the instrument."[36] Indeed, issues regarding MWPs "require careful attention to the precise terms of the parties' agreements within the framework established by [the law of the jurisdiction

governing the transactional documents.]"[37] "When parties set down their agreement in a clear and complete document. . .their writing should as a rule be enforced according to its terms. Evidence outside the four corners of the document. . .is generally inadmissible to add to or vary the writing."[38] An MWP *will not* be enforced in the absence of a clear contractual provision that authorizes its imposition.[39]

Further, the enforceability of an MWP is also linked to the type of default giving rise to the obligation,[40] and only if the amount of the MWP is deemed reasonable.[41] Several commentators have categorized four events precipitating the potential for a lender to collect a MWP.[42] The first category giving rise to a prepayment premium arises when the borrower wishes to voluntarily satisfy the debt before maturity.[43] The second category is triggered by the borrower's monetary default under the instrument and the lender's contractual right thereunder to accelerate the indebtedness.[44] The third category is triggered by a non-monetary default — arising, for example, from the sale of the property that secures the indebtedness — which may enable the lender at its option to accelerate the indebtedness under the instrument.[45] The fourth category, often identified as a "force majeure default"[46] is triggered by an event outside the borrower's control, which gives rise to the lender's right to accelerate[47] "such as the commencement or loss of significant litigation, the loss of important property as a result of a sale or condemnation proceedings, or the passage of a governmental law or regulation that interferes with the borrower's business."[48]

While a loan agreement or bond indenture may expressly entitle the lender to an MWP in the scenarios described, *supra*, there are certain limitations on their enforceability. By way of example, at least one court has refused to enforce a prepayment premium clause where the funds for the early repayment were generated from a governmental unit's exercise of its eminent domain powers.[49] Similarly, another court refused to award a prepayment premium when the premature payoff originated from the borrower's insurance carrier following the destruction by fire of the premises securing the indebtedness.[50]

Another prohibition against enforceability of an MWP under state law relates to the lender's ability to exercise acceleration as a remedy following the borrower's default.

> The rationale for this rule is logical and clear: by accelerating the debt, the lender advances the maturity of the loan and any subsequent payment by definition cannot be a prepayment. In other words, rather than being compensated under the contract for the frustration of the desire to be paid interest over the life of the loan, the lender has, by accelerating, instead chosen to be paid early.[51]

Courts have recognized two exceptions to the proposition that acceleration prevents a lender from collecting an MWP.[52] If the lender can establish that the borrower purposefully defaulted under the loan agreement causing the lender's right to accelerate and escape the MWP, the borrower will continue to be liable for the MWP.[53] The second exception arises when a "clear and unambiguous clause calls for the payment of the [MWP] even in

event of acceleration of, or the establishment of a new maturity date for, the debt."[54] "If parties to a loan agreement expressly agree that a prepayment fee will be payable upon or after acceleration, that agreement will be respected by courts."[55]

Separate and distinct from the event triggering the right and ability to actually collect the MWP, a court will generally not enforce an MWP whose value is commercially unreasonable or part of an unenforceable penalty clause.[56] On this front, at least one commentator suggests a two-part inquiry to determine if the MWP is enforceable. First, the court should "determine whether to apply a liquidated-damages analysis or an alternate-contract-theory analysis; then, if necessary, it would use the Restatement [of Contracts] to determine if the liquidated damages clause was an unenforceable penalty."[57]

> A liquidated-damages approach. . .looks at the bargain struck at the time of contracting and then again at the time of the breach to determine whether the damages provision resembles the actual damages. . .Alternate-contract theory[58] looks at the bargain at the time of the contract only [and] the provision is unenforceable only where a court determines that the contract is unconscionable as made.[59]

Using a slightly varied approach to this two-part inquiry, the United States Court of Appeals for the Seventh Circuit in *River East Plaza, LLC v. Variable Annuity Life Ins. Co.* provides helpful guidance regarding the reasonableness and enforceability of an MWP under state law. In *River East* a developer borrowed $12 million from the lender to construct a retail store.[60] The loan agreement contained a yield-maintenance MWP, which permitted River East to pay the loan prior to maturity so long as the developer repaid the principal balance *and* tendered an amount the lender would have received if it had invested the balance in Treasuries through the original loan maturity.[61] The developer tendered the principal balance and MWP, but sued the lender, arguing that the MWP was an unenforceable "penalty."

The Seventh Circuit declined to accept River East's argument after performing a detailed analysis of the "relative value of the alternatives"[62] from the viewpoint of both River East and the lender at the time they entered into the loan transaction.[63] Inasmuch as River East could have obtained a sizable benefit by satisfying the indebtedness prior to maturity — notwithstanding that it would also have to tender the MWP — the Seventh Circuit opined that the developer had an actual choice between two options; the eventual relative value of the two alternatives was entirely dependent on whether interest rates increased or decreased.[64] The clause was not one whose "sole purpose is to secure performance of the contract."[65] Therefore, the MWP was enforceable according to its plain language.

V. The Enforceability of Make-Whole Premiums in Bankruptcy

Courts have been called on with seemingly greater frequency to weigh in on the enforceability of MWPs in the context of cases filed under the Bankruptcy Code than in nonbankruptcy cases.[66] Before delving into bankruptcy

decisional law addressing the enforceability of MWPs in bankruptcy, a practical starting point for this section is a review of some of the more prevalent Bankruptcy Code sections that may be touched upon when bankruptcy and MWPs intersect. Chief among them are the Code sections pertaining to claims and their allowance in a bankruptcy case. After all, when distilled to its most basic form, a lender's ability to enforce its right to an MWP in a bankruptcy case is subject to its allowance as a claim under section 502 of the Bankruptcy Code. If an MWP is disallowed under section 502, it is not enforceable against the bankruptcy estate.

Pursuant to section 101(5) of the Bankruptcy Code, a "claim" is broadly defined to encompass a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured. . ."[67] The "term 'claim' is sufficiently broad to encompass any possible right to payment."[68] "[A] valid bankruptcy claim depends on (1) whether the claimant possessed a right to payment, and (2) whether that right arose before the filing of the petition."[69] "A claim will be deemed to have arisen pre-petition if the relationship between the debtor and the creditor contained all of the elements necessary to give rise to a legal obligation—a right to payment—under the relevant non-bankruptcy law."[70]

As noted by Bankruptcy Judge Elizabeth Stong in *In re South Side House, LLC*:[71]

> A claim will be allowed to the extent it is permissible under nonbankruptcy law, subject to any qualifying or contrary provisions of the Bankruptcy Code. That is, claims that are "enforceable under applicable state law will be allowed in bankruptcy unless they are expressly disallowed [by bankruptcy law]." [I]f a claim arises from a prepetition right to payment under applicable nonbankruptcy law, then there is a presumption that the claim will be allowed, subject to an express provision of the Bankruptcy Code disallowing it.[72]

As such, two additional concepts, both drafted into section 502 of the Bankruptcy Code, are relevant to any analysis regarding the enforceability of an MWP — and the existence of a claim — in bankruptcy. First, pursuant to section 502(b)(1) of the Bankruptcy Code, a claim cannot be an allowed claim if it is not enforceable under the agreement giving rise to the claim or applicable nonbankruptcy law.[73] "In other words, for a creditor to have an allowable claim under section 502, the claim must be valid under the terms of the underlying loan document or indenture."[74]

In accordance with section 502(b)(2) of the Bankruptcy Code, a claim for unmatured interest cannot be deemed an allowed claim.[75] "As explained by one court, '[t]he Bankruptcy Code does not define 'unmatured interest,' but case law has determined that unmatured interest includes interest that is not yet due and payable at the time of a bankruptcy filing, or is not yet earned."[76] Most courts that have considered the issues in the context of an MWP have concluded that a WMP should not be considered unmatured interest.[77] As noted by Charles and Kleinhaus in their seminal work, *Prepayment Clauses in Bankruptcy*:

> The basic rationale [supporting the majority opinion] is that [MWPs], although often computed as being interest that would have been received through the life of the loan, do not constitute unmatured interest because they fully mature pursuant to the provisions of the contract. In other words, an obligation to pay a prepayment charge is triggered by the prepayment itself, and therefore "matures" as soon as the prepayment occurs. At least one court has applied the same logic to [No Call Damages], apparently concluding that common-law damages, like liquidated damages, mature at the time of breach.[78]

On the other hand, the minority view is that an MWP *is* unmatured interest and should not be an allowed claim in accordance with section 502(b)(2).[79] "The same logic has been applied to…[No Call Damages], which are likewise intended to compensate lenders fully for lost interest income."[80]

One additional Bankruptcy Code provision that is oft discussed in the context of enforcing MWPs is section 506 of the Bankruptcy Code, which entitles an over-secured creditor to interest on its claim, along with reasonable fees and costs arising from the loan agreement or indenture or state law.[81] "In general, under section 506(b), courts will enforce [MWPs] as long as the prepayment charge is provided in the agreement and the agreement is reasonable."[82]

With these key Bankruptcy Code provisions providing the structural framework, and Sections II through IV providing the backdrop, several recent bankruptcy decisions will provide needed context regarding an MWP's enforceability in bankruptcy.

At the circuit level, the primary focus of the courts as of late has been on the enforceability of the MWP in view of state law and the clear and unambiguous provisions of the loan agreement or indentures that authorize them.[83] In *Bank of New York Mellon vs. CG Merchandise Mart, L.L.C.*,[84] the U.S. Court of Appeals for the Fifth Circuit was called upon to determine whether the lender was entitled to enforce an MWP following its acceleration of a note based upon a payment default. The borrower in *CG Merchandise Mart* filed for bankruptcy protection under Chapter 11 approximately five months after the payment default. In addition to the $24 million in principal and interest due and owing under the loan agreement on the petition date, the lender also sought an MWP in the amount of $1.8 million.[85] The bankruptcy court disallowed the MWP and the lender ultimately found itself at the Fifth Circuit after the district court affirmed the bankruptcy court's disallowance decision.[86]

In the absence of plain language under the contract allowing an MWP, the Fifth Circuit affirmed the disallowance by the bankruptcy court. The Circuit Court first analyzed the enforceability of the MWP under state law,[87] noting that under Colorado law: (i) the lender was entitled to assess an MWP only if the "contract expressly provide[d] for such prepayment penalty;"[88] (ii) the lender was prohibited from assessing an MWP if it had previously accelerated the loan, absent a showing that the borrower purposefully defaulted to avoid the MWP;[89] (iii) the MWP was the price the borrower was required to

pay to bypass the Perfect Tender Rule and was not, therefore, a liquidated damages clause;[90] and (iv) the parties "were free to contract however they wished around these general rules, provided they [did] so clearly."[91]

The lender argued that the plain language of the note permitted it to assess the MWP, notwithstanding that it had accelerated the note following the borrower's payment default.[92] The Fifth Circuit disagreed. After painstakingly analyzing the relevant provisions of the loan agreement, the court concluded that there was not clear and unambiguous language in the loan agreement that (i) permitted the assessment of the MWP following the lender's acceleration of the indebtedness; or (ii) that allowed the assessment of the MWP in any instance other than the premature payment of the indebtedness, which did not occur in the case.[93]

> The plain language of the contract does not require the payment of [the MWP] in the event of mere acceleration. Quite the opposite, in fact: the plain language provides that no [MWP] is owed unless there is an actual prepayment, whether voluntary or involuntary [and] the lender has advanced no viable alternative interpretation of the note.[94]

The Second Circuit in *U.S. Bank Trust National Assoc. v. AMR Corp.*[95] was recently called upon to decide whether the plain language of an indenture permitted noteholders to collect an MWP following an acceleration of the indebtedness that was automatically triggered by the borrower's voluntary bankruptcy filing.[96] In *AMR Corp.*, the lender (as trustee for the secured noteholders) objected to the borrower's attempts in the underlying bankruptcy case to refinance the bank's indebtedness through new debtor in possession financing, without also tendering the MWP.[97] In its DIP financing objection, the lender argued, among other things, that (i) the borrower's "voluntary" repayment of the indebtedness through the proceeds generated from the DIP financing must also include tendering the full amount of the MWP; and (ii) if the debt was accelerated under a bankruptcy event of default, the lender should be permitted to waive the default and decelerate the debt in an effort to collect the MWP.[98]

The Second Circuit first addressed the issue whether the borrower's voluntary repayment of the indebtedness using funds generated by the DIP financing, noting that under New York law "when parties set down their agreement in a clear and, complete document. . .their writing should as a rule be enforced according to its terms."[99] The court then analyzed the indenture which made clear that the filing of the borrower's bankruptcy *automatically* accelerated the indebtedness, leaving the lender with no discretion in that regard.[100] Once accelerated, the indenture also made plain that "[n]o [MWP] shall be payable. . .as a consequence of or in connection with. . . the acceleration of the Equipment Notes."[101]

Next, the *AMR Corp.* court addressed the lender's rights to rescind the acceleration and decelerate the indebtedness. On this issue the court agreed "with the bankruptcy court that any attempt by the lender to rescind acceleration now—after the automatic stay had taken effect—is an effort to affect [the borrower's] contract rights, and thus property of the estate. . .[the

lender's] efforts represent 'a direct attempt to get more property from the debtor and the estate, either through a simple increase in the amount of pro-rata plan distribution or through recovery of a greater amount of collateral that secures a claim.' ''[102]

The decision of the U.S. District Court for the Southern District of New York in *U.S. Bank National Association vs. Wilmington Savings Fund Society (In re MPM Silicones, LLC)* ("*Momentive*")[103] — affirming the bankruptcy court's decision[104] regarding the enforceability of an MWP — is in accord with the Second Circuit's decision in *AMR Corp*. In *Momentive* the borrower's voluntary bankruptcy filing caused a default that triggered the automatic acceleration of the borrower's indebtedness.[105] The indenture and underlying notes contained clauses giving rise to the MWP: the acceleration clause *and* the MWP, itself.[106] After analyzing the acceleration provision the district court agreed with the bankruptcy court that "[t]he acceleration clause [did] not clearly and unambiguously call for the payment of the make-whole premium in the event of an acceleration of debt."[107] Turning next to the language of the MWP clauses contained in the indenture, the district court concluded that neither of the MWP in the indentures required the tender of the MWP after acceleration of debt and "under New York law, the payment of debt pursuant to an acceleration clause [did] not constitute an early redemption."[108] Rather, the automatic acceleration of the indebtedness triggered by bankruptcy "changed the date of maturity from some point in the future . . . to an earlier date based on the debtor's default under the contract."[109] Finally, the lender (as trustee for the noteholders) relying on the decision of the bankruptcy court in *In re Chemtura Corp.*,[110] argued that the "prepayment before maturity" language in the indenture mirrored similar language in *Chemtura* and the court there permitted the MWP.[111] The district court dismissed this argument noting that, notwithstanding acceleration in *Chemtura*, that indenture permitted the payment of the MWP if the indebtedness was retired at any time before the "*original* maturity date," even if there was acceleration.[112] Because the maturity date in *Momentive* had been accelerated due to voluntary bankruptcy, and because the indenture did not possess the "*original* maturity date" language, a distinction was easily drawn between the two cases.[113]

The decision from the U.S. Bankruptcy Court for the District of Delaware in *Delaware Trust Co. vs. Energy Future Intermediate Holding Co., L.L.C.* ("*Energy Future Holdings*")[114] is similar in many ways to the facts and conclusions reached in *Momentive*; however, the lender (as trustee for certain noteholders) pursued a count in an adversary proceeding for a declaratory judgment seeking an allowed secured claim equal to the indenture's MWP based upon allegations that the borrower's bankruptcy filing was purposefully done to trigger the automatic acceleration provisions under the indenture *and* to avoid the MWP.[115] As noted in Section IV, supra, courts have enforced an MWP following acceleration if the lender is able to establish that the borrower purposefully defaulted to escaped the MWP or the loan documents or indenture provide as much.[116]

In seeking summary judgment, the lender argued that there was no material fact in dispute and that the borrower filed bankruptcy to avoid having to pay the MWP. Specifically, the lender argued that liability for the MWP "was a reason for the bankruptcy filing"[117] and that any allegations by the borrower that liquidity triggered its bankruptcy were fabricated insofar as the borrower "avoided the most obvious potential source of liquidity for [the borrower] outside of bankruptcy, a sale of [the borrower's] equity stake in its principal assets."[118]

The *Energy Future Holdings* court denied the lender's summary judgment motion and entered judgment on the issue in favor of the borrower after concluding, among other things, that the indenture lacked language "stating that the [MWP] will be owed if the [borrower] intentionally causes an event of default to avoid paying the [MWP]"[119] and that the lender's arguments and allegations were "insufficient to create a genuine issue of material fact as to why the [borrower] filed for bankruptcy."[120]

> While it is certainly the case that the [borrower] planned pre-petition and followed through after filing bankruptcy to use the default created by that filing to refinance the notes without having to pay the [MWP] that is not enough to counter the overwhelming evidence that the [borrower] filed bankruptcy because they were facing a severe liquidity crisis. . .The [borrowers] are no different than any other debtor that is forced into bankruptcy because of financial reasons but decides to use the tools provided by that bankruptcy, such as the power to reject unprofitable leases, for business reasons.[121]

VI. Conclusion

As discussed, MWPs have evolved into omnipresent clauses in current commercial loan agreements and bond indentures. As prevalent as MWPs have become, so too has the prevalence of bankruptcy courts to rule on their enforceability in cases where borrowers seek to have them disallowed and lenders fight to have them satisfied. As the decisional law discussed herein evidences, bankruptcy courts will first look closely at state law to determine whether the MWP is enforceable. If the MWP *is* permitted under state law, the courts will then analyze the "clear and ambiguous" terms of the MWP to ensure that all conditions precedent have been satisfied prior to permitting an MWP's allowance. Then, the court will look at the relevant provisions of the Bankruptcy Code to ensure that amounts due under the MWP can ultimately be considered an allowed claim. Based on recent decisional law, lenders are well advised to carefully craft MWP provisions in loan documents and indentures to increase the likelihood that the creative methodologies employed by borrowers to reduce exposure to MWPs, which have been negotiated by sophisticated commercial parties at arm's length, are rejected in favor of the claim being adjudicated by the bankruptcy court as allowed. In that connection, in light of the disallowance of MWPs by some bankruptcy courts because the contract provides for automatic acceleration of the debt upon a bankruptcy filing, some lenders may conclude, after considering the implications of the automatic stay, that it is in their interest to provide for such acceleration at the lender's option rather than automatically.

NOTES:

[1]Abbe v. Goodwin, 7 Conn. 377, 1829 WL 36 (1829). See also Scott K. Charles & Emil A. Kleinhaus, Prepayment Clauses in Bankruptcy, 15 Am. Bankr. L. Rev. 537, 541 n. 9 (2007) ("[*Abbe*]has been identified as the first American case to embrace the perfect tender in time rule.") (citing Rebecca C. Dietz, Silence is Not Always Golden: Mortgage Prepayment in the Commercial Loan Context, 22 Univ. of Balt. L. Rev. 297, 307 (1993)).

[2]Abbe, 7 Conn. at 282. Notably, the borrower in the *Abbe* case agreed to pay the lender all interest due under the mortgage note through maturity, notwithstanding the prepayment.

[3]Brown v. Cole, 14 L.J.-Ch. 167 (1845).

[4]Brown, 14 L.J. at 167; see also Frank S. Alexander, Mortgage Prepayment: The Trial of Commonsense, 72 Cornell. L. Rev. 288, 304 (1986–1987) ("There is little evidence to support a rule prohibiting mortgage prepayment until the beginning of the nineteenth century.").

[5]Alexander, supra note 4, at 309.

[6]Alexander, supra note 4, at 291–292; Charles & Kleinhaus, supra note 1, at 540; Michael T. McNelis, Note, Prepayment Penalties and Due-on-Sale Clauses in Commercial Mortgages: What Next?, 20 Ind. L. Rev. 735, 746 (1987); see also Metropolitan Life Ins. Co. v. Strnad, 255 Kan. 657, 663, 876 P.2d 1362 (1994) ("The common-law rule regarding prepayment of a note and mortgage was that absent a specific provision in the written instruments providing for prepayment, there was no right for the debtor to prepay the note and mortgage.").

[7]Charles & Kleinhaus, supra note 1, at 540–41 (citing Arthur v. Burkich, 131 A.D.2d 105, 520 N.Y.S.2d 638, 639 (3d Dep't 1987). See also McNelis, supra note 6.

[8]McNelis, supra note 6.

[9]Alexander, supra note 4, at 310.

[10]Alexander, supra note 4, at 311.

[11]McNelis, supra note 6 ("The common law rule has been rejected in a variety of modern day contexts."); Charles & Kleinhaus, *supra* note 1, at 544 (noting that the perfect tender in time rule "is no longer inviolate (it has been rejected in several states) and routinely criticized by scholars.").

[12]Charles & Kleinhaus, supra note 1, at 540–41.

[13]Charles & Kleinhaus, supra note 1, at 540–41 (citing Arthur v. Burkich, 131 A.D.2d 105, 520 N.Y.S.2d 638, 639 (3d Dep't 1987); see also McNelis, supra note 6; Robert K. Baldwin, Prepayment Penalties: A Survey and Suggestion, 40 Vand. L. Rev. 409, 413 (1997).

[14]Richard L. Kuersteiner, James O. Johnston, Richard L. Wynne, and Lance Miller, Your Bond Issuer Has Filed for Bankruptcy? A Survey of Tips, Traps, and Opportunities that Await Corporate Bondholders in Chapter 11 Case, 2008 Ann. Surv. Of Bankr. Law. 6, 15 (2009).

[15]Charles & Kleinhaus, supra note 1, at 542.

[16]Charles & Kleinhaus, supra note 1, at 542.

[17]Robert K. Baldwin, Prepayment Penalties: A Survey and Suggestion, 40 Vand. L. Rev. 409, 413 (1997).

[18]Kent H. Roberts, Prepayment Penalties in Texas: The Triumph of Logic and the Need for Legislative Reform, 45 Baylor. L. Rev. 585, 587 (Summer, 1993) (emphasis added); *see also* Black's Law Dictionary 1182 ("A penalty under a note, mortgage, or deed of trust, imposed when the loan is paid before its due date. Consideration to terminate a loan at borrower's election before maturity.").

[19]Charles & Kleinhaus, supra note 1, at 543–44.

[20]U.S. v. Harris, 246 F.3d 566, 573, 2001 FED App. 0096P (6th Cir. 2001); see also Eastern Savings Bank, FSB v. Munson, 50 Conn. Supp. 374, 932 A.2d 1079, 1081, 43 Conn.

L. Rptr. 354 (Super. Ct. 2007); see also Norwest Bank Minnesota v. Blair Road Associates, L.P., 252 F. Supp. 2d 86, 96 (D.N.J. 2003) ("The rationale for enforcing prepayment premiums rests on the recognition that such premiums serve as compensation to the lender for the losses incurred by the lender when it receives prepayment of its loan earlier than originally planned.").

[21]Harris, 246 F.3d at 573.

[22]Harris, 246 F.3d at 573; see also Eastern Savings Bank, 932 A.2d at 1081; see also Northwest Bank of Minn., 252 F. Supp. 2d at 96 ("The rationale for enforcing prepayment premiums rests on the recognition that such premiums serve as compensation to the lender for the losses incurred by the lender when it receives prepayment of its loan earlier than originally planned.").

[23]Charles & Kleinhaus, supra note 1, at 543–44. See also 4 Collier on Bankruptcy (16th ed. 2011), ¶ 502.03[3][d][ii] ([MWPs] are payments provided for in loan agreements to compensate lenders when loans are repaid prematurely.").

[24]Charles & Kleinhaus, supra note 1, at 543.

[25]Charles & Kleinhaus, supra note 1, at 543.

[26]Charles & Kleinhaus, supra note 1, at 544. See also Megan W. Murray, Prepayment Premiums: Contracting for Future Financial Stability in the Commercial Lending Market, 96 Iowa L. Rev. 1037, 1048 (2011) (identifying fixed fee prepayment provisions and sliding scale prepayment provisions as two separate and distinct types of prepayment penalties).

[27]Charles & Kleinhaus, supra note 1, at 545.

[28]Charles & Kleinhaus, supra note 1, at 544–545.

[29]Charles & Kleinhaus, supra note 1, at 544.

[30]Charles & Kleinhaus, supra note 1, at 544.

[31]Charles & Kleinhaus, supra note 1, at 544.

[32]Charles & Kleinhaus, supra note 1, at 544.

[33]Charles & Kleinhaus, supra note 1, at 545.

[34]Metropolitan Life Ins. Co. v. Strnad, 255 Kan. 657, 670–71, 876 P.2d 1362 (1994); see also Portland Regency, Inc. v. RBS Citizens, N.A., 2015 WL 1279628 (D. Me. 2015) (granting summary judgment in favor of the defendant bank on the enforceability of a MWP after noting that the borrowers did "not claim fraud in the inducement or mutual mistake between them and the bank so as to void the agreements").

[35]Strnad, 255 Kan. at 670–71.

[36]Strnad, 255 Kan. at 671.

[37]In re South Side House, LLC, 451 B.R. 248, 254, 55 Bankr. Ct. Dec. (CRR) 26 (Bankr. E.D. N.Y. 2011), order aff'd, Bankr. L. Rep. (CCH) P 82170, 2012 WL 273119 (E.D. N.Y. 2012).

[38]In re AMR Corp., 730 F.3d 88, 98, 58 Bankr. Ct. Dec. (CRR) 122 (2d Cir. 2013), cert. denied, 134 S. Ct. 1888, 188 L. Ed. 2d 913 (2014); see also South Side House, 451 B.R. at 262 ("In interpreting a contract, the court's initial inquiry 'is whether the agreement on its face is reasonably susceptible of more than one interpretation" and "matters extrinsic to the agreement may not be considered when the intent of the parties can be gleaned from the face of the instrument.").

[39]Northwestern Mut. Life Ins. Co. v. Uniondale Realty Associates, 11 Misc. 3d 980, 816 N.Y.S.2d 831, 836 (Sup 2006); see also In re MPM Silicones, 2014 WL 4436335 at *12 (Bankr. S.D.N.Y. Sept. 9, 2014) ("Without a contractual option, under the [Perfect Tender Rule], the borrower/issuer would be precluded from paying the debt early").

[40]M. Phillips & T. Homburger, What You See Is Not Always What You Get: The Enforceability of Loan Pre-Payment Penalties, 23 J. Marshall L. Rev. 65, 68 (1989).

[41]Murray, supra note 26, at 1051.

[42]Phillips & Homburger, supra note 40.

[43]Phillips & Homburger, supra note 40.

[44]Phillips & Homburger, supra note 40.

[45]Phillips & Homburger, supra note 40.

[46]Phillips & Homburger, supra note 40.

[47]Phillips & Homburger, supra note 40.

[48]George A. Nation, III, Prepayment fees in Commercial Promissory Notes: Applicability to Payments Made Because of Acceleration, 72 Tenn. L. Rev. 613, 623 (2005).

[49]In Jala Corp. v. Berkeley Sav. & Loan Ass'n of Newark, 104 N.J. Super. 394, 250 A.2d 150, 153–55 (App. Div. 1969) ("Thus, in the instant case we find that the plaintiffs did not voluntarily exercise any 'right' or 'privilege' to prepay the unpaid balance of the mortgage, as was contemplated by the prepayment clause contained in the mortgage. Rather, the mortgagee was prepaid by reason of the fact that the State pursuant to its paramount right of eminent domain took the property for public use.").

[50]Chestnut Corp. v. Bankers Bond & Mortg. Co., 395 Pa. 153, 149 A.2d 48, 50, 70 A.L.R.2d 1331 (1959).

[51]In re MPM Silicones, 2014 WL 4436335 at *12 (Bankr. S.D.N.Y. Sept. 9, 2014).

[52]In re MPM Silicones, 2014 WL 4436335 at *13 (Bankr. S.D.N.Y. Sept. 9, 2014) (citing Donnelly v. Lynch, 691 F.2d 1029, 1053 (1st Cir. 1982), judgment rev'd on other grounds, 465 U.S. 668, 104 S. Ct. 1355, 79 L. Ed. 2d 604 (1984).

[53]In re MPM Silicones, 2014 WL 4436335 at *13 (Bankr. S.D.N.Y. Sept. 9, 2014) (citing U.S. Bank Nat. Ass'n v. South Side House, LLC, Bankr. L. Rep. (CCH) P 82170, 2012 WL 273119 at *5 (E.D. N.Y. 2012).

[54]MPM Silicones, 2014 WL 4436225, at *12.

[55]Charles & Kleinhaus, supra note 1, at 546.

[56]See River East Plaza, L.L.C. v. Variable Annuity Life Ins. Co., 498 F.3d 718, 722 (7th Cir. 2007) ("When the sole purpose of the [MWP] is to secure performance of the contract, the provision is an unenforceable penalty. . . Penalties, or liquidated damages clauses in general, are distinct from alternative forms of performing the obligations under the contract"); *see also* Portland Regency, Inc. v. RBS Citizens, N.A., 2015 WL 1279628 at *2 n.6 (D. Me. 2015) ("The borrowers have not argued that either the loan prepayment provisions or the swap breakage fees here are unenforceable penalty clauses.").

[57]Murray, supra note 26, at 1058.

[58]"Alternate-contract theory" is also referred to as "alternate performance options." See Charles & Kleinhaus, supra note 1, at 567.

[59]Murray, supra note 26, at 1058–59. See also Charles & Kleinhaus, supra note 1, at 567 ("Notwithstanding the apparent distinction between (a) prepayment fee clauses that function as alternative performance options and (b) those that function like liquidated damages clauses, bankruptcy courts have generally treated all prepayment fee clauses as liquidated damages clauses.").

[60]River East Plaza, L.L.C. v. Variable Annuity Life Ins. Co., 498 F.3d 718, 719 (7th Cir. 2007).

[61]River East Plaza, L.L.C. v. Variable Annuity Life Ins. Co., 498 F.3d 718, 719 (7th Cir. 2007).

[62]River East Plaza, L.L.C. v. Variable Annuity Life Ins. Co., 498 F.3d 718, 722–23 (7th Cir. 2007).

[63]River East Plaza, L.L.C. v. Variable Annuity Life Ins. Co., 498 F.3d 718, 722–23 (7th Cir. 2007) (applying Restatement (Second) of Contracts § 356).

[64]River East Plaza, L.L.C. v. Variable Annuity Life Ins. Co., 498 F.3d 718, 722–23 (7th Cir. 2007).

[65]River East Plaza, L.L.C. v. Variable Annuity Life Ins. Co., 498 F.3d 718, 723 (7th Cir. 2007); see also Portland Regency, Inc. v. RBS Citizens, N.A., 2015 WL 1279628 at *5 (D. Me. 2015) (granting summary judgment as to the enforceability of the MWP); compare Ridgefield Surgical Center v. People's United Bank, 46 Conn. L. Rptr. 384, 2008 WL 4307490 at *5 (Conn. Super. Ct. 2008) (denying lender's motion for summary judgment as to the enforceability of the prepayment premium finding "a genuine issue of material fact exists as to the reasonableness of the prepayment premium in conjunction with the" MWP).

[66]Richard F. Hahn, My Chi To, & Shannon Rose Selden, Fifth Circuit Provides a Reminder that Language Providing for a Prepayment Premium Must be Unambiguous, 131 Banking L.J. 443 (May 2014) (noting a "recent flurry of decisions concerning prepayment premiums").

[67]11 U.S.C.A. § 101(5).

[68]In re Mazzeo, 131 F.3d 295, 302, 32 Collier Bankr. Cas. 2d (MB) 38, Bankr. L. Rep. (CCH) P 77567, 84 A.F.T.R.2d 99-6469 (2d Cir. 1997).

[69]In re Chateaugay Corp., 53 F.3d 478, 497, 19 Employee Benefits Cas. (BNA) 1169, Bankr. L. Rep. (CCH) P 76459 (2d Cir. 1995).

[70]Ogle v. Fidelity & Deposit Co. of Maryland, 586 F.3d 143, 147, 52 Bankr. Ct. Dec. (CRR) 89, 62 Collier Bankr. Cas. 2d (MB) 1247, Bankr. L. Rep. (CCH) P 81617 (2d Cir. 2009).

[71]In re South Side House, LLC, 451 B.R. 248, 254, 55 Bankr. Ct. Dec. (CRR) 26 (Bankr. E.D. N.Y. 2011), order aff'd, Bankr. L. Rep. (CCH) P 82170, 2012 WL 273119 (E.D. N.Y. 2012).

[72]In re South Side House, LLC, 451 B.R. 248, 254, 55 Bankr. Ct. Dec. (CRR) 26 (Bankr. E.D. N.Y. 2011), order aff'd, Bankr. L. Rep. (CCH) P 82170, 2012 WL 273119 (E.D. N.Y. 2012). (citing and quoting Travelers Cas. and Sur. Co. of America v. Pacific Gas and Elec. Co., 549 U.S. 443, 450, 127 S. Ct. 1199, 167 L. Ed. 2d 178, 47 Bankr. Ct. Dec. (CRR) 265, 57 Collier Bankr. Cas. 2d (MB) 314, Bankr. L. Rep. (CCH) P 80880 (2007)).

[73]11 U.S.C.A. § 502(b)(1).

[74]4 Collier on Bankruptcy at ¶ 502.03[3][d][ii].

[75]11 U.S.C.A. § 502(b)(2).

[76]South Side House, 451 B.R. at 261.

[77]See Charles & Kleinhaus, supra note 1, at 580 (citing In re Lappin Elec. Co., Inc., 245 B.R. 326, 330, 35 Bankr. Ct. Dec. (CRR) 205 (Bankr. E.D. Wis. 2000); In re Outdoor Sports Headquarters, Inc., 161 B.R. 414, 424, 25 Bankr. Ct. Dec. (CRR) 30, 30 Collier Bankr. Cas. 2d (MB) 710 (Bankr. S.D. Ohio 1993); In re Skyler Ridge, 80 B.R. 500, 508, 16 Bankr. Ct. Dec. (CRR) 1122, Bankr. L. Rep. (CCH) P 72167 (Bankr. C.D. Cal. 1987); In re 360 Inns, Ltd., 76 B.R. 573, 576, 16 Bankr. Ct. Dec. (CRR) 358 (Bankr. N.D. Tex. 1987).

[78]Charles & Kleinhaus, supra note 1, at 580.

[79]Charles & Kleinhaus, supra note 1, at 580 (citing In re Ridgewood Apartments of DeKalb County, Ltd., 174 B.R. 712, 721 (Bankr. S.D. Ohio 1994).

[80]Charles & Kleinhaus, supra note 1, at 581–81 (citing Continental Securities Corp. v. Shenandoah Nursing Home Partnership, 188 B.R. 205, 213–14 (W.D. Va. 1995)).

[81]11 U.S.C.A. § 506(b) ("To the extent that an allowed secured claim is secured by property the value of which, after any recovery under [Section 506(c)], is greater than the amount

of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement or State statute under which such claim arose.").

[82]4 Collier on Bankruptcy at ¶ 502.03[3][d][ii].

[83]Hahn, To, & Selden, supra note 66, at 443.

[84]In re Denver Merchandise Mart, Inc., 740 F.3d 1052, 58 Bankr. Ct. Dec. (CRR) 274 (5th Cir. 2014).

[85]In re Denver Merchandise Mart, Inc., 740 F.3d 1052, 1054, 58 Bankr. Ct. Dec. (CRR) 274 (5th Cir. 2014).

[86]In re Denver Merchandise Mart, Inc., 740 F.3d 1052, 1054, 58 Bankr. Ct. Dec. (CRR) 274 (5th Cir. 2014).

[87]See supra Section IV for further discussion regarding the enforceability of MWPs under state law.

[88]Denver Merchandise Mart, 740 F.3d at 1056.

[89]Denver Merchandise Mart, 740 F.3d at 1056.

[90]The Fifth Circuit bypassed a section 506(b) analysis by adopting the reasoning in Planned Pethood Plus, Inc. v. KeyCorp, Inc., 228 P.3d 262, 264 (Colo. App. 2010), wherein an MWP was tantamount to the price the borrower was required to prepay the loan prior to maturity, and not a "fee or cost" that the lender may have been entitled to if it was oversecured.

[91]Denver Merchandise Mart, 740 F.3d at 1057.

[92]Denver Merchandise Mart, 740 F.3d at 1054.

[93]Denver Merchandise Mart, 740 F.3d at 1057–58.

[94]Denver Merchandise Mart, 740 F.3d at 1059.

[95]In re AMR Corp., 730 F.3d 88, 58 Bankr. Ct. Dec. (CRR) 122 (2d Cir. 2013), cert. denied, 134 S. Ct. 1888, 188 L. Ed. 2d 913 (2014); see also In re United Merchants and Mfrs., Inc., 674 F.2d 134, 141–142, 6 Collier Bankr. Cas. 2d (MB) 321, Bankr. L. Rep. (CCH) P 69005 (2d Cir. 1982) (concluding in a case decided under the Bankruptcy Act that a liquidated damages clause, which was triggered by the borrower's filing for bankruptcy, was enforceable under New York law).

[96]AMR Corp., 730 F.3d at 95–97.

[97]AMR Corp., 730 F.3d at 95–96.

[98]AMR Corp., 730 F.3d at 95–96. Relying on sections 365(e)(1), 541(c)(1)(B) and 363(l) of the Bankruptcy Code, the lender also argued that an automatic acceleration of the debt was an unenforceable *ipso facto* clause. The *AMR Corp.* court rejected the lender's arguments noting that the *ipso facto* clause provisions contained in section 365(e)(1) of the Bankruptcy Code only pertained to executory contracts, and the indentures were not executory. AMR Corp., 730 F.3d at 106. The Court also rejected the lender's reliance on sections 541(c)(1)(B) and 363(l) noting those provisions were equally inapposite. AMR Corp., 730 F.3d at 106.

[99]AMR Corp., 730 F.3d at 98.

[100]AMR Corp., 730 F.3d at 98.

[101]AMR Corp., 730 F.3d at 99–100; see also Matter of LHD Realty Corp., 726 F.2d 327, 330–31 (7th Cir. 1984) ("[A]cceleration, by definition, advances the maturity date of the debt so that payment thereafter is not prepayment but instead is payment made after maturity." (citation omitted)).

[102]AMR Corp., 730 F.3d at 103.

[103]In re MPM Silicones, LLC, 531 B.R. 321 (S.D. N.Y. 2015)).

[104]In re MPM Silicones, LLC, 2014 WL 4436335 (Bankr. S.D. N.Y. 2014), order aff'd, 531 B.R. 321 (S.D. N.Y. 2015).

[105]In re MPM Silicones, LLC, 531 B.R. 321 (S.D. N.Y. 2015).

[106]In re MPM Silicones, LLC, 531 B.R. 321 (S.D. N.Y. 2015).

[107]In re MPM Silicones, LLC, 531 B.R. 321 (S.D. N.Y. 2015).

[108]In re MPM Silicones, LLC, 531 B.R. 321 (S.D. N.Y. 2015) (citing In re AMR Corp., 730 F.3d 88, 58 Bankr. Ct. Dec. (CRR) 122 (2d Cir. 2013), cert. denied, 134 S. Ct. 1888, 188 L. Ed. 2d 913 (2014)).

[109]In re MPM Silicones, LLC, 531 B.R. 321 (S.D. N.Y. 2015).

[110]In re Chemtura Corp., 439 B.R. 561 (Bankr. S.D. N.Y. 2010).

[111]In re MPM Silicones, LLC, 531 B.R. 321 (S.D. N.Y. 2015). Notably, the bankruptcy court in *Chemtura* was not being called on to adjudicate the enforceability of the MWP, rather it was canvassing the issues regarding the approval of a settlement motion brought pursuant to Rule 9019 of the Federal Rules of Bankruptcy Procedure. *See* Ryan M. Murphy, Great Expectations: Chemtura Revisits the Treatment of "Make-whole" and "No-call" Provisions Under the Bankruptcy Code, 20 J. Bankr. L. & Prac. 6 Art. 6 (December 2011).

[112]In re MPM Silicones, LLC, 531 B.R. 321 (S.D. N.Y. 2015).

[113]In re MPM Silicones, LLC, 531 B.R. 321 (S.D. N.Y. 2015).

[114]In re Energy Future Holdings Corp., 527 B.R. 178 (Bankr. D. Del. 2015).

[115]Energy Future Holdings, 527 B.R. at 195.

[116]In re MPM Silicones, LLC, 2014 WL 4436335 (Bankr. S.D. N.Y. 2014), order aff'd, 531 B.R. 321 (S.D. N.Y. 2015) (citing U.S. Bank Nat. Ass'n v. South Side House, LLC, Bankr. L. Rep. (CCH) P 82170, 2012 WL 273119 at *5 (E.D. N.Y. 2012).

[117]Energy Future Holdings, 527 B.R. at 187.

[118]Energy Future Holdings, 527 B.R. at 187.

[119]Energy Future Holdings, 527 B.R. at 195.

[120]Energy Future Holdings, 527 B.R. at 196.

[121]Energy Future Holdings, 527 B.R. at 196.