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Trends in Finance Law: Prepayment Penalties – Express Language Aids Enforcement

By Deborah P. Low and Sue P. Murphy

Loan agreements commonly contain provisions permitting or requiring the early repayment of all or a portion of the indebtedness under the loan agreement prior to the stated maturity date of such indebtedness. These provisions may specify that prepayments may be made at any time, at the borrower's election ("***Optional Prepayments***"), or that prepayments must be made upon the occurrence of certain events ("***Mandatory Prepayments***"). Several courts have recently examined whether the acceleration of the maturity of indebtedness under a loan agreement, either automatically, in the event of certain events of default, or at the election of the lenders in accordance with the terms of the loan agreement, constitutes a prepayment of the loan that would give rise to the obligation of the borrower to pay a premium or penalty. This issue has been most prevalently discussed by the courts in a number of bankruptcy proceedings where lenders have been unable to recover such penalty or premium payments. While each court holding relies on the specific facts of the case being considered, recent decisions indicate that lenders which clearly specify in the operative loan documents that a prepayment penalty is due upon acceleration of the maturity of the indebtedness have a significantly better chance of having the penalty enforced than those who do not include express language to that effect.

What are Prepayment Premiums?

Loan agreements often expressly provide that the borrower is required to pay a premium in connection with its prepayment (a "***Prepayment Premium***," sometimes called a "make whole payment"). The Prepayment Premium is intended to compensate the lender for interest or other fees that it expected to earn on the prepaid indebtedness, had it remained outstanding to stated maturity. Additionally, Prepayment Premiums in connection with Optional Prepayments provide important protection for the lender against market conditions in which the borrower may be tempted to prepay the loan in order to obtain financing at lower rates and/or where the lender may need coverage for "breakage costs" - the cost of redeployment of funds obtained by the lender at a fixed rate for a fixed period in the LIBOR or other similar markets for the period from the prepayment until the end of the relevant interest period.

Loan Agreements also often provide for the acceleration of indebtedness automatically following the commencement of bankruptcy or other insolvency proceedings by or against the borrower. This is because once a bankruptcy proceeding is commenced, an automatic stay is imposed prohibiting the lender from pursuing any remedies outside the proceeding. In order to avoid the automatic stay, acceleration will occur automatically, and under such circumstances the consequences of default and acceleration, including the imposition of a default interest rate, are not dependent on any affirmative post-petition action. However, a number of recent cases have arisen in which the lender has asserted that an automatic acceleration of indebtedness constitutes an Optional Prepayment or Mandatory Prepayment, which would obligate the borrower to pay a Prepayment Premium. This assertion has then been challenged in bankruptcy proceedings where the borrower or other creditors are attempting to limit the lender's recovery.

Are Prepayment Premiums Enforceable?

Courts have generally held that Prepayment Premiums are enforceable, if properly assessed by the lender in accordance with the terms of the loan agreement. Courts have further held that to the extent that a Prepayment

Premium was due and payable by the borrower prior to the commencement of bankruptcy proceedings by or against the borrower, then such Prepayment Premium may be recoverable by the creditor in a bankruptcy proceeding. An example of this is *In re School Specialty, Inc., No. 13-10125, 2013 WL 1838513 (Bankr. D. Del. Apr. 22, 2013)*, a case decided by the United States Bankruptcy Court for the District of Delaware. In that case, the terms of the loan agreement expressly provided that the borrower would be required to pay a Prepayment Premium if the loan was accelerated. Further, when the loan was accelerated, the borrower agreed in a forbearance agreement that an event had occurred which triggered the borrower's obligation to pay the Prepayment Premium. The court therefore upheld the validity of the Prepayment Premium and required the borrower to pay it in bankruptcy. The fact that the lender in *In re School Specialty* declared the Prepayment Premium due prior to the commencement of bankruptcy proceedings distinguishes this case from subsequent cases in which lenders attempted to argue that the obligation of the borrower to pay the Prepayment Premium was only triggered upon the commencement of bankruptcy proceedings.

The U.S. Court of Appeals for the Second Circuit examined this issue in *US Bank Trust Nat'l Ass'n v. AMR Corp. (In re AMR Corp.)*, 730 F.3d 88, 98-105 (2d Cir. 2013), and determined that the underlying loan documents did not permit the creditors to recover a Prepayment Premium as part of their recovery in bankruptcy. In *In re AMR Corp*., an event of default occurred under an indenture as a result of the borrower filing for bankruptcy, which mandated an automatic acceleration of the maturity date of all outstanding indebtedness. The lenders argued that the borrower's bankruptcy filing was an attempt by the borrower to take advantage of more favorable market conditions through the bankruptcy filing. Therefore, the automatic acceleration of the indebtedness as a result of the bankruptcy filing was effectively equivalent to an Optional Prepayment under the loan agreement, which would give rise to the obligation to pay a Prepayment Premium. In rejecting the lender's argument, the court noted that the terms of the indenture expressly stated that if the loan was accelerated automatically in the event of a bankruptcy proceeding, the accelerated indebtedness would be "without Make-Whole Amount." The court therefore refused to imply the obligation of the borrower to pay the Prepayment Premium in the wake of specific language to the contrary in the indenture.

Following the decisions in *In re School Specialty* and *In re AMR Corp.* courts have increasingly focused on the express language contained in the underlying loan documents in their determination as to whether a Prepayment Premium can be included in a creditor's recovery in a bankruptcy proceeding. Recently the Federal Bankruptcy Court of the Southern District of New York weighed in on the issue in *In re MPM Silicones, LLC,* No. 14-22503, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014). In this bench decision, the court held that under New York law a lender will forfeit its right to compensation for early payment by accelerating the balance of the loan (including in the event of an automatic acceleration due to bankruptcy), unless the underlying loan document contains "clear and unambiguous" language providing for payment of the Prepayment Premium when the indebtedness is repaid prior to scheduled maturity for any reason, including after acceleration. The *In re MPM Silicones* decision was heavily relied on in *Del. Trust Co. v. Energy Future Intermediate Holding Co. LLC (In re Energy Future Holdings Corp.)*, 527 B.R. 178 (Bankr. D. Del. 2015), in which the Delaware Bankruptcy Court noted that the provisions of the applicable indenture that mandated automatic acceleration of the indebtedness upon a bankruptcy proceeding did not expressly include a requirement that payment of the Prepayment Premium was due upon acceleration. However, the court in *In re MPM Silicones* further held that a lender could recover a Prepayment Premium in a situation where the borrower intentionally defaulted in order to trigger an acceleration of indebtedness and avoid paying a Prepayment Premium, which was an argument made by the lender that was unsuccessful in *In re AMR Corp*. in light of the specific language in the indenture.

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Conclusion

In light of recent case law, the enforceability of Prepayment Premiums incurred as a result of acceleration of indebtedness remains murky. However, recent decisions provide important guidance to lenders that are expecting to recover Prepayment Premiums in the event of acceleration of the maturity of indebtedness. There is a strong trend toward respecting express language in the underlying loan agreement, indenture or other applicable contract which either allows for, or prohibits, the payment of a Prepayment Premium upon default and/or acceleration of the debt. Lenders that are looking to recover such amounts should consider whether to revise loan document drafts to include explicit language that a Prepayment Premium will be payable in the event of acceleration of the indebtedness, as without such language it appears increasingly likely that a court would prohibit such recovery.

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