ACCFL

THE TRANSACTIONAL LAWYER

Volume 12 – December 2022

MAKING DOLLARS AND SENSE OF MAKE-WHOLE PREMIUMS

Stephen L. Sepinuck

In mid-October, the U.S. Court of Appeals for the Fifth Circuit sent the commercial finance world into a bit of a tizzy when it issued a decision in the *Ultra Petroleum* bankruptcy case.[1] The court ruled, that:

- A claim of note holders for a $14 million make-whole premium, triggered by the debtors' bankruptcy filing, was in the nature of unmatured interest, and hence ordinarily disallowed under § 502(b)(2) of the Bankruptcy Code;
- However, because the debtors were solvent at the time their plan of reorganization was confirmed, and the solvent-debtor exception survived enactment of § 502(b), the debtors were liable for the make-whole premium provided the obligation was enforceable under non-bankruptcy law;
- The obligation to pay the make-whole premium is a valid liquidated-damages provision under New York law;
- There is no double recovery in awarding both the make-whole premium and post-petition interest; and
- The debtors had to pay post-petition interest at the contractual default rate, not the federal judgment rate, on claims treated as unimpaired.

Although the decision was a major victory for the claimants in that case, the decision is less favorable for creditors generally. Even if the court's ruling about the solvent debtor exception is correct, because few bankruptcy debtors are solvent, the exception will rarely apply. Consequently, by treating a claim for a make-whole premium as a claim for unmatured interest, the decision creates a significant impediment to the allowance of a claim for such a premium in bankruptcy.

Three weeks later, Judge Walrath of the United States Bankruptcy Court for the District of Delaware made a similar oral ruling regarding a $223 million make-whole premium owed by reorganized debtor Hertz Global for redeeming unsecured notes early. The judge concluded that, because the premium was calculated based on future interest, it was the equivalent of unmatured interest and had to be disallowed under § 502(b)(2).[2]

Already, law firms from around country have issued client alerts about one or both of these rulings.[3] Most of these alerts explain the Fifth Circuit's analysis of each issue presented and explain how that analysis fits in with other rulings relating to the enforceability of make-whole premiums. They are thoughtful and informative. Some even offer general advice.

This article attempts something slightly different. It begins by explaining the various issues that can arise in connection with make-whole premiums. Two of those issues lead to somewhat conflicting advice on how to draft contract language providing for a make-whole premium. The article then navigates a path through those countervailing considerations and offers suggestions on drafting for transactional lawyers and their clients to consider.

WHAT ARE MAKE-WHOLE PREMIUMS?

A make-whole premium is an amount a borrower must pay – beyond the outstanding principal and accrued interest due – if the debt is repaid before maturity. Included in many loan agreements, bond indentures, and other debt instruments, make-whole premiums are rooted in the "perfect-tender-in-time rule."[4] Under that rule, a borrower has no right to repay early unless the agreement so provides.[5] Most jurisdictions, including New York, still adhere to the perfect-tender-in-time rule. Even in those jurisdictions that do not follow the rule, contracting parties are free to prohibit prepayment or to condition prepayment on payment of a make-whole premium.

A make-whole premium compensates the creditor for the lost expectancy if prepayment occurs after interest rates have fallen. In essence, the creditor bargained for interest at the contractual rate for a specified period of time. If the debtor repays early, at a time when interest rates are lower than the rate

Contents

Making Dollars and Sense of Make-whole Premiums. 1

A Call for Opaque and Questionable Terms. . . . 7

Recent Cases. 8

of the debt, the creditor is faced with either reinvesting the amount prepaid in a lower-yield investment or finding a similar-yielding investment with greater risk. Most make-whole premiums protect the creditor by basing the premium amount on the present value of the interest that the creditor would have received had the loan been repaid at the stated maturity date (often then reduced by the interest that would accrue at the Treasury Bill rate, plus 50 basis points). Some use a different formula, such as a fixed percentage of the amount of principal outstanding or prepaid.

THE ISSUES RELATING TO THE ENFORCEABILITY OF MAKE-WHOLE PREMIUMS

There are at least five issues relating to the enforceability of a make-whole premium, several of which have sub-issues:

- Has a claim for the premium been triggered?[6]
    - If the only trigger is the filing of a bankruptcy petition, is such a trigger enforceable?
- Is the premium enforceable under applicable state law?
- Is a bankruptcy claim for the premium disallowed as a claim for unmatured interest?
    - If so, is the result different if the debtor is solvent?[7]
        - If so, is interest on the claim for the premium due at – or is the premium itself to be calculated using – the contract rate, the federal judgment rate, or some other rate?[8]
- If a bankruptcy claim for the premium is secured, is the amount of the secured claim limited by § 506(b)?
    - If so, is the amount in excess of the allowed secured claim disallowed or allowed as an unsecured claim?[9]
- If a claim for the premium is allowable in bankruptcy, can the debtor avoid the obligation by reinstating the loan pursuant to § 1124(2)?

Each of the first three main issues is affected by how the term providing for the make-whole premium is drafted. That said, the first issue – has the premium been triggered – is fairly discrete, and can ordinarily be avoided by not using undefined terms such as "prepayment," "redemption," or "maturity," which a court might interpret more narrowly than desired. Transactional lawyers appear to have heeded this advice.[10] Consequently, this article does not focus on that issue. The remaining issues are matters of statutory interpretation. They do not appear to be affected by how the term is drafted and are therefore also beyond the scope of this article.

The second and third issues – the enforceability of the premium under applicable state law and disallowance of the premium in bankruptcy as a claim for unmatured interest – are challenging. That is because the advice typically put forth to ensure the enforceability of the premium under state law is apt to increase the likelihood that a bankruptcy claim for the premium will be disallowed, and vice versa.

ENFORCEABILITY UNDER APPLICABLE STATE LAW

A make-whole premium that becomes due upon breach – that is, upon the borrower's default – is typically analyzed as a liquidated damages provision.[11] Under that rubric, a contractual clause fixing unreasonably large damages in the event of breach operates as a disguised penalty, and is unenforceable.[12] In contrast, a clause fixing damages at an amount that is reasonable in light of the anticipated or actual loss and the anticipated difficulty in proving loss, is enforceable.[13] New York law, which is often selected to govern debt instruments, is in accord:

> A contractual provision fixing damages in the event of breach will be sustained if the amount liquidated bears a reasonable proportion to the probable loss and the amount of actual loss is incapable or difficult of precise estimation. If, however, the amount fixed is plainly or grossly disproportionate to the probable loss, the provision calls for a penalty and will not be enforced.[14]

The party seeking to invalidate a liquidated damages clause has the burden to show that the damages are, in fact, a penalty.[15]

Under this standard, courts have generally enforced make-whole premiums based on the amount of future contractual interest, discounted to present value using prevailing market rates, such as the yield on U.S. Treasury bonds of comparable maturity.[16] Courts have also enforced make-whole premiums based on a small percentage of the principal of the debt,[17] or the larger of the two.[18] In contrast, courts have refused to enforce make-whole premiums that fail to discount future interest to present value,[19] or that are based on an unreasonably high percentage of principal.[20]

The analysis is different for a make-whole premium that becomes due, not on breach, but upon voluntary prepayment. Such a premium cannot be either liquidated damages or a penalty. Liquidated damages are, at their core, *damages*; that is, they compensate for the injury resulting from a breach. Contractual penalties, though unenforceable, are another agreed-upon remedy for breach. If there is no breach, there simply cannot be a penalty for breach.

Consequently, liquidated damages vs. penalty analysis has no relevance to a contractual term providing for a make-whole premium triggered by a voluntary prepayment.[21] Such a premium is instead simply the price for exercising an option to

prepay. Put another way, pursuant to the perfect-tender-in-time rule, the creditor has no duty to accept a prepayment, and a make-whole premium is the creditor's fee for waiving that right. The implications of this are important. The amount of a make-whole premium triggered by voluntary prepayment need not be reasonable in relation to the creditor's expected loss, expected return, or anything else. Instead, as long as the amount of the premium is not unconscionable, it should be enforceable. And, given the voluntariness of the prepayment (not to mention the voluntariness of entering into the contract), there should be little risk that a court would regard the premium as unconscionable.

DISALLOWANCE AS A CLAIM FOR UNMATURED INTEREST

In the *Ultra-Petroleum* case, the debtors – Ultra Petroleum Corp. and its affiliates – entered bankruptcy "deep in the hole" but became "supremely solvent" post-petition when natural gas prices soared.[22] The debtors' plan of reorganization provided for the payment of all unsecured claims in full and in cash, and deemed such creditors unimpaired under the plan. The plan did not, however, provide for payment of make-whole premiums triggered upon the filing of the bankruptcy.[23]

Two groups of noteholders objected to confirmation, arguing that they were, in fact, impaired because the plan did not provide for payment of the make-whole premiums. Pursuant to a stipulation, the debtors created a $400 million reserve to deal with the issue and the bankruptcy court confirmed the plan.[24]

Post-confirmation, the bankruptcy court then ruled that the objecting noteholders were impaired unless they were paid the full amount permitted under applicable non-bankruptcy law. In 2019, the Fifth Circuit reversed, concluding that if a plan does not pay a claim disallowed by the Code, it is the Code – not the plan – that does the impairing. Hence, if the claim for the make-whole premium was properly disallowed, the creditors were not entitled to the premium.[26] The court remanded the case back to the bankruptcy court for further consideration.

The bankruptcy court then ruled that the make-whole premium was enforceable under New York law, and that the creditors' claim for the premium was not disallowed under § 502(b)(2) as a claim for "unmatured interest" or its "economic equivalent."[27] The debtors appealed directly to the Fifth Circuit.

The court began by noting that § 502(b)(2) applies not only to claims for unmatured interest but also to claims for the "economic equivalent" of unmatured interest,[28] such as claims for unamortized original issue discount.[29] From this premise, the court observed that the make-whole premiums the debtors were obligated to pay – the amount of which was the present value of future interest payments – were expressly designed to compensate "fixed-rate lenders' damages flowing from debtor default while market interest rates are lower than their contractual rates" and, as a result, are "nothing more than a lender's unmatured interest, rendered in today's dollars."[30]

The noteholders argued that, even though the premiums were based on the present value of future interest payments, the premiums were neither "interest" nor "unmatured."[31] The court was unpersuaded. Even accepting the creditors' argument that "interest" compensates lenders for the use or forbearance of their money accruing over time, the court concluded that the make-whole premiums do precisely that: they compensate creditors "for the *future* use of their money."[32] This was simply a different way of saying that the interest is unmatured. Moreover, the claim was "unmatured" when the bankruptcy petition was filed because the obligation to pay the premium was triggered by the petition.[33] The court then added that, even if the claim was not for unmatured interest, it was for the economic equivalent.[34]

The court then confronted the noteholders' argument that the claim for the make-whole premium was one for liquidated damages, not unmatured interest. Several courts have accepted this position,[35] although about an equal number have rejected it.[36] The Fifth Circuit sided with the latter group, rejecting the proposition that the claim had to be for one or the other. "[I]nterest labeled 'liquidated damages' is still interest," the court wrote.[37] And a make-whole premium is "both liquidated damages and the 'economic equivalent of unmatured interest' – indeed, that is its whole point."[38]

To support its conclusion, the court discussed a make-whole premium equal to the sum of all unmatured interest payments plus $1. Referring to this as a "Fake-Whole" premium, the court stated that such a formula is obviously "nothing more than unmatured interest plus one dollar."[39] The additional dollar would not transform a claim for the premium from a disallowed claim for unmatured interest into an allowable claim for liquidated damages.

But the court did not go so far as to say that all make-whole premiums are the economic equivalent of unmatured interest. The bankruptcy court had posed during oral argument a hypothetical involving a three-party transaction:

> Borrower prepays a 6% loan from Lender precisely one year before maturity. That prepayment triggers a reinvestment fee equal to the costs that Lender would incur in making a replacement loan, in the same industry as the original loan, with cash flows that match the remaining payments had the original loan not been prepaid. Lender pays Broker a 2.25% fee to locate a new borrower who accepts a new loan identical to the remaining term on the original loan to Borrower. Is any portion of the 2.25% reinvestment fee unmatured interest?[40]

The Fifth Circuit agreed with the bankruptcy court that the answer is "no." The reinvestment fee is simply the "negotiated cost to compensate the lender for making a new loan on comparable terms." But, the court added, this simply means that liquidated damages can compensate for anticipated transaction

costs that are not unmatured interest. It does not mean that a make-whole premium is not both liquidated damages and the economic equivalent of unmatured interest. In other words, liquidated damages and unmatured interest are overlapping circles in a Venn Diagram, with make-whole premiums falling in the overlapping areas.[42]

The principal implication of the court's decision is that a make-whole premium based wholly or mostly on the present value of future interest will be disallowed (unless the debtor is solvent). In contrast, a make-whole premium that compensates for other injury would not be. But this is where things get a bit tricky.

For a claim for a make-whole premium, triggered by breach, to be allowable in bankruptcy, it must be both enforceable under applicable state law and not one for unmatured interest. To be enforceable under applicable state law, the premium must represent a reasonable measure of anticipated loss. Foregone future interest, discounted to present value, is one judicially accepted way to reasonably measure anticipated loss. But that measure is also the economic equivalent of unmatured interest. In short, a premium amount most likely to be enforceable under state (*i.e.*, non-bankruptcy) law is also the least likely to be the basis of an allowable claim in bankruptcy. Transactional lawyers must find a way to steer between these two potentially fatal traps for a make-whole premium.

ADVICE FOR TRANSACTIONAL LAWYERS (AND THEIR CLIENTS)

One possible approach is to create two different premiums: (i) a make-whole premium that applies after default; and (ii) a yield maintenance premium that applies when there is no default.

The make-whole premium risks both being regarded as an unenforceable penalty and disallowed under § 502(b)(2). To avoid the latter, the premium should *not* be based on future interest. Instead, it might be a fixed sum or a fixed percentage of the outstanding indebtedness.[43] Setting the amount of the premium in this manner might force lender clients into a deal other than what they truly want. But sometimes what they want is simply not legally attainable.[44]

To help ensure that the premium is not an unenforceable penalty, the agreement should specify what anticipated damages – other than lost interest – the premium is designed to compensate for. These damages might include the expenses of finding a suitable alternative investment. Such expenses might be out-of-pocket expenses, such as the fee paid to a broker in the bankruptcy court's hypothetical during oral argument, or the creditor's internal costs of paying employees to find another investment and conduct due diligence. The amount of both external expenses and internal costs is very difficult to determine in advance, at the time the loan is made, and the latter is also difficult to determine even in hindsight. Thus, they should provide an appropriate basis for liquidated damages. Anticipated damages might also include the diminished value of the loan to the creditor following default, because the creditor might choose to sell the loan.[45]

The yield maintenance premium, in contrast, could be for any amount set in any way. It could be based on future interest, discounted to present value, because the premium would not apply during a bankruptcy case,[46] and thus the potential for disallowance under § 502(b)(2) would not be relevant. But because the yield-maintenance premium would not apply after default, it would also not be a form of liquidated damages and should not be susceptible to being struck down as a penalty. Consequently, the yield maintenance premium need not be a reasonable measure of the lender's anticipated damages. The premium would simply be the option price for voluntarily prepaying the loan, subject only to the minimal standard that it not be unconscionable.

The principal benefit of this two-premium approach is that it insulates the yield maintenance premium from attack. As the transactional lawyer attempts to navigate the make-whole premium between the Scylla of invalid penalties and the Charybdis of § 502(b)(2), the yield maintenance premiums sails off in a completely different direction, unobstructed by and unconcerned with either of those dangers.

There is another benefit of creating two different premiums. Documents providing for a make-whole premium can include a declaration by which the parties acknowledge that the premium is a reasonable estimate of the lender's anticipated damages, given the difficulty of estimating them. It is not clear that such a declaration serves any purpose,[47] but it might help if the premium is claimed to be a penalty and probably cannot hurt. On the other hand, such a declaration should not be included in a term providing for a prepayment premium due in the absence of default. Such a premium is *not* liquidated damages. Accordingly, the loan agreement should not, through the inclusion of such language, imply otherwise and thereby suggest that the amount of the premium must be a reasonable estimate of the lender's anticipated harm. Having two different premiums signals to the parties – and to courts – that the different premiums are subject to different rules and should not be conflated.

Stephen L. Sepinuck is Special UCC Advisor at Paul Hastings LLP and an adjunct professor at Vanderbilt Law School.

Notes:

1. In re Ultra Petroleum Corp., 51 F.4th 138 (5th Cir.), *petition for rehearing en banc denied* (5th Cir. Nov. 9, 2022).

2. *See* Donald L Swanson, *Make-Whole Premium: The Equivalent Of Unmatured Interest (Wells Fargo v. Hertz)* (available here).

3. *See, e.g.*, Joel Moss & Amber Bennett, *Solvent-debtor Exception Carries the Day in Fifth Circuit Ultra Petroleum Ruling on Make-wholes and Post-petition Interest* (Sherman & Sterling); Gabriel A. Morgan, Tristan M. Sierra & Destiny Parker-Thompson, *Ultra IV: Make-Wholes, Never Say Never Again* (Weil); *Fifth Circuit Decides Make-whole Premiums Are Disallowed as Equivalent of Unmatured Interest* (Davis Polk); *Fifth Circuit Holds That Make-Whole Amount Constitutes Unmatured Interest* (Paul Weiss Oct. 25, 2022); *Has the Make-Whole Been Plugged? The Fifth Circuit's Latest Opinion in Ultra Petroleum* (Sidley Austin Oct. 17, 2022); *Fifth Circuit Hands Holders of Bankrupt Ultra Petroleum Unsecured Bonds a Major Make-Whole Victory While Gutting Make-Whole Entitlements in Louisiana, Mississippi and Texas, Ending Years of Speculation and Legal Wrangling* (Chapman & Cutler Oct. 31, 2022); *Fifth Circuit: Make-Whole Premiums Should Be Disallowed in Bankruptcy* (McGuire Woods Nov. 14, 2022); *Fifth Circuit Rules on the "Solvent-Debtor Exception" and Make-Whole Premiums* (Jones Day Oct. 2022).

4. *See* In re South Side House, LLC, 451 B.R. 248, 266-67 (Bankr. E.D.N.Y. 2011) (indicating that prepayment provisions, including make-whole premiums, are the consequence of the perfect-tender-in-time rule).

5. *See* Stephen L. Sepinuck, *Perfect Tender in Time, Redemption, and Their Impact on Prepayment Premiums*, 10 The Transactional Lawyer 1 (Feb. 2020). *See also* Trilon Plaza, Inc. v. Comptroller of State of New York, 788 A.2d 146 (D.C. 2001) (the perfect-tender-in-time rule prohibited a debtor from compelling a creditor to accept prepayment); Hoffman v. Kounkel, 2016 WL 4051885 (Iowa Ct. App. 2016) (Iowa law presumes there is no right to prepay a debt before it is due).

6. *Compare* In re MPM Silicones, LLC, 874 F.3d 787 (2d Cir. 2017) (a make-whole premium due upon a "redemption" is due only upon a repayment prior to maturity; it is not triggered by acceleration of the debt), *with* In re Energy Future Holdings Corp., 842 F.3d 247 (3d Cir. 2016) (although a make-whole premium contingent on "prepayment" cannot apply after the debt's maturity, a premium tied to "redemption" can; hence a make-whole premium became due to first-lien and second-lien noteholders following automatic acceleration upon bankruptcy); In re Hertz, 637 B.R. 781, 785-89 (Bankr. D. Del. 2021) (following *Energy Future Holdings* but ruling that a redemption premium on one set of notes triggered by payment prior to "maturity" was not owing after the notes were accelerated, whereas a redemption premium on another set of notes triggered by payment before a specified date was due). *Cf.* In re Vanderveer Estates Holdings, Inc., 283 B.R. 122, 127-28 (Bankr. E.D.N.Y. 2002) (declining to determine whether a yield maintenance premium due upon prepayment was triggered by acceleration because the debtor's reorganization plan had to provide for payment of what the claimant would receive in a Chapter 7 liquidation, and there was no scenario in which liquidation of the debtor would not trigger the payment of the yield maintenance premium).

Traditionally, a lender is not entitled to a prepayment premium after default and acceleration because the premium is due only when the borrower voluntarily prepays the debt. In other words, by accelerating the loan, the lender elects to relinquish the right to a future stream of payments in return for an immediate right to collect the entire debt. *See, e.g.*, In re South Side House, LLC, 451 B.R. 248, 268-69 (Bankr. E.D.N.Y. 2011). However, the parties may agree to alter this general rule and require payment of a make-whole premium even after default and acceleration. *Id.*

7. *See* In re Ultra Petroleum Corp., 51 F.4th 138 (solvent debtor exception applies); In re PG&E Corp., 46 F.4th 1047, 1053-61 (9th Cir. 2022) (same). *See also* In re Mullins, 633 B.R. 1 (Bankr. D. Mass. 2021) (in solvent debtor cases, the requirement in § 1129(b) that a reorganization plan be fair and equitable might require the payment of post-petition interest in an amount greater than needed to give creditors the liquidation value of their claims).

8. *See* In re Ultra Petroleum Corp., 51 F.4th at 157-60 (using the contractual rate); In re PG&E Corp., 46 F.4th at 1061 (a reorganization plan of a solvent debtor that classified unsecured claims as unimpaired had to pay post-petition interest at the rate provided for by contract or applicable state law, not at the federal judgment rate). *But cf.* In re LATAM Airlines Group S.A., 2022 WL 2962948, at *12, n.22 (Bankr. S.D.N.Y. 2022) (suggesting that even if the solvent debtor exception applies, post-petition interest would be at the federal judgment rate, not at the contractual default rate); In re Hertz, 637 B.R. at 793-801 (an insolvent debtor must may pay post-petition interest on unimpaired claims at the federal judgment rate).

9. *See* In re Gencarelli, 501 F.3d 1, 4-7 (1st Cir. 2007) (allowance as a claim under § 502 is unaffected by disallowance as a secured claim under § 506(b)); In re Welzel, 275 F.3d 1308, 1317-18 (11th Cir.2001) (same).

10. *See* 4 Collier on Bankruptcy ¶ 502.03[3][d][ii] (16th ed. 2021) (suggesting that while the divergent decisions in *MPM Silicones* and *Energy Future Holdings* have led to uncertainty, lenders have responded by incorporating into their loan documents language that unambiguously states that the make-whole premium is due regardless of acceleration and regardless of bankruptcy).

11 *See, e.g.*, JMD Holding Corp. v. Congress Fin. Corp., 828 N.E.2d 604 (N.Y. 2005) (an early termination fee, triggered by default and equal to $600,000 – 1.5% of the maximum loan principal of $40 million – was an enforceable liquidated damages clause); In re 1141 Realty Owner LLC, 598 B.R. 534 (Bankr. S.D.N.Y. 2019) (a $3.1 million make-whole premium on a defaulted $25 million loan was enforceable as liquidated damages); In re School Specialty, Inc., 2013 WL 1838513 (Bankr. D. Del. 2013) (a $23.7 million make-whole premium on a $70 million term loan, triggered by default and based on discounted future interest, was enforceable as liquidated damages); In re Madison 92nd Street Assocs. LLC, 472 B.R. 189 (Bankr. S.D.N.Y. 2012) (a $3.1 million prepayment premium, equal to 5% of the outstanding loan balance and triggered by default, was enforceable as liquidated damages); Northwestern Mutual Life Ins. Co. v. Uniondale Realty Assocs., 816 N.Y.S.2d 831, 836 (N.Y. Sup. Ct. 2006) (a prepayment premium due after default and calculated to compensate the lender for lost yield was enforceable as liquidated damages). *See also* In re South Side House, LLC, 451 B.R. at 270 ("Courts review prepayment consideration terms that are triggered by default and acceleration under the standards applicable to liquidated damages."); In re Hidden Lake Ltd. P'ship, 247 B.R. 722 (Bankr. S.D. Ohio 2000) (upholding a claim for a prepayment charge after default as liquidated damages).

12. *See* RESTATEMENT (SECOND) OF CONTRACTS § 356(1).

13. *See id*. at § 356(1); U.C.C. § 2-718(1). *Cf.* Cal. Civ. Code § 1671(b) (amended in 1977 to make liquidated damages clauses in non-consumer transactions valid "unless the party seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the contract was made.").

14. *See* JMD Holding Corp., 828 N.E.2d at 609 (quoting Truck Rent-A-Center, Inc. v Puritan Farms 2nd, Inc., 361 N.E.2d 1015, 1018 (N.Y. 1977)).

15. *Id.*

16. *See* In re School Specialty, Inc., 2013 WL 1838513; Mutual Life Ins. Co. v. Uniondale Realty Assocs., 816 N.Y.S.2d 831; In re Vanderveer Ests. Holdings, Inc., 283 B.R. 122, 130 (Bankr. E.D.N.Y. 2002) (a yield maintenance premium based on the interest rate on Treasury Bonds was enforceable as liquidated damages). *See also* In re South Side House, LLC, 451 B.R. at 271 (indicating that a prepayment premium calculated on the basis of the interest rate on U.S. Treasury Bonds is generally enforceable, but concluding that the obligation to pay the premium had not been triggered in the case before it).

17. *See* SAC Fund II 0826, LLC v. Burnell's Enterprises, Inc., 2022 WL 1519515 (E.D.N.Y. 2022) (a prepayment charge of 1% of the principal – based on a clause providing for a charge ranging from 5% to 1% of the principal, depending on when the loan was prepaid); In re Neelkanth Hotels, LLC, 2021 WL 4944100 (Bankr. N.D. Ga. 2021) (a yield maintenance premium of 1% of the principal); JMD Holding Corp. v. Congress Fin. Corp., 828 N.E.2d 604 (an early termination fee of between 1% and 2% of the $40 million maximum credit). *See also* Walter E. Heller & Co. v. American Flyers Airline Corp., 459 F.2d 896, 899 (2d Cir. 1972) (a flat fee of $250,000 for not borrowing $8.9 million was enforceable as liquidated damages).

18. *See* In re 1141 Realty Owner LLC, 598 B.R. 534 (a yield maintenance premium equal to the greater of: (i) 3% of the principal amount being repaid; or (ii) the present value of all scheduled payments of principal and interest in respect of the principal amount of the loan being repaid divided by the principal amount being repaid); In re Madison 92nd Street Assocs. LLC, 472 B.R. 189 (a prepayment premium equal to the greater of: (i) 1% of the outstanding balance of the loan or (ii) a formula intended to estimate the present value of the future interest payments that would be eliminated by virtue of the prepayment).

19. *See, e.g.*, In re Kroh Bros. Dev. Co., 88 B.R. 997, 1000–01 (Bankr. W.D. Mo. 1988) (applying Missouri law); In re Skyler Ridge, 80 B.R. 500, 505 (Bankr. C.D. Cal. 1987) (applying Kansas law).

20. *See, e.g.*, Automotive Fin. Corp. v. Ridge Chrysler Plymouth L.L.C., 219 F. Supp. 2d 945 (N.D. Ill. 2002) (a fee equal to 15% of the principal for prepaying a consumer car loan during the first year was an unenforceable penalty based on Illinois law).

21. *See* Stephen L. Sepinuck, *Liquidated Damages, Alternative Performance, and Ensuring the Enforceability of Contingent Charges and Fees*, 5 The Transactional Lawyer 3 (Oct. 2015).

22. 51 F.4th at 142.

23. *Id.*

24. *Id*. at 143.

25. In re Ultra Petroleum Corp., 575 B.R. 361, 366-75 (Bankr. S.D. Tex. 2017).

26. In re Ultra Petroleum Corp., 943 F.3d 758, 765 (5th Cir. 2019).

27. In re Ultra Petroleum Corp., 624 B.R. 178, 191–95 (Bankr. S.D. Tex. 2020).

28. 51 F.4th at 145-46 (citing cases).

29. *See, e.g.*, In re Pengo Indus., Inc., 962 F.2d 543 (5th Cir. 1992) (so indicating but ruling that debt instruments issued as part of an exchange of earlier debt securities did not create original issue discount); In re Chateaugay Corp., 961 F.2d 378 (2d Cir. 1992) (a claim for unamortized original issue discount

on debentures issued by debtor had to be disallowed but new notes issued in a debt-for-debt exchange did not create original issue discount); In re Public Serv. Co. of N.H., 114 B.R. 800 (Bankr. D.N.H. 1990). *But cf.* Thrifty Oil Co. v. Bank of America Nat'l Trust & Sav. Ass'n, 322 F.3d 1039, 1048–49 (9th Cir. 2003) (a claim for periodic payments and termination fees due under interest rate swap agreements was not disallowed under § 502(b)(2) as a claim for "unmatured interest" because there was no actual loan).

30. 51 F.4th at 144 & n.3, 146.

31. *Id.* at 146.

32. *Id.*

33. *Id.* at 147. *Cf.* In re Hidden Lake Ltd. P'ship, 247 B.R. at 730 (declining to treat a prepayment premium as unmatured interest because it became fully due prepetition).

34. *Id.*

35. *See, e.g.*, In re School Specialty, Inc., 2013 WL 1838513 at *5; In re Trico Marine Servs., Inc., 450 B.R. 474, 480-81 (Bankr. D. Del.2011).

36. *See, e.g.*, In re Doctors Hosp. of Hyde Park, Inc., 508 B.R. 697, 705-06 (Bankr. N.D. Ill. 2014) (suggesting that a yield maintenance premium was for unmatured interest and rejecting as a "false dichotomy" the argument that it cannot be both liquidated damages and unmatured interest); Northwestern Mut. Life Ins. Co. v. Uniondale Realty Assocs., 816 N.Y.S.2d at 834 (analyzing as liquidated damages but noting that "[t]his premium represents a type of unaccrued interest."); In re Ridgewood Apartments of DeKalb Cty., Ltd., 174 B.R. 712, 720-21 (S.D. Ohio 1994) (disallowing a claim for a prepayment premium as one for unmatured interest because the purpose of the premium is to compensate the lender for lost interest).

37. 51 F.4th at 148.

38. *Id.* at 149.

39. *Id.* at 148.

40. 624 B.R. at 190 (the hypothetical is indented for ease of reading; but it is a paraphrase, not a quotation).

41. 51 F.4th at 149.

42. *Id.*

43. *See Fifth Circuit: Make-Whole Premiums Should Be Disallowed in Bankruptcy* (McGuire Woods) (suggesting that under the Fifth Circuit's *Ultra-Petroleum* analysis, a flat prepayment fee or a fee based on a percentage of outstanding principal balance might be acceptable).

44. For example, a lender might want to charge interest at a usurious rate. A transactional lawyer for such a lender should advise the lender to change the deal, and a lawyer who drafts a usurious loan agreement for a lender client is probably not serving the client's interests.

45. This argument is commonly used to justify an increase in the applicable interest rate after default, which is also a form of liquidated damages. *See* Stephanie J. Richards, *The Enforceability of Default Interest*, 5 THE TRANSACTIONAL LAWYER 1 (Oct. 2015); Stephen L. Sepinuck, *Very Interesting . . . or Is It: Limitations on Default Interest*, 3 THE TRANSACTIONAL LAWYER 2 (Feb. 2013).

46. For this purpose, it is assumed that being the subject of a bankruptcy filing is an event of default.

47. In *JMD Holding Corp.*, the loan agreement recited that the early termination fee was "in view of the impracticality and extreme difficulty of ascertaining actual damages, . . . a reasonable calculation of [the lender's] lost profits" in the event of early termination, "presumed to be the amount of damages" the lender would sustain in the event of such a termination, and "reasonable under the circumstances currently existing." 828 N.E.2d at 607. Nevertheless, the court evaluated whether the fee was an enforceable term for liquidated damages, apparently without regard to the declaration. *See id.* at 609-12.

A Call for Opaque and Questionable Terms

Have you encountered a term in a written agreement and are unsure what purpose the term serves? You hesitate to remove the term, for fear of taking out something that might be important, but you are also comfortable leaving it in. Or perhaps you have seen a term that seems to make sense but are unsure if a court would enforce the term or if a change in the law has made the term unnecessary or anachronistic.

If so, please send the term to the editors of this newsletter, along with a brief explanation of what you know about the term and what your questions about the term are. Our crack research team will then get to work investigating whether the term is really worth keeping. One or more future issues of this newsletter will report on the term submitted.

Please send submissions to:

wendy@managementservices.org

Recent Cases

SECURED TRANSACTIONS

Attachment Issues

The Peoples Bank of Marion v. Nutrien AG Solutions, Inc., 2022 WL 4588418 (W.D. Ky. 2022)

The trial court did not err in ruling that a bank that loaned money to a partnership formed by two brothers, which in turn authenticated a security agreement granting the bank a security interest in the partnership's farm equipment, did not in fact acquire a security interest in the equipment. Although the evidence was conflicting, there was ample evidence to support the trial court's conclusion that the brothers were the owners of the equipment and neither contributed the equipment to the partnership.

Anthony v. Celtic Bank Corp., 2022 WL 16631079 (Cal. Ct. App. 2022)

An assignment of a life insurance policy to a bank as additional collateral for a business loan that the insured individual had guaranteed was not invalid even though the bank had not recorded the assignment with the insurance company. Although the insurance policy stated that no assignment of this policy would be binding on the insurer until filed with and recorded by the insurer, that clause was designed to protect the insurer; it did not invalidate an assignment between the insured, as policy owner, and his creditor. Accordingly, the trustee of a trust created by the insured, to which the insured later purported to transfer the policy, was not entitled to a declaration that the bank's security interest was invalid.

Perfection Issues

In re Young, 2022 WL 4295267 (Bankr. E.D. Ky. 2022)

A secured party that financed the debtor's acquisition of a vehicle did not have a perfected security interest because the application for a certificate of title and lien statement were filed in a county other than the county in which the debtor resided. Although a 2020 amendment to the statute provides a safe harbor if a motor vehicle dealer or lender under a retail installment contract files in the county of residence designated by the debtor on a signed notarized form, that safe harbor did not apply because the statement must also be sworn to. The statement the debtor signed was notarized, but the notarial certificate stated that document was "subscribed and attested before me" by the debtor, not sworn to by the debtor.

Priority Issues

In re Waggoner Cattle, LLC, 2022 WL 6217920 (Bankr. N.D. Tex. 2022) (report and recommendation)

Lone Star Bank of West Texas v. Rabo Agrifinance, LLC, 644 B.R. 505 (N.D. Tex. 2022) (objections overruled)

A cattle financier did not have a PMSI in any cattle of the debtor because it failed to prove that the debtor used the financier's loans to purchase any cattle. Even if the financier did have a PMSI, the financier did not have PMSI priority in the cattle under § 9-324(d) because the financier failed to provide a bank that had a prior perfected security interest in cattle with notification of the financier's PMSI financing. The financier's intercreditor agreement with the bank did not provide that notification because it said nothing about a PMSI and did not describe any cattle that the debtor would purchase from third parties, which is the only cattle in which the financier claimed to have a PMSI.

The intercreditor agreement, which provided that the bank's security interest had priority in cattle owned by the debtor at one location and the financier's security interest had priority in cattle owned by a related entity at a second location, also provided that priority would shift from the bank to the financier with respect to cattle upon their delivery to the second location "and receipt of payment in full" by the debtor. This additional language applied only to cattle sold by the debtor to the related entity. As to cattle at the second location and purchased by the related entity from any third party, the financier had priority. The intercreditor agreement did not define "payment in full," and thus summary judgment could not be rendered on claims between the bank and the financier relating to whether payment remained due or excessive was payment made. Although the intercreditor agreement referred in the recitals to a specified credit agreement, that reference was not sufficient to incorporate the terms of the credit agreement into the intercreditor agreement.

The sons of the debtor's owner were not buyers in the ordinary course of business of cattle within the meaning of the Food Security Act because the transactions were not documented, the sons never paid for the cattle, the debtor's owner had complete control over the quantity of cattle sold, the price to be paid, and how the proceeds of the cattle were used, and in all these respects the sales differed from the debtor's sales to unrelated buyers. Consequently, the bank's lien remained attached to the cattle sold to the sons, and that security interest had priority over the security interest granted by the sons to the financier.

Enforcement Issues

Worthy Lending LLC v. New Style Contractors, Inc., 2022 WL 17095585 (N.Y. 2022)
A lender with a security interest in the borrower's accounts to secure the loan was an "assignee" of the accounts within the meaning of § 9-406. Accordingly, an account debtor could not discharge its obligation by paying the borrower after receiving an instruction from the lender to pay the lender.

Hawk Investment Holdings Ltd v. Stream TV Networks, Inc., 2022 WL 17258460 (Del. Ch. Ct. 2022)
A secured party that had assigned the secured obligation to a newly formed subsidiary could nevertheless exercise enforcement rights against the debtor because the subsidiary had irrevocably appointed the secured party as its collateral agent upon the debtor's default, and expressly granted the secured party authority to do "all acts and things which the Collateral Agent deems necessary to protect, preserve or realize upon" the security interest. Accordingly, the secured party could exercise the power granted in the security agreement to vote the debtor's shares in a corporation, and thereby change the corporation's director. It did not matter that a senior secured party had brought a foreclosure action.

Liability Issues

First Financial Bank v. Fox Capital Group, Inc., 2022 WL 4622687 (S.D. Ohio 2022)
A secured party with a perfected security interest in the debtor's deposit accounts had no claim for conversion against a factor that purchased the debtor's accounts and received payment from the debtor's deposit account, because the factor took free under § 9-332(b) unless it acted in collusion with the debtor to violate the secured party's rights, and there was no allegation of collusion.

In re Abeinsa Holding, Inc., 2022 WL 5303258 (Bankr. D. Del. 2022)
A debtor had no claim against a factor that received a prepetition payment from the debtor based on an invoice from an unlicensed contractor. Although California law prohibits a contractor from bringing an action to recover compensation for performance of its work unless the contractor was duly licensed at all times during construction, and permits the counter-contract party to recover compensation paid to that unlicensed contractor, the law does not authorize recovery against anyone other than the unlicensed contractor and § 9-404 prohibits affirmative recovery against a secured party.

BANKRUPTCY

Claims & Expenses

In re Zilkha Biomass Selma, LLC, 2022 WL 4647792 (Bankr. S.D. Ala. 2022)
A secured party was properly surcharged under § 506(c) of the Bankruptcy Code for the trustee's expenses in disposing of combustible pellets that were part of the secured party's collateral. The trustee's actions were necessary, reasonable, and beneficial to the secured party. The trustee could not abandon the pellets due to the public health and safety risk they posed. Moreover, moving the pellets to offsite storage lowered the risk to the secured party's remaining collateral and resulted in one less obstacle for the trustee to deal with in conjunction with the marketing and liquidation of the other collateral. Finally, if the trustee had abandoned the pellets, the secured party would have had to deal with their disposal.

Avoidance Powers

In re J&M Sales, Inc., 644 B.R. 440 (Bankr. D. Del. 2022)
Summary judgment could not be issued on the trustee's preference claim against a supplier to the debtor. Although the supplier's account had been sold to a factor, and the debtor made payments to the factor, the supplier might have remained a creditor of the debtor, and might have benefitted from the payments to the factor, if the factor had recourse against the supplier, something that could not readily be determined from the face of the factoring agreement.

Other Bankruptcy Matters

In re 85 Flatbush RHO Mezz LLC, 2022 WL 11820407 (S.D.N.Y. 2022)
The issue of whether the senior lender violated an intercreditor agreement by failing to provide the junior lender with notification of an option to purchase the senior debt did not have to be resolved before confirming a reorganization plan, under which the senior lender would credit bid during a sale of the debtor's hotel. The intercreditor agreement provided that a breach by the senior lender had no effect other than to extend the length of the junior lender's purchase option and that the junior lender was prohibited from bringing an adversary proceeding against the senior lender or objecting to the senior lender's reorganization plan. The junior lender remained able to bring a claim against the senior lender in a non-bankruptcy court after the sale was consummated.

GUARANTIES & RELATED MATTERS

Hovde v. ISLA Development LLC,
51 F.4th 771 (7th Cir. 2022)
Language in a guaranty agreement stating that the guarantor's obligation was unconditional, irrespective of "any other circumstance which might otherwise constitute a legal or equitable discharge or defense of a guarantor" was insufficient to waive a defense based on the statute of limitations. In a guaranty agreement, the term "unconditional" is a term of art providing that the creditor need not attempt collection from the principal debtor before looking to the guarantor. The language therefore provided merely that the guaranty was unconditional; it did not waive defenses.

LENDING, CONTRACTING & COMMERCIAL LITIGATION

Cintrifuse Landlord, LLC v. Loreto,
2022 WL 17072373 (Ohio Ct. App. 2022)
A term in a commercial lease of a restaurant requiring the landlord to "provide its best efforts" to obtain the necessary property and approval for an outdoor bar and service area obligated the landlord to do more than act in good faith; the landlord had to pursue its contractual obligations diligently and with reasonable effort considering its ability, the means at its disposal, and the other party's justifiable expectations, and required the landlord to pursue all reasonable methods of satisfying its obligations in light of circumstances beyond its control, but did not require leaving no stone unturned or making every conceivable effort. There may be rare cases in which summary judgment is appropriate on whether a contracting party has met its best-efforts obligation, but this was not such a case.

Sage Systems, Inc. v. Liss,
2022 WL 11360123 (N.Y. 2022)
A partnership agreement, which provided for each partner to indemnify the partnership and each other "from and against any and all claims, demands, liabilities, costs, damages, expenses and causes of action of any nature whatsoever arising out of or incidental to any act performed by a Partner which is not performed in good faith," did not cover attorney's fees incurred in an unsuccessful action to dissolve the partnership. To depart from the "American Rule," and to make an unsuccessful litigant responsible for the attorney's fees incurred by the successful litigant, an agreement must contain "unmistakably clear" language. The language in the partnership agreement did not mention attorney's fees.

In re Moon Group, Inc.,
2022 WL 4658615 (Bankr. D. Del. 2002)
A borrower had no cause of action against a lender for breach of contract, breach of the implied duty of good faith, tortious interference with contract, fraud, misrepresentation, or promissory estoppel based on the lender's refusal to advance funds under a revolving credit facility or to release the proceeds of accounts that had been received into a lockbox. The credit agreement clearly gave the lender "sole discretion" to discontinue making advances and the parties' prior conduct did not amount to a waiver of this discretionary authority.

Patel v. FisherBoyles, LLP,
2022 WL 17170377 (Mich. Ct. App. 2022)
A term in a promissory note, which provided that the borrower would have no personal liability if: (i) a corporation that had secured the debt voluntarily surrender its collateral and (ii) the borrower complied with his obligations under the Pledge Agreement, was satisfied as to the first condition but not as to the second. Even though the corporation had breached the security agreement by granting a purchase-money security interest to at least two suppliers, the note required only that the corporation "voluntarily surrender its collateral," not that the corporation comply with all the provisions of the security agreement. However, the borrower had not complied with the pledge agreement because he had not delivered a stock certificate to the lender.

BrewFab, LLC v. 3 Delta, Inc.,
2022 WL 7214223 (11th Cir. 2022)
The individual president of a corporation was liable as a guarantor after sending a text message to a supplier stating, "As per our conversation on Jan. 30th 2020 I george Russo from 3 Delta do promise to pay brew fab in full all outstanding bills as of this date and all agreed upon work done for 3 delta future forward." The message was not ambiguous as to whether it was sent in an individual capacity. Although the message was ambiguous as to whose bills were owed, the individual had conceded that the message referred to the bills owned by 3 Delta. There was no Statute of Frauds defense because the language "I george Russo from 3 Delta" constitutes an electronic signature under Florida's Electronic Signature Act. There was consideration because Russo promised to pay not merely the outstanding bills but also for work performed in the future, and hence the statement was an offer for a unilateral contract that BrewFab accepted by resuming work and sending additional equipment after receiving the text message.

Pecos I, LLC v. Meyer,
2022 WL 16752272 (Mo. Ct. App. 2022)
Because a note maker's allegation that the note holder orally agreed to allow payment through the provision of services was a "financial accommodation" within the meaning of the Missouri Statute of Frauds governing credit agreements, evidence of the alleged agreement was inadmissible and summary judgment was properly granted on the maker's liability for nonpayment.

Uniloc USA, Inc. v. Motorola Mobility, LLC,
2022 WL 16704090 (Fed. Cir. 2022)
There was "considerable force" to the argument that a patent owner – as distinguished from an exclusive licensee – does not lose standing to sue for infringement by granting its secured lender a non-exclusive license, effective upon default, that entitled the lender to sub-license the patent, and then later defaulting. Nevertheless, the patent owner was collaterally estopped from making that argument by not appealing a ruling against it in another case.

Uniloc USA, Inc. v. Google LLC,
2022 WL 16704091 (Fed. Cir. 2022)
Even if a patent owner's grant of a nonexclusive license to its secured lender, which entitled the lender to sub-license the patent, divested the patent owner of exclusionary rights and, therefore, of the right to sue others for infringement, that lack of standing was cured, before this infringement action was commenced, when the patent owner and the secured lender terminated the license. Although the original license agreement described the license as "irrevocable," that meant only that the patent owner could not revoke the license; the parties remained free to terminate the license by agreement.

Pitz v. United States Cellular Operating Co. of Dubuque,
2022 WL 16631229 (Iowa Ct. App. 2022)
Because one clause of a lease agreement provided that the lessee could exercise an option to renew by giving written notification to the lessor at least sixty days before the expiration of the initial lease term, and this clause made notification an express condition to the exercise of the option, another clause providing that the lessee "shall pay" rent for the renewal period "in a lump sum in advance at the exercise of the option" was a covenant but not a condition. Thus, the lessee's failure to make payment at the time it sent notification did not affect the efficacy of the lessee's exercise of the option.

■ ■ ■

Edited By:

Stephen L. Sepinuck
Special UCC Advisor, Paul Hastings LLP

Scott J. Burnham
Professor Emeritus, Gonzaga University School of Law

John F. Hilson
Former Professor, UCLA Law School

To be added (free of charge) or removed from the distribution list for *The Transactional Lawyer*, send an email message to: wendy@managementservices.org.

The Transactional Lawyer is distributed free of charge by the American College of Commercial Finance Lawyers Inc. (the "ACCFL"), which exercises no control over the content of The Transactional Lawyer. The Transactional Lawyer is provided for informational purposes only; nothing therein constitutes the provision of legal or professional advice or services by the authors, the editors, or ACCFL. If legal or professional services are required, the services of a competent professional should be sought. ACCFL is not responsible for any action the reader may take or any damages a reader may suffer as a result of anything in The Transactional Lawyer or from using the information contained therein. The views expressed in The Transactional Lawyer by the authors are their own, and their inclusion in The Transactional Lawyer does not imply endorsement of or agreement with such views by the editors, ACCFL, any Fellow of ACCFL, or any firm, organization or institution with which any Fellow is affiliated.