MAKING SENSE OF MAKE-WHOLES AND NO-CALLS IN BANKRUPTCY

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To Our Clients and Friends:

A recent decision in the *Chemtura* chapter 11 proceedings[1] adds to conflicting case law on the issue of whether creditors whose debt is repaid in bankruptcy are entitled to receive "make-whole" amounts or damages for breach of "no-call" provisions. While ultimately siding with courts recognizing the right of creditors to be compensated if they are repaid early by solvent debtors, the decision highlights potential issues for creditors asserting similar make-whole and damage claims in insolvent debtor cases.[2]

BACKGROUND

Provisions prohibiting a borrower from prepaying a loan ("no-call" provisions) or requiring the borrower to pay a fee in the event of an early repayment ("make-whole" provisions) are designed to protect the lender's right to receive the yield expected at the time the loan was made. While make-whole provisions are common in fixed-rate financings where yield protection is particularly important, these provisions are less frequently used in bank and high-yield bond deals, where it is more typical to see no-calls and/or prepayment fees based on fixed percentages of the prepaid amount.

Although financing agreements sometimes specify that prepayment fees or make-whole amounts become immediately due upon a bankruptcy default, they often do not. In that more common situation, courts have generally taken one of two approaches to creditors' claims for make-whole amounts or damages for violations of no-call provisions.

Certain courts have held that a debtor's repayment of secured notes during a no-call period gives rise to an unsecured claim for damages. Recognizing that section 506(b) of the Bankruptcy Code does not permit noteholders to include a prepayment premium in their secured claim if the agreement does not explicitly provide for such a payment, these courts have nonetheless allowed noteholders to assert unsecured claims for damages as compensation for their "dashed"

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1 *In re Chemtura Corp., et al., No. 09-11233 (REG), 2010 Bankr. LEXIS 3773, 2010 WL 4272727 (Bankr. S.D.N.Y. Oct. 21, 2010).*

2 *For a more detailed analysis of the Chemtura decision, see Making Sense Of Bankruptcy Make-Wholes, No-Calls, by My Chi To and Shannon Rebholz, Law360 (Dec. 7, 2010), available at www.law360.com/bankruptcy/articles/213308.*

expectations. In both of the cases cited in *Chemtura* in support of this position, the debtors were solvent, and therefore all claims, including unsecured claims, were paid in full.[3]

Other courts have reached the opposite conclusion, denying expectation damages to holders of secured notes that were repaid during a no-call period, even if the debtor was solvent. These courts have refused to read "into agreements between sophisticated parties provisions that are not there"[4] and held that contractual provisions that are unenforceable in bankruptcy (such as no-calls) cannot give rise to liability. Further, some courts have relied on section 502(b)(2) of the Bankruptcy Code to find that a claim for expectation damages for the breach of a no-call is in fact a claim for unmatured interest, which is not allowed.[5]

THE *CHEMTURA* DECISION

The debtors' plan of reorganization implemented a settlement that allocated $70 million in value to bondholders on account of make-whole claims and violations of no-call provisions in two series of notes. One indenture required the payment of a make-whole amount if the notes were paid prior to their stated maturity date; the other only provided that the notes could not be redeemed prior to their stated maturity date. Although equity holders were entitled to a distribution under the plan, they took issue with the value allocated to the make-whole and no-call provisions in the two indentures.

At the outset, the court made clear that it was not asked to decide the issues on the merits. However, in ultimately approving the settlement as reasonable, the court walked through the existing case law, setting out with some specificity what the court believed was the proper analysis for determining the bondholders' likelihood of success.

The court started by looking to state law to determine whether, as a matter of contract interpretation, either a breach of the no-call or a trigger of the make-whole amount had occurred and what the appropriate damages would be if a breach of the no-call was found. Under New York law, the court would consider the interest income that the lender could have earned by making an investment comparable to the loan being repaid and/or the reasonableness of the make-whole amount.

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3 *In re Premier Entertainment Biloxi LLC, 2010 WL 3504105 (Bankr. S.D. Miss. Sept. 3, 2010); In re Calpine Corp., 365 B.R. 392 (Bankr. S.D.N.Y. 2007).*

4 *In re Solutia Inc., 379 B.R. 473, 485 n.7 (Bankr. S.D.N.Y. 2007).*

5 *See HSBC Bank USA, N.A. v. Calpine Corp., No. 07-3088 (GBD), 2010 U.S. Dist. LEXIS 96792, 2010 WL 3835200 (S.D.N.Y. Sept. 15, 2010).*

The court then discussed applicable federal bankruptcy law principles. First, the court disagreed with the position that provisions that are not enforceable in bankruptcy cannot form the basis for damage claims if these provisions are breached. Next, the court questioned the conventional judicial wisdom that make-whole claims triggered by a repayment during bankruptcy should not be treated as unmatured interest. The court expressed its support for what it described as the "minority view" that make-whole premiums and damages for breaches of no-call provisions are proxies for unmatured interest and therefore should not be allowed under section 502(b)(2). Because Chemtura was solvent, the court concluded that section 502's disallowance of unmatured interest was irrelevant since "issues as to fairness amongst creditors, in sharing a limited pie, no longer apply."[6]

IMPLICATIONS

Although the *Chemtura* decision is ultimately favorable to the bondholders, the court's discussion of relevant cases and its reliance on the debtors' solvency as a principal reason for upholding the settlement, may make life more difficult for creditors asserting claims based on these types of provisions in insolvent debtor cases. Specifically, are make-whole claims and damages for breaches of no-call provisions, as Judge Gerber suggests, really no more than disguised unmatured interest, which should be disallowed under section 502(b)(2) (unless, in the case of a make-whole claim, it satisfies the conditions of section 506(b))? It remains to be seen whether other judges will follow Judge Gerber's lead or whether investors will take note and consider changes to standardized prepayment provisions in financing agreements.

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6 *In re Chemtura Corp., 2010 Bankr. LEXIS 3773 at *110.*