CLIENT UPDATE

DELAWARE BANKRUPTCY COURT ALLOWS MAKE-WHOLE CLAIM REPRESENTING 37% OF LOAN BALANCE

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On April 22, 2013, Judge Kevin J. Carey of the Bankruptcy Court for the District of Delaware allowed a lender's $23.7 million pre-petition make-whole claim, representing approximately 37% of the outstanding principal of the loan, in the Chapter 11 case of School Specialty, Inc. [1] In a decision that will win cheers from the lending community, the court enforced the clear terms of the loan agreement over the objection of the Official Unsecured Creditors' Committee, holding that the make-whole claim was enforceable under New York law.

BACKGROUND

On May 22, 2012, School Specialty, which was already in financial distress, entered into a $70 million secured term loan with Bayside Finance, LLC at an annual rate equal to three-month LIBOR, with a 1.5% floor, plus 11%. The loan matured on October 31, 2014, unless certain of the company's bonds were refinanced, in which case the maturity would be extended to December 31, 2015. The loan agreement provided that an early payment fee was payable to Bayside in the event of a prepayment or an acceleration of the loan. If the loan is prepaid or accelerated in the first 18 months of the loan, the early termination fee is equal to a make-whole amount calculated

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[1] *In re School Specialty, Inc., et al.*, No. 13-10125 (KJC) (Bankr. D. Del. April 22, 2013) (ECF No. 854). A copy of the decision can be found here: http://www.debevoise.com/publications/pdf/0854OPINIONreMakeWholePaymentMotion.pdf

by discounting, at the Treasury rate plus 50 basis points, the future stream of interest payments between the prepayment or acceleration date and December 31, 2015. However, if the loan is prepaid or accelerated after the 18th month, the early termination fee becomes fixed at 6% of the outstanding principal of the loan, declining to 1% after the 30th month.

After the breach of a minimum liquidity covenant less than a year after the loan was put in place, Bayside entered into a forbearance agreement, which, among other things, accelerated the loan, thereby triggering the obligation to pay the make-whole amount.[2] A few weeks later, School Specialty filed for bankruptcy protection.

The Committee filed a motion to disallow Bayside's make-whole claim, arguing that the make-whole amount is grossly disproportionate to any probable loss suffered by Bayside and thus constitutes an impermissible penalty under New York law. The Committee also argued that the make-whole claim should not be allowed because it is unreasonable under Section 506(b) of the Bankruptcy Code and because it constitutes a claim for unmatured interest under Section 502(b)(2) of the Bankruptcy Code. The court denied the Committee's motion.

BANKRUPTCY COURT'S DECISION

Starting with the basic principle that state law governs the substance of claims in bankruptcy, the court first analyzed whether the make-whole claim is enforceable under applicable state law. Under New York law (which governs the loan agreement), prepayment premiums are treated like liquidated damages and are enforceable when actual damages are not easily ascertainable and when the amount of the premium is not "grossly disproportionate" to the lender's possible loss. The court stressed that the reasonableness of the premium must be determined at the time the loan agreement is entered into, and not with the benefit of hindsight, and specifically noted that the test is whether the premium is disproportionate to the lender's possible loss, and not to the principal amount of the loan.

The court found that the make-whole amount is not grossly disproportionate to Bayside's potential damages and refused to interfere with the clear terms of a contract resulting from arms-length negotiations. In particular, the court was not swayed by the Committee's argument that the make-whole calculation should only have included discounted interest payments for the first 18 months. In addition, the court noted with approval other

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[2] In this case, there was no dispute that the make-whole amount was due upon acceleration, unlike other recent cases, such as *In re AMR Corp.*, 485 B.R. 279 (Bankr. S.D.N.Y. 2013), which held the opposite. Our client alert discussing the *AMR* decision can be found here: http://www.debevoise.com/clientupdate20130129a/

decisions by New York courts holding that make-whole calculations tied to Treasury rates are not plainly disproportionate to lenders' potential loss, without regard to the actual rate of interest on their loan.

The court then addressed the Committee's argument that the make-whole amount must be "reasonable" under Section 506(b), which allows oversecured creditors to claim reasonable post-petition fees, costs and charges provided for under their agreement. Without deciding whether Section 506(b) applied to Bayside's pre-petition make-whole claim, the court determined that, assuming Section 506(b) applies, a make-whole claim that is not grossly disproportionate under New York law would also satisfy the Section 506(b) reasonableness standard.

Finally, the court firmly sided with the majority view on the issue of whether the make-whole claim should be disallowed as a claim for unmatured interest under Section 502(b)(2). Following Judge Shannon's decision in *In re Trico Marine*,[3] the court held that the make-whole claim should be treated like a claim for liquidated damages, and not a claim for unmatured interest.

IMPLICATIONS

In the current low interest environment, make-whole amounts based on yield maintenance formulas tied to Treasury rates may be sizeable compared to outstanding loan balances. Judge Carey's decision should provide comfort to lenders that, if such a make-whole amount is clearly provided by the loan agreement, it will be enforced, especially if the payment obligation is triggered prior to the bankruptcy filing as was the case in *In re School Specialty*. In addition, the clear endorsement by Judge Carey of the dominant view that make-whole claims are not claims for unmatured interest provides a helpful counterweight to recent statements made by New York courts in the *Chemtura*[4] and *Calpine*[5] cases reaching the opposite conclusion on this important issue for the lending community.

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Please do not hesitate to contact us with any questions.

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3 *In re Trico Marine Servs., Inc.*, 450 B.R. 474 (Bankr. D. Del. 2011).

4 *In re Chemtura Corp.*, 439 B.R. 561, 604-05 (Bankr. S.D.N.Y. 2010).

5 *HSBC Bank USA, Nat'l Assoc. v. Calpine Corp.*, 2010 WL 3835200 at *5 (S.D.N.Y. Sept. 15, 2010).