

CLIENT UPDATE

FIFTH CIRCUIT PROVIDES A REMINDER THAT LANGUAGE PROVIDING FOR A PREPAYMENT PREMIUM MUST BE UNAMBIGUOUS

NEW YORK

Jasmine Ball
jball@debevoise.com

Richard F. Hahn
rfhahn@debevoise.com

M. Natasha Labovitz
nlabovitz@debevoise.com

George E.B. Maguire
gebmaguire@debevoise.com

Shannon Rose Selden
srselden@debevoise.com

My Chi To
mcto@debevoise.com

Michael E. Wiles
mewiles@debevoise.com

On January 27, 2014, in the latest in a recent flurry of decisions concerning prepayment premiums,¹ the United States Court of Appeals for the Fifth Circuit held that the acceleration of a promissory note based on a payment default did not trigger a prepayment premium.² The Fifth Circuit's ruling in *In re Denver Merchandise Mart, Inc.* is grounded in contractual interpretation and, along with the recent decision of the Second Circuit in *American Airlines*,³ reaffirms the importance of clear and unambiguous drafting where prepayment premiums are concerned.

BACKGROUND

In October 2010, GC Merchandise Mart, LLC ("GCM") defaulted on a promissory note (the "Note") when it stopped making payments to Bank of New York Mellon ("Mellon"). GCM and a number of its affiliates (the "Debtors") filed for bankruptcy in March 2011.

Mellon filed proofs of claim in the Debtors' bankruptcy cases that included its asserted right to a prepayment premium on the

¹ See, e.g., *U.S. Bank Trust National Association, et al. v. American Airlines, Inc., et al.* (*In re AMR Corp.*), 730 F.3d 88 (2d Cir. 2013); *In re School Specialty, Inc. et al.*, 2013 WL 1838513 (Bankr. D. Del. Apr. 22, 2013). Our client updates discussing these decisions can be found here: <http://www.debevoise.com/clientupdate20130916a> and here: <http://www.debevoise.com/clientupdate20130426a/>.

² *Bank of New York Mellon v. GC Merchandise Mart, L.L.C., et al.* (*In re Denver Merchandise Mart, Inc.*), No. 13-10461 (5th Cir. Jan. 27, 2014). A copy of the decision can be found here: <http://www.ca5.uscourts.gov/opinions%5Cpub%5C13/13-10461-CV0.pdf>

³ *In re AMR Corp.*, 730 F.3d 88.

accelerated Note amounting to approximately \$1.8 million. A prepayment premium is an amount that may be due under the terms of a debt agreement if the debt is paid before its stated maturity. Whether such a premium is due when the debt is accelerated (rather than prepaid voluntarily) has been a regular subject of dispute in bankruptcy proceedings.

The Debtors filed an objection to Mellon's proofs of claim, arguing that the prepayment premium should be disallowed because the premium was not due by the terms of the Note absent an actual prepayment by GCMM. Because the Debtors' plan of reorganization provided for the reinstatement of the loan rather than the immediate repayment of the accelerated loan, GCMM argued that the premium was not due. On January 31, 2012, the Bankruptcy Court for the Northern District of Texas sustained the Debtors' objection and disallowed the claim to the extent of the prepayment premium. The Bankruptcy Court's decision was affirmed by the District Court for the Northern District of Texas on March 27, 2013. Mellon appealed from the District Court's decision.

THE EXPLICIT TERMS OF THE CONTRACT WILL CONTROL

Applying Colorado law, the Fifth Circuit observed that a prepayment premium may not be assessed when a debt is accelerated at a lender's option unless the contract specifically provides for such assessment.

The Fifth Circuit then examined the terms of the Note, finding that two provisions were relevant to determining whether specific provision had been made for the payment of a prepayment premium following acceleration. The first, an acceleration provision, provided that principal, interest, "other sums as provided in this Note" and "all other moneys agreed or provided to be paid by Borrower in this Note . . . shall without notice become immediately due and payable at the option of Lender" upon the occurrence of an event of default. The prepayment premium was not specifically enumerated in this section.

The second, a prepayment provision, provided that GCMM had the "right or privilege to prepay all . . . of the unpaid principal balance of this Note," explicitly requiring the payment of the prepayment premium in connection with such prepayment. The prepayment provision also governed prepayments following an event of default, requiring the payment of the prepayment premium in the event of a Default Prepayment and defining Default Prepayment to mean "a prepayment of the principal amount of this Note made during the continuance of any Event of Default or after an acceleration of the Maturity Date under any circumstances" Additionally, the prepayment provision stated that the "Borrower shall pay the Prepayment Consideration due hereunder whether

the prepayment is voluntary or involuntary (including without limitation in connection with Lender's acceleration of the unpaid principal balance of this Note)" The Note thus expressly provided for the payment of the prepayment premium in the event of (i) a prepayment, (ii) a Default Prepayment or (iii) a voluntary or involuntary prepayment.

In analyzing these provisions, the Fifth Circuit first noted that the acceleration provision did not explicitly provide for payment of the prepayment premium, and that to be due, the premium would have to qualify as "other sums" provided in the Note or "other moneys" agreed or provided to be paid by GCMM pursuant to the Note. The Fifth Circuit then looked to the prepayment provision to determine whether it provided that the prepayment premium was due in the circumstances under consideration and found that none of the explicit triggers for the payment of the prepayment premium applied in the absence of an actual payment by GCMM. Instead, in each case, the Note provided for payment of the prepayment premium only if an actual prepayment by GCMM was required. Additionally, the Fifth Circuit noted the absence of language deeming the prepayment to have been made in the event of acceleration and provided that such drafting "is not difficult to achieve"

IMPLICATIONS

The Fifth Circuit's decision makes clear once again that, where prepayment premiums are concerned, courts will enforce only the explicit and unambiguous terms of contracts. If the parties to a financing wish to receive a premium upon the acceleration of debt, they must draft their agreements to explicitly provide for such payment.

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Please do not hesitate to contact us with any questions.

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