Bankruptcy Alert

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Delaware Bankruptcy Judge Enforces Makewhole Provision Over Objection of Creditors' Committee

On April 22, 2013, Judge Kevin J. Carey of the Bankruptcy Court for the District of Delaware (the "Bankruptcy Court") issued a decision holding, among other things, that a "makewhole premium" calculated in accordance with a provision negotiated at arm's length between sophisticated parties was not "plainly disproportionate" under New York State law to the prepetition secured lender's possible loss, notwithstanding the fact that the premium was approximately 37% of the principal amount outstanding. *In re School Specialty, Inc.*, No. 13-10152 (KJC) (Bankr. D. Del. Apr. 22, 2013), ECF No. 854 (the "SSI Decision").[1] This alert examines Judge Carey's opinion in *School Specialty* and its implications for lenders asserting a makewhole premium in future chapter 11 cases.

Background

In May 2012, School Specialty, Inc. and certain affiliates executed a credit agreement with Bayside pursuant to which Bayside provided the company with a $70 million secured term loan. The credit agreement included a "makewhole" provision entitling the lender to a premium (the "Makewhole Premium") in the event of voluntary prepayment or acceleration, which was calculated utilizing a discount rate based on the yield on U.S. Treasury Bonds plus 50 basis points. In December 2012, School Specialty defaulted under the credit agreement. On January 4, 2013, Bayside entered into a forbearance agreement, in connection with which it accelerated the debt but otherwise agreed not to exercise remedies for thirty days. The acceleration of the term loan indebtedness triggered Bayside's entitlement to the Makewhole Premium under the credit agreement in the amount of approximately $24 million. On January 28, 2013, School Specialty and certain affiliates filed for bankruptcy in the District of Delaware.

In February 2013, the official committee of unsecured creditors (the "Committee") filed a motion to disallow the Makewhole Premium, claiming among other things that the premium was an unenforceable penalty. Bayside opposed the Committee's motion, arguing among other things that the Makewhole Premium was not "plainly disproportionate" to Bayside's possible loss, and that because the prepetition credit agreement had been negotiated at arm's length, applicable non-bankruptcy law dictated against judicial revision of the agreement. An evidentiary hearing took place on April 5, 2013, at which expert and fact witnesses testified with respect to the enforceability of the Makewhole Premium.

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[1] Akin Gump Strauss Hauer & Feld LLP represents Bayside Finance, LLC ("Bayside") in these chapter 11 cases.

The Bankruptcy Court's Decision

On April 22, 2013, the Bankruptcy Court entered a memorandum and order denying the Committee's motion.[2] In its decision, the Bankruptcy Court ruled on four issues: (i) whether the Makewhole Premium was an unenforceable liquidated damages provision; (ii) whether the "reasonableness" standard set forth in Bankruptcy Code section 506(b) had been satisfied (to the extent applicable); (iii) whether the Makewhole Premium was a claim for unmatured interest under Bankruptcy Code section 502(b)(2); and (iv) whether Bayside had a duty to mitigate damages.

The Bankruptcy Court began its analysis by applying the two-part New York State liquidated damages test, which requires a court to consider (i) whether actual damages are difficult to determine and (ii) whether the sum stipulated is not plainly disproportionate to the probable loss. In so doing, the Bankruptcy Court emphasized New York State law's general admonition against judicial interference with contractual agreements "absent some element of fraud, exploitive over-reaching or unconscionable conduct."[3] The Bankruptcy Court held that the Makewhole Premium was not plainly disproportionate to Bayside's probable loss because, among other things, the Makewhole Premium (x) was calculated to preserve Bayside's bargained-for yield and (y) was the result of an arm's-length transaction between represented, sophisticated parties. While the Bankruptcy Court noted that the magnitude of the Makewhole Premium "[gave] the Court pause, the applicable standard [for evaluation of the Makewhole Premium] is whether the payment is "plainly disproportionate" to the possible loss - - not whether the payment at issue is disproportionate to the principal amount of the loan.[4]

Having decided that the Makewhole Premium was enforceable under New York State law, the Bankruptcy Court concluded that the reasonableness standard set forth in Bankruptcy Code section 506(b), to the extent applicable to a prepetition claim, had also been met. Moreover, the Bankruptcy Court adopted the majority view previously articulated by Delaware bankruptcy courts that prepayment premiums are in the nature of liquidated damages provisions and are not akin to unmatured interest, which is disallowed under Bankruptcy Code section 502(b)(2). Finally, the Bankruptcy Court applied New York State law to determine that a valid liquidated damages provision obviates any duty to mitigate damages.

Conclusion

The Bankruptcy Court's decision is an important precedent for lenders seeking to enforce the terms of makewhole or prepayment premiums over the objection of a borrower or creditor group. While the facts and circumstances of each particular case are always critical, this decision supports a creditor's entitlement to a makewhole premium on a number of grounds, including the following: (1) makewhole clauses are properly treated as liquidated damages provisions, which should be set aside only in extreme circumstances, (2) makewhole damages are not claims for unmatured interest subject to disallowance under Bankruptcy Code section 502(b)(2), and (3) a makewhole damages formula based on lost future

[2] The Committee will have fourteen days from April 22, 2013 to appeal Judge Carey's decision to the District Court.
[3] SSI Decision at 5.
[4] SSI Decision at 7 n.7.

interest discounted to present value based on prevailing U.S. Treasury rates plus 50 basis points is not prima facie unreasonable.

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