THE ENFORCEABILITY OF MAKE-WHOLE CLAUSES IN BANKRUPTCY

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When a lender makes an interest bearing loan to a borrower for a fixed term, the contract may provide that the borrower cannot repay the principal sum before maturity. This is often referred to as a "no call" provision. The intent of this provision is to protect the lender's expected return on its investment during the term of the contract. Otherwise, the lender could be faced with the loss of interest payments that the borrower would have otherwise paid to the lender. Borrowers may, however, bargain for relief from the no call provision and seek greater flexibility to prepay the debt to take advantage of an improved credit rating or lower market interest rates. In exchange for this request by the borrower, a lender may bargain for a prepayment premium or a make-whole to compensate the lender in exchange for the borrower's freedom of choice to voluntarily repay the loan early. For the purposes of this article we refer to both prepayment premiums and compensation paid to a lender pursuant to a make-whole provision as "Early Repayment Compensation".

The ability of a lender to effectively recover Early Repayment Compensation in an insolvency or bankruptcy proceeding in Canada continues to be uncertain. This is due to the relative scarcity of case law on the issue as well as a result of a number of other legal principles that operate as potential challenges to effective enforcement.

One threshold issue is whether the requirement to pay Early Repayment Compensation is triggered on an acceleration of the loan which has the effect of bringing forward the maturity and requiring the borrower to immediately repay the loan. The question then becomes whether this acceleration is a "voluntary" repayment by the borrower or a forced repayment by the lender? There is a principle of law that if the lender has required early repayment then it forfeits its right to insist on payment of the Early Repayment Compensation unless the parties have expressly bargained that these amounts are also payable upon acceleration. Recent case law in both Canada and the US continues to demonstrate that debt instruments providing for Early Repayment Compensation must be carefully drafted if they are to be enforceable upon an acceleration of a loan in an insolvency proceeding. In such cases, standard default and acceleration of debt provisions, along with provisions regarding whether pre-payment is "voluntary", can unintentionally alter the interpretation and applicability of the provision for Early Repayment Compensation.

Make-Whole in Canada and the United States

The judicial interpretation of the voluntary nature of Early Repayment Compensation arose in Canada in the Alberta Court of Queen's Bench case of *Re Cage Logistics, Inc.* ("**Cage**")[1]. In Cage, the Court addressed the issue of breakage fees (which can be viewed as another form of Early Repayment Compensation) in the context of a proceeding under the *Companies' Creditors Arrangement Act* ("**CCAA**"). In Cage, the credit agreement provided for a voluntary prepayment clause. On an event of default by Cage, the lender delivered demands for accelerated repayment and notices of intention to enforce security. Cage disputed the payment to the lender of the prepayment premium. The Court in Cage held that where a creditor takes steps to compel full payment of a debt or realize on its security to satisfy that debt, it must accept full payment of the whole amount of principal and accrued interest in satisfaction of that debt, even where the debt has not yet matured. By the lender choosing to demand the accelerated amount of their indebtedness, the Court held that it could not be said that the demand ought to be characterized as being made with the tacit consent of the debtors to prepay the loan, i.e., the prepayment was not voluntary. The Court also distinguished the agreement at issue in Cage with a US Bankruptcy Court decision that dealt with an agreement that contained express language that the Early Repayment Compensation was both payable by the borrower upon acceleration by the lender as well as upon voluntary prepayment by the borrower.

Unlike the United States, there is relatively little case law in Canada on the enforceability of clauses providing for Early Repayment Compensation in an insolvency or bankruptcy proceeding. It is therefore helpful to look to the treatment of these clauses by the US courts for guidance, particularly in situations where a Canadian debtor is governed by a US debt document. Recently, provisions providing for Early Repayment Compensation were the subject of two contentious bankruptcy cases in the US, including the bankruptcy and district court's decision in *U.S. Bank N.A. v. Wilmington Savings Fund Society, FSB (In re MPM Silicones, LLC)*[2] ("Momentive") and the Third Circuit Court's decision in *Delaware Trust Co. v. Energy Future Intermediate Holding Co. LLC*[3] ("**Energy Future**").

In Momentive, the company issued notes governed by an Indenture which provided for a payment of a redemption premium. The Indenture specifically provided that the notes could be redeemed by the debtor from time to time subject to the redemption prices set out therein. Under the Indenture, if Momentive voluntarily filed for bankruptcy, the notes would be automatically accelerated and "principal, premium if any, and interest" would become immediately due and payable.

In its decision, the U.S. Bankruptcy judge cited well established New York law which provides that a lender forfeits the right to early prepayment if the lender accelerates the balance of the loan. The Court noted that the rationale for this logic is that by accelerating the debt and advancing the maturity of the loan, the lender has chosen to be paid early. The Bankruptcy Court also noted that a lender forfeits the right to demand the redemption premium if the lender has accelerated the loan unless: (i) the debtor has intentionally defaulted to trigger acceleration; or (ii) the debt documents contain a clear and unambiguous clause that requires the payment of the redemption premium notwithstanding acceleration. In Momentive, the Bankruptcy Court ruled that the automatic acceleration of the maturity of the notes meant that Momentive could not prepay the debt and therefore the redemption premium was not payable. In addition, the Bankruptcy Court found that there was not clear and unambiguous wording which provided for the payment of the redemption premium notwithstanding the acceleration. The bankruptcy court's reasoning in the Momentive case was affirmed at the district court level. The noteholders, however, have sought to appeal their case to the Second Circuit. The Second Circuit has not yet issued its decision.

Subsequently, the Third Circuit Court in Energy Future came to the opposite result than the Bankruptcy Court and District Court in Momentive. In Energy Future, the Third Circuit Court for the District of Delaware drew a distinction between a prepayment premium and a redemption premium. The Third Circuit Court noted that a prepayment premium results from an option to voluntarily prepay the loan and terminate the mortgage *prior to maturity*. Unlike a prepayment, a redemption can occur *at or prior to maturity*. Accordingly, a premium tied to a redemption would be unaffected by the acceleration of the debt's maturity. In Energy Future, the indentures contained an optional redemption provision which provided that Energy Future may at any time prior to a certain date, redeem all or part of the notes equal to 100% of the principal plus the applicable premium. The indenture further provided that on a filing of bankruptcy all outstanding notes were due and payable immediately. In Energy Future, the Third Circuit Court therefore focused on two questions: (i) was refinancing in the Chapter 11 proceeding a redemption; and (ii) was the redemption optional.

In Energy Future, the Third Circuit Court found that the Chapter 11 refinancing was a redemption and that the redemption was optional in the circumstances, notwithstanding that as a result of the acceleration the debt was due and payable. When Energy Future filed for Chapter 11 protection voluntarily, it had the option to reinstate the notes under the Bankruptcy Code rather than paying them off immediately. Energy Future, however, chose to pay rather than reinstate. In these circumstances, the Third Circuit Court was clear that the acceleration clause and a make-whole clause can and should be interpreted together. As the acceleration of the maturity date through the Chapter 11 filing was voluntary, the redemption was also voluntary and the redemption premium was therefore payable. Subsequent to the Third Circuit decision, Energy Future petitioned the Third Circuit Court for a rehearing or en banc review of the panel's decision. However, prior to any rehearing, Energy Future announced that it had reached a settlement in principle which called for termination of all further appeals and challenges to the make-whole claims in exchange for certain discounts on the redemption premium owed.

The differing results achieved in the Momentive and Energy Future cases illustrate that the drafting of the

Indenture, the facts and circumstances of the case, and the jurisdiction of the bankruptcy filing, may continue to have a significant impact on whether a Early Repayment Compensation will be payable. The interpretation of provisions providing for Early Repayment Compensation by the US courts could be persuasive to Canadian courts with carriage of restructurings in Canada and for Canadian debtors whose debt instruments are governed by US law.

While Canada has yet to see authoritative case law interpreting the enforceability of Early Repayment Compensation, the recent case of *Re Tervita Corp.*[4] ("**Tervita**") suggests that this issue may come to the forefront in Canada in the near future.

In Tervita, the company applied to the Alberta Court of Queen's Bench for approval of an interim order relating to a plan of arrangement pursuant to section 192 of the *Canada Business Corporations Act* ("**CBCA**") and also sought recognition of the CBCA proceedings in the US. The proposed plan of arrangement in Tervita contemplated that the secured noteholders would be paid in full, however the secured noteholders would not be entitled to an early redemption fee in connection with such payment. Certain secured noteholders opposed the non-payment of the redemption fee and the Court approved a litigation protocol to address the issue. However, prior to the hearing on the issue the parties entered into a court approved settlement agreement which provided for payment to the secured noteholders of an amount representing a portion of the total amount of the redemption premium owed. While the parties settled the matter, the issues for determination would have included: (i) whether a filing for CBCA proceedings constituted an insolvency proceeding and therefore an automatic acceleration of the loan; (ii) whether the filing of the Chapter 15 proceedings constituted an insolvency proceeding; and (iii) and whether the redemption premium was payable in these circumstances under the terms of the Indenture. The authors note that as the settlement agreement was entered into prior to the release of the Third Circuit decision in Energy Future, it remains to be seen how the decision in Energy Future might affect future disputes regarding Early Repayment Compensation and the interpretation of situations of voluntary prepayment in Canada, either in a CBCA proceeding or a CCAA insolvency proceeding.

It is clear that the party that wishes to be in the best position to enforce the payment of Early Repayment Compensation in bankruptcy must at minimum ensure the applicable agreements are unequivocal and clear that the obligation to make such payment exists in all circumstances whatsoever, including when partial or full payment is made before the stated maturity date of the obligation, upon acceleration and that it is payable irrespective of whether the debtor files voluntary insolvency proceedings or is forced to file by the lender as a result of an event of default.

Unfortunately, proper drafting does not assure ultimate success on recovery by the lender in insolvency proceedings. There are a number of other principles that present challenges on successfully claiming and recovering that are beyond the scope of this bulletin. However, for the sake of completeness the other issues include:

- whether a payment made after the acceleration of the maturity date of the debt instrument pursuant to an insolvency filing is "a prepayment" that triggers prepayment premium;
  whether there are differing treatments between a prepayment and a redemption premium;
- whether a prepayment premium payable pursuant to a make-whole clause is really a claim for post-filing or un-matured interest, which may conflict with the interest stops rule that generally applies to unsecured or undersecured claims, subject to certain exceptions;
- whether the prepayment premium is a reasonable estimate of liquidated damages or a penalty; and
- whether the prepayment premium taken together with all other interest and fees constitutes a criminal rate of interest and is therefore unenforceable.

McMillan LLP has had occasion to consider these issues in live cases and has had success in navigating clients through the design, structure and enforcement of provisions for Early Repayment Compensation as well as assisted with negotiations relating to such issues.

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

[1] *Re Cage Logistics, Inc.,* (2002), 50 CBR (4th) 169; leave to appeal refused 2003 ABCA 36, 320 AR 281.
[2] *U.S. Bank N.A. v. Wilmington Savings Fund Society, FSB (In re MPM Silicones, LLC)*, 531 B.R. 321 (S.D.N.Y. 2015).
[3] *Delaware Trust Co. v. Energy Future Intermediate Holding Co. LLC*, No. 16-1351.
[4] *Re Tervita Corp.*, 2016 ABQB 662.