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News & Alerts

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Bankruptcy Considerations for Drafting Make-Whole Clauses in Loan Documents

Bankruptcy litigation over the enforceability of make-whole clauses in loan documents (also called "prepayment penalties" or "yield maintenance premiums") has been on the rise in recent years. A "make-whole" clause is a common contractual provision in a loan document that is triggered when the principal amount of the loan is either prepaid or becomes due early because of a default by the borrower. Under a make-whole clause, the lender has the right to demand that the borrower pay all interest that would have been paid over the full term of the loan, notwithstanding the prepayment of the principal or the acceleration of the loan payments due to the borrower's default.

Borrowers who have filed for bankruptcy often oppose the enforceability of make-whole clauses in bankruptcy, arguing that a lender forfeits the right to a make-whole premium when the lender accelerates the amounts due under the note, because a borrower cannot "prepay" a fully-mature note. Borrowers also rely on Section 502(b)(2) of the Bankruptcy Code, which bars claims in bankruptcy cases for un-matured interest. In response, lenders seeking to enforce make-whole provisions argue that they are entitled to receive the full benefit of the contractual benefit they made with the borrower.

Three U.S. Circuit Courts of Appeal—the Second, Third, and Fifth—have decided cases involving make-whole clauses in the bankruptcy context. These court have held that the enforceability of such a make-whole clause necessarily turns on the plain language of the contract between the parties.

A recent case from the U.S. Bankruptcy Court for the Southern District of New York, In re 1141 Realty Owner LLC, 2019 Bankr. LEXIS 834, 2019 WL 1270818 (Bankr. S.D.N.Y. March 18, 2019), demonstrates that the contractual terms of the loan documents and applicable state law govern the treatment of a make-whole premium included in a bankruptcy proof of claim. In that case, a pre-bankruptcy default prompted the lender to accelerate a note prior to the bankruptcy filing. In the bankruptcy case, the lender claimed amounts owed under a "yield maintenance default premium" clause (i.e., a make-whole clause) in its proof of claim. The debtor/borrower objected to the amounts owed under the yield maintenance default premium clause, which added more than $3 million to the lender's proof of claim. The Bankruptcy Court upheld the application of the yield maintenance default premium clause, finding that the plain language of the note explicitly allowed for any post-default payment to be considered a "voluntary prepayment" requiring the payment of all amounts owed under the yield maintenance default premium clause. Because the debtor/borrower made at least one post-default payment, the yield maintenance default premium clause was triggered, and subsequently the lender was able to claim such amounts in its proof of claim.

Careful drafting of make-whole clauses can ensure that these contractual provisions are enforceable should the borrower file for bankruptcy, and may allow a lender to realize its anticipated return on a loan. Experienced legal counsel can aid in drafting contractual provisions with

bankruptcy considerations in mind. Please contact the Hirschler Bankruptcy and Creditors' Rights Group for more information.

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