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Momentous Decision in Momentive?

Enforceability of Make-Whole Provisions in Doubt

by Julie Schaeffer

The United States Bankruptcy Court for the Southern District of New York has issued a ruling that questions the enforceability of make-whole provisions in the context of a bankruptcy – and may serve as a guide for those drafting make-whole provisions in indentures.

Outside of bankruptcy, make-whole provisions – which compensate noteholders for lost interest when debt is paid early – are simple. To determine if a creditor is entitled to be "made whole," you simply look at the indenture that governs the debt and applicable law. Inside bankruptcy, however, the issue becomes more complicated, with a multilayered approach that analyzes the indenture under applicable state law, then brings in bankruptcy law.

First, the indenture is analyzed under applicable state law to determine three things. Is there a make-whole provision? If there is a make-whole provision, has it been triggered? If there is a make-whole provision and it has been triggered, is it enforceable under applicable state law?

If the answers are yes, the make-whole provision is analyzed under bankruptcy law to determine four things. Does the bankruptcy filing automatically accelerate the obligations under the controlling contract (the indenture)? If so, does that acceleration trigger a make-whole provision? Should the make-whole provision be disallowed as a claim for "unmatured interest?" Is the indenture trustee or lender able to decelerate the acceleration caused by the bankruptcy filing?

This process played out in the bankruptcy of MPM Silicones, LLC, a specialty chemicals manufacturing company, and certain affiliates, which filed for Chapter 11 in April 2014. Under the company's plan of reorganization, senior noteholders were to be paid in full, in cash, but without the interest that would have accrued all the way through the original 2015 maturity of the notes. That interest was more than $200 million.

The senior noteholders objected to the confirmation of the plan on the grounds that it violated the terms of the indenture, which provided for payment of a make-whole premium in the event of any redemption of the notes before October 2015 – and a redemption of the notes occurred with the automatic acceleration of the notes upon the filing of the bankruptcy.

MPM Silicones disagreed on the grounds that there was not a voluntary redemption of the notes before October 2015; instead, the maturity date was automatically accelerated by the bankruptcy filing. Because the indenture did not expressly require a payment following an automatic acceleration of the maturity date, MPM Silicones argued, no make-whole premium was due.

At the confirmation hearing for the plan of reorganization, Judge Robert D. Drain ruled against the senior noteholders, primarily on the grounds that the language in the indenture relating to the make-whole premium was not specific. According to Drain, in order for the make-whole premium to apply, the indenture needed to specifically provide that such a payment would be due in the event of automatic acceleration of the maturity date. He did leave open the possibility that a contract might provide for a make-whole payment

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as part of a bankruptcy claim, but only if this language is expressly set forth in the contract.

That was not the only issue at hand. For example, the noteholders also tried to argue that the indenture included a no-call provision stating that the notes were not redeemable, thereby prohibiting early repayment of the debt. Drain said that this provision was not specifically a no-call provision, but a mechanism to introduce a provision that provided for a make-whole premium to be paid under certain circumstances, none of which were triggered here. Additionally, the noteholders sought, post-petition, to rescind the automatic acceleration of the notes that occurred upon the bankruptcy filing, holding that the automatic stay barred the deceleration of the debt, but Drain didn't allow this. However, these issues are too expansive for current discussion.

In regard to the issue of enforceability of a make-whole provision, however, the ruling in the case, generally referred to as *Momentive*, is consistent with other recent decisions on enforceability of make-whole provisions in bankruptcy, says Andrew I. Silfen, a partner in the bankruptcy and financial restructuring group of Arent Fox LLP. "Make-whole provisions generally are enforced by bankruptcy courts where the premium is triggered by the express contract terms, the make-whole provision is a valid liquidated damages provision under state law, and the premium is reasonable under section 506(b) of the Bankruptcy Code," he explains. "Therefore, while the decision is garnering significant attention, it does not alter existing law."

Rather, Silfen says, the ruling should serve as a guide to attorneys drafting make-whole provisions in indentures. "The language that specifies when a payment is triggered should be clear and unambiguous," he says. "Specifically, such provisions should explicitly require payment even upon acceleration of maturity as a result of a bankruptcy filing or other enforcement actions taken by the indenture trustee or holders. Parties should also be careful to limit the amount of the make-whole provision so that it is proportionate to the expected loss due to early repayment (i.e., not an impermissible penalty)."

Silfen notes that this may be easier said than done. "Raising an issue that is only implicated upon a bankruptcy filing will not be a popular position around the drafting table," he says.

"It's not that lawyers don't know how to draft language that works; at this point, we do," says Damian S. Schaible, a partner in the insolvency and restructuring group at Davis Polk & Wardwell LLP. "The question is what the market will bear when putting together new financings. Will the market support and demand make-whole provisions that actually work, as opposed to provisions that just conform to precedent deals?"

Next month we'll discuss another element of Judge Drain's *Momentive* ruling, that the debtors could satisfy the cramdown provisions of 1129(b) without providing a market rate of interest. ¤