

## FUND FINANCE FRIDAY

## Make-Whole Clauses: It's All About the Enforceability Question

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Make-whole clauses (also known as prepayment premiums, call premiums or call protection) are provisions in financing transactions that require the borrower to make a specified payment to the lender if a loan is prepaid before the scheduled maturity. This payment is typically made by the borrower as a lump sum upon early termination and is designed to compensate the lender for the loss of the anticipated yield that lenders expect when providing (or committing to provide) the financing over a specified term.

When drafting make-whole provisions it is important to consider the threshold question of whether the provision would be enforceable under the law of the contract. Under New York law, a make-whole provision generally will be considered tantamount to liquidated damages provisions in contracts. Such liquidated damages provisions may be enforceable in circumstances where actual damages are difficult to calculate, and the premium being paid by the borrower is proportional to the loss incurred by the lender. New York courts will consider whether the lender's damages are difficult to ascertain, and whether the contract's proposed formula for calculating the make-whole or prepayment premium is proportional to the loss suffered by the lender. In contrast, however, New York courts will not enforce liquidated damages provisions that function mainly as a penalty or that are otherwise punitive to the borrower. Make-whole provisions should also clearly state that they are liquidated damages, and should not represent an unreasonable percentage of the principal amount of the loan (courts have varied on what is an unreasonably high percentage). Finally, a New York court also will consider if the make-whole premium actually has been triggered under the terms of the debt instrument. Accordingly, it may be helpful to provide that the payment of prepayment premiums are crystallized prior to the filing of a bankruptcy and that the trigger occurs whether the prepayment is voluntary or involuntary.

Lenders should bear in mind that, in a bankruptcy case, their entitlement to a prepayment premium or make-whole can be challenged. Indeed, make-wholes and prepayment premiums have been the source of much litigation in recent chapter 11 cases. Because section 502(b)(2) of the Bankruptcy Code provides that a claim is disallowed "to the extent that . . . such claims is

for unmatured interest,” parties have used this to challenge claims for make-wholes and prepayment premiums. Two leading examples of bankruptcy challenges to the enforceability of make-whole clauses are *In re Ultra Petroleum Corp.*, 51 F. 4th 138 (5th Cir. 2022) (“Ultra”) and *Wells Fargo Bank N.A. v. The Hertz Corp. (In re The Hertz Corp.)*, Case No. 1:21-ap-50995, Dkt. No. 71 (Bankr. D. Del. Nov. 21, 2022) (“Hertz”), where the courts disallowed lender claims for make-whole premiums, finding that such payments represented payments of unmatured interest under Section 502(b)(2) of the Bankruptcy Code. The court in *Ultra* initially declined to enforce the make-whole payment on the grounds that the payment was unmatured interest. However, over the course of the bankruptcy, as natural gas prices increased following its bankruptcy filing, Ultra became massively solvent. The court ultimately allowed for payment of the make-whole amount pursuant to the “solvent debtor” exception to Section 502(b)(2), which allows for payment of unmatured interest if the debtor is solvent. In *Hertz*, the court likewise disallowed the lender’s claim for the make-whole premium as post-petition interest. However, the Delaware Bankruptcy Judge in *Hertz* certified that decision for direct appeal to the Third Circuit, given that there is a burgeoning circuit split on the enforcement of such provisions. No decision on the appeal has yet been issued.

In light of the complexity of these issues and the potential for disputes over the enforceability of prepayment provisions, lenders negotiating such clauses should carefully consider whether the premium accurately represents the actual damages that would be incurred by the lender upon prepayment, and whether the make-whole premium is reasonable as a percentage of the principal amount of the loan. They also should be mindful of the other criteria that courts have used, both in and outside of the bankruptcy context, to enforce such provisions. We will provide further updates on this evolving area of the law as the case law develops.