Secured Lender's Large "Makewhole" Claim Upheld By Delaware Bankruptcy Court

The United States Bankruptcy Court for the District of Delaware recently upheld a secured lender's claim for a $23.5 million "makewhole" premium (the "Makewhole Claim") over the heavily litigated objection raised by the unsecured creditors' committee in *In re School Specialty, Inc.*, No. 13-10125 (KJC) (Apr. 22, 2013). Although this is not the first time that the Delaware Bankruptcy Court has enforced a lender's entitlement to a contractual prepayment premium, the factual circumstances of this case—particularly the fact that the $23.5 million Makewhole Claim stemmed from a $70 million loan that was entered into just eight months earlier—make the Bankruptcy Court's decision instructive for lenders and borrowers in drafting and negotiating loan documents.

For lenders, this decision should reinforce the importance of carefully drafting provisions covering when the borrower must pay a "makewhole" premium, including explicitly requiring payment of such fees upon the acceleration or prepayment of loan obligations for any reason, including a bankruptcy filing. This decision can also provide guidance to lenders on key terms (*e.g.*, the discount rate) in crafting "makewhole" provisions that likely would be upheld by a bankruptcy court (particularly in Delaware).

School Specialty's May 2012 Term Loan

In May 2012, School Specialty, Inc. (together with certain of its affiliates, "SSI") entered into a $70 million loan agreement (the "Term Loan") with Bayside Finance, LLC ("Bayside"). The Term Loan featured a minimum interest rate of 12.5%, and all of SSI's obligations under the Term Loan were secured by a first priority lien on its assets. The Term Loan would mature on October 31, 2014 with SSI having the option to push out the maturity until December 31, 2015 if SSI could refinance approximately $157.5 million of SSI's outstanding convertible notes prior to the initial maturity date.

The Term Loan also contained a number of lender-friendly provisions, including, among other things, a provision requiring SSI to pay a "makewhole" fee if either: (a) SSI was to prepay the Term Loan voluntarily prior to maturity or (b) the Term Loan was accelerated by Bayside (or automatically if SSI filed for bankruptcy). The size of the fee would depend on the timing of the prepayment or acceleration, as applicable. If the Term Loan was prepaid or accelerated in the first 18 months, the fee would be the present value of the future stream of interest payments that Bayside would have received from SSI from the date of prepayment or acceleration until the extended December 2015 maturity date using a discount rate of the then-prevailing Treasury yield + 50 bps. If prepaid or accelerated after the 18th month but before the end of the 30th month, the fee would be 6% of the outstanding principal amount of the Term Loan. If prepaid or accelerated thereafter, the fee would be only 1% of the outstanding principal amount.

Early Acceleration of the Term Loan

In early January 2013, Bayside accelerated the Term Loan on account of SSI's breach of a minimum liquidity covenant. Contemporaneously therewith, Bayside agreed to forbear from exercising remedies to allow SSI to prepare its chapter 11 filing, which would be funded, in part, by a "DIP" loan to be provided by Bayside. Notably, the Bayside DIP loan required SSI to use a portion of the proceeds to repay all of the outstanding Term Loan obligations, including the entire Makewhole Claim. The Bayside DIP loan was designed to facilitate an expedited "free and clear" sale of substantially all of SSI's assets to Bayside, with little or nothing remaining for junior creditors. Additionally, as a condition of Bayside's forbearance, SSI was required to acknowledge its obligations under the Term Loan, including the Makewhole Claim.

School Specialty Files For Chapter 11

SSI filed for chapter 11 in the Delaware Bankruptcy Court on January 28, 2013 and immediately sought, among other things, interim approval of the Bayside DIP. An *ad hoc* group of SSI's unsecured noteholders immediately opposed the Bayside DIP (which was approved on an interim basis) and ultimately prevailed by agreeing to provide a replacement DIP containing less onerous terms that would immediately "take out" Bayside (except for the Makewhole Claim). The noteholders providing the replacement DIP also agreed to escrow approximately $25 million pending the Bankruptcy Court's decision on the Creditors' Committee's motion to disallow the Makewhole Claim.

The Committee's motion sought disallowance of the Makewhole Claim on the following three grounds: (a) the Makewhole Claim, the amount of which exceeded 35% of the approximately $67 million in outstanding principal under the Term Loan, is an impermissible penalty under applicable New York law and not enforceable as a measure of liquidation damages because it was "grossly disproportionate" to Bayside's probable loss, (b) the Makewhole Claim is not "reasonable" as required by section 506(b) of the Bankruptcy Code to be allowed as part of a lender's secured claim; and (c) the Makewhole Claim is a claim for unmatured interest that is disallowed under Bankruptcy Code section 502(b)(2) because its sole purpose and function is to compensate Bayside for lost future interest income.

The Bankruptcy Court's Decision

The Bankruptcy Court denied the Committee's motion, effectively allowing the Makewhole Claim in its entirety. In its decision, the Bankruptcy Court addressed each of the Committee's three central points for disallowance.

First, the Bankruptcy Court found that the prepayment provision in the Term Loan giving rise to the Makewhole Claim was enforceable under New York law, which generally disfavors court interference with a contract negotiated and entered into by sophisticated parties. New York courts will enforce a prepayment provision if it satisfies the standards applicable to liquidated damages: (a) actual damages are difficult to determine in the event of a breach; and (b) the agreed amount is not "plainly disproportionate" to the lender's possible loss as of the time the loan was entered into.

In holding that the Makewhole Claim was not "plainly disproportionate" to Bayside's possible loss as of the time the Term Loan was entered into, the Bankruptcy Court, in accordance with New York law, found that the Term Loan's prepayment provision was: (a) designed to permit Bayside to realize its bargained-for yield and (b) the result of an arms-length transaction between sophisticated parties represented by competent legal counsel. That the Makewhole Claim may have ultimately exceeded Bayside's "actual" damages in hindsight or was disproportionately large compared to the outstanding principal under the Term Loan were, in the Court's view, irrelevant.

The Bankruptcy Court also found reasonable Bayside's use of the extended December 2015 maturity date (instead of the initial October 2014 maturity date) in calculating the Makewhole Claim despite universal skepticism among the parties to the Term Loan that SSI could realistically refinance its convertible notes as required to extend the Term Loan's maturity. The Court reasoned that at the time it provided the Term Loan, Bayside had firmly committed to lend SSI those funds until December 31, 2015 and should be compensated for that commitment accordingly.

Next, the Bankruptcy Court quickly dismissed the Committee's argument that the Makewhole Claim fails to satisfy section 506(b)'s reasonableness requirement, holding that, so long as the Makewhole Claim passes muster as liquidated damages under New York law, it is *per se* "reasonable." In so holding, the Bankruptcy Court departed from a number of bankruptcy courts in other jurisdictions that have treated the "reasonableness" inquiry under federal bankruptcy law as independent from, and potentially stricter than, the "liquidated damages vs. penalty" inquiry under applicable state law.

Finally, the Bankruptcy Court decided that the Makewhole Claim was not subject to disallowance as "unmatured interest" under Bankruptcy Code section 502(b)(2). Following Judge Sontchi's reasoning in *In re Trico Marine Services, Inc.*, the Bankruptcy Court held that the Makewhole Claim was not a claim for unmatured interest because it: (a) matured immediately upon acceleration of the Term Loan and (b) sought to recover liquidated damages under a contract, which are distinct from interest payments on a loan.

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