Feature

KEY POINTS

- A make-whole provision typically requires the borrower to make a payment to compensate the lender for the loss of a future income stream when the financing is repaid early.
- The effect of such a provision under English law will turn primarily on its particular wording. Most such provisions would be unlikely to be void as a penalty.
- A US court has recently ruled such a provision unenforceable when triggered by the debtor's insolvency. Despite differences between US and English insolvency law, there is good reason to think the same result would be reached by an English court.

Author James Sheehan

Make-whole payments in English financial law: an insolvency perspective

A US court has recently denied creditors the right to recover US$387m in "make-whole" payment obligations triggered by the borrower's entry into insolvency. In the light of that decision, this article considers the nature of make-whole provisions and their effect under English law, and in particular their enforceability in the borrower's insolvency.

INTRODUCTION

A commercial loan or other financing agreement will invariably provide for the periodical payment of interest by the borrower in addition to repayments of principal. If the borrower repays the loan in instalments or in full at the end of the term, the lender can expect to receive income in the form of interest payments for the full term.

At the same time, financing agreements will often confer on the borrower a right of optional prepayment, sometimes at specified times or on the occurrence of specified events. Provisions providing for mandatory prepayment in specified circumstances are just as (if not more) common. An obvious example is an event of default, such as entry by a borrower into an insolvency process. However, where a borrower prepays, the lender is deprived of income in the form of future interest payments.

For this reason, some loan agreements provide for the payment of premiums on early repayment (whether optional or mandatory), also referred to as make-whole or spens payments. Such provisions may require the payment of interest calculated up to the end of a particular period, or even up to the end of the full term of the loan (often discounted). In this way, they protect the creditor's anticipated yield under the financing arrangement.

A US court has recently ruled such clauses ineffective when triggered by the debtor's insolvency. This article considers that decision and the effectiveness of such clauses as a matter of English law, with a particular focus on their enforceability in the debtor's insolvency.

THE *ULTRA PETROLEUM* CASE

On 17 January 2019, the US Court of Appeals for the Fifth Circuit handed down judgment in the *Ultra Petroleum* case.[1] In summary, Ultra Petroleum was a group of oil and gas exploration and production companies. One group company had issued unsecured notes worth around US$1.46bn and borrowed a further US$999m under a revolving credit facility. The note agreement provided for a make-whole payment, calculated by reference to the discounted value of future unpaid principal and interest. According to its terms, if the debtor petitioned for bankruptcy, the make-whole payment became immediately due and payable, together with all outstanding principal and interest.

As a result of the sharp decline in oil prices between mid-2014 and early 2016, Ultra Petroleum fell into financial difficulty, and in April 2016 the group companies voluntarily petitioned for reorganisation under Chapter 11 of the US Bankruptcy Code.

In the course of the bankruptcy proceedings, oil prices rose again significantly, and Ultra Petroleum returned to solvency. It proposed a reorganisation plan which it said would compensate creditors in full. But the plan did not provide for payment of the make-whole amount (some US$387m). The creditors therefore claimed to be able to object to the plan on the basis that it altered their legal, equitable and contractual rights.

This gave rise to a number of issues of US bankruptcy law, one of which – the court's characterisation of the make-whole payment and its enforceability – is of particular interest when viewed from the perspective of English law. In short, the court held that the make-whole payment was disallowed by § 502(b)(2) of the US Bankruptcy Code, a provision which prevents a creditor from proving in the bankruptcy to the extent that its claim is for "unmatured interest". It reasoned that whether a claim sought unmatured interest was to be determined as a matter of economic reality, and that the make-whole payment was the economic equivalent of unmatured interest: its very purpose was to compensate the lender for future interest which it lost by the prepayment.

The effect of the decision in *Ultra Petroleum* was accordingly that the companies' entry into Chapter 11 proceedings prevented the noteholders from enforcing their contractual rights in full against the issuer, even though the issuer was ultimately solvent.

THE ENGLISH LAW PERSPECTIVE

The legal effectiveness of a make-whole provision has received limited attention in the English courts. It is however possible to make some general observations.

First of all, the effect of a make-whole provision will of course depend on its particular terms. Such provisions are comparatively sophisticated and vary from one financing agreement to another. Variables include the precise circumstances in which a make-whole amount is payable (eg on voluntary or mandatory prepayment), and the amount payable (eg calculated up to the

end of an interest period or for the full term, discounted or undiscounted).

Second, whilst some may take the view that make-whole provisions are unfair to a debtor, particularly if they are applied on mandatory prepayment, the scope for challenging such provisions as penal under English law is now very limited.

The question of whether a make-whole provision would be characterised as a penalty under English law was considered by Rian Matthews in a previous article in this Journal,[2] who pointed out that, whilst a requirement to pay all principal and all future interest on early repayment and without a discount might constitute a penalty, this is an extreme and (in practice) rare example. Make-whole payments are more commonly calculated by reference to the net present value of the future income stream from interest payments. In any event, the rule against penalties only applies to obligations triggered by a breach of contract.

The law on penalties was restated by the Supreme Court in *Cavendish Square Holding BV v Makdessi*.[3] The Supreme Court confirmed that the rule only applies to obligations triggered by a breach of contract.[4] It also stated the true test of whether a provision gave rise to a penalty to be "whether the impugned provision is a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation".[5]

This emphasises the high threshold which must be met before a contractual provision, including a make-whole provision, will be struck down as a penalty. In one case decided shortly after the Supreme Court's decision, *Canary Wharf Finance plc v Deutsche Trustee Company Ltd*,[6] Phillips J in the Commercial Court had to construe the terms of mortgage-backed loan notes in order to decide whether or not a prepayment made by the issuer had been voluntary or mandatory. If voluntary, on the facts of the case the borrower was required to pay a sum equivalent to the price of treasury stock which would produce the same yield as the loan notes would have produced for their duration (in either case, plus accrued interest). As can be seen, this formula is functionally equivalent to a make-whole provision, calculated as the net present value of a future income stream equivalent to that receivable under the loan notes.

Phillips J held that the prepayment had been voluntary, triggering an effective make-whole payment in respect of the full term of the financing. It does not appear from the decision that the issuer even argued that such an obligation would be penal. In light of the Supreme Court's decision in *Cavendish*, it is thought that such an argument would have been given short shrift. And in *Edgeworth Capital (Luxembourg) Sarl v Ramblas Investments BV*[7] the Court of Appeal relied on *Cavendish* in dismissing an argument that a prepayment fee of €90m on a loan of €200m was penal.

Of course, the possibility of a make-whole provision so exorbitant that it falls foul of the rule against penalties cannot be ruled out. But on the current state of English law it would be a rare case, not least given that the rule is limited to obligations triggered by a breach of contract.

RECOVERABILITY OF MAKE-WHOLE PAYMENTS IN AN ENGLISH INSOLVENCY

The question of creditors' rights to claim interest in an English insolvency has a long history (some of which was in fact charted in the Fifth Circuit's decision in *Ultra Petroleum*). The current law is statutory, and may be summarised as follows:

- Where a debt proved in insolvency proceedings bears interest, that interest is provable as part of the debt except in so far as it is payable in respect of any period after the "relevant date", usually the date of entry into liquidation or administration.[8] This provision has obvious parallels with § 502(b)(2) of the US Bankruptcy Code, applied in *Ultra Petroleum*.
- In the event of a liquidation or administration which produces a surplus, the surplus falls to be applied, in priority to other claims, in paying interest on debts submitted to proof in respect of the period since the company went into liquidation or administration.[9]

The effect of these provisions has received detailed consideration as part of the so-called "Waterfall" applications in the administration and potential liquidation of Lehman Brothers.[10]

The essential position, therefore, is that a creditor's right to prove in the insolvency in respect of interest is limited to the interest accrued up to the date of the insolvency; but where there is a surplus, a claim to interest revives (though as a statutory rather than contractual right[11]), at least up to the date of the payment of a dividend and so long as there is a sufficient surplus to pay the creditor in full (if not, distribution is made on a rateable or *pari passu* basis).

When considering the effect of an insolvency on the enforceability of a make-whole provision, a distinction may be drawn between two scenarios.

In the first scenario, the make-whole provision is triggered prior to the debtor's entry into insolvency, for example by an event of default which accelerates the whole loan plus interest (and the make-whole amount). This scenario was recently considered in a decision of the US Bankruptcy Court for the Southern District of New York, *In re 1141 Realty Owner LLC, et al*.[12] Following an event of default by the borrower, the lender exercised its right to accelerate the debt. Under the terms of the loan, any payment made after an event of default was deemed to be a voluntary prepayment which triggered the obligation to pay the make-whole amount. Only subsequently did the borrower file for Chapter 11 relief. The court ruled that the make-whole payment obligation was enforceable by way of proof in the bankruptcy.

It is debatable whether the same result would be reached under English law. Whilst English insolvency law permits a creditor to prove for both present and future debts,[13] as far as interest is concerned this is subject to r 14.23(1), which prevents proof for interest "payable in respect of any period after" the onset of insolvency. On the facts in *In re 1141 Reality Owner LLC*, the make-whole payment fell due prior to the debtor's entry into formal insolvency, but on one view it was primarily payable "in respect of" the period

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James Sheehan is a barrister practising at Essex Court Chambers, Lincoln's Inn Fields, London. Email: jsheehan@essexcourt.net / website: www.essexcourt.com

after insolvency; following the analysis in the *Ultra Petroleum* case, as a matter of economic reality it was an upfront payment of interest which would otherwise have fallen due after the debtor's entry into insolvency.

The second scenario is one in which the debtor's entry into insolvency itself triggers the obligation to pay the make-whole amount. This was the position in *Ultra Petroleum*. A clause such as this, which terminates or alters the parties' rights on an insolvency, is sometimes referred to as an *ipso facto* clause. In *Ultra Petroleum*, the court stated that an *ipso facto* clause was unenforceable, at least in the sense that it had to be ignored for the purposes of determining whether the make-whole amount constituted matured or unmatured interest.

However, English law takes a different attitude to *ipso facto* clauses. In *Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Ltd*,[14] Lord Mance referred to the position under US bankruptcy law but noted that the enforceability of such clauses under US law was the product of legislation, and that no equivalent principle was recognised in English law, concluding that "any general rule invalidating *ipso facto* termination clauses ought to be a matter for legislative attention, rather than novel common law development".

A creditor's attempt to prove for a make-whole amount in an English insolvency could therefore not be denied simply by reference to any objection to the validity of an *ipso facto* clause. But that is not the end of the story. To start with, the same issue arises in this second scenario as in the first, namely that the make-whole payment may be treated as (in effect) interest payable in respect of the period after the onset of insolvency. Indeed the issue is starker in this second scenario, because the make-whole amount only becomes payable *as a result of* the debtor's entry into administration or liquidation (even if the creditor might still argue that it becomes payable on the date of entry into insolvency, which is *on* the "relevant date" and not *after* it).

There is also a more fundamental point which affects both scenarios. Although English law does not recognise the rule against *ipso facto* clauses as such, it is nevertheless a central principle of English insolvency law that parties cannot contract out of the effect of the insolvency legislation, including the principle of *pari passu* distribution.[15] This principle would potentially be engaged by a creditor's attempt to prove in respect of a make-whole payment obligation triggered by the debtor's insolvency.

In particular, as already set out, the combined effect of Insolvency Rule 14.23 and s 189 of the Insolvency Act is that, in the absence of any make-whole provision, the creditor may only prove in respect of interest accruing due up to the date of the insolvency. Any further right to interest is not contractual but statutory and depends on there being a surplus. The practical effect of a make-whole provision, if upheld as part of a proof, would however be to allow the creditor to recover in respect of interest which, but for the insolvency, would have accrued due after the onset of insolvency. That could be said to circumvent the statutory code and be liable to be disallowed on that basis.

On the other hand, if the effect of the contract is that the make-whole payment is due, and the obligation to pay it would be enforceable at common law, it may be said that there is nothing objectionable in allowing the creditor to prove for it, and no infringement of the *pari passu* principle: the creditor is simply claiming for what is due under his contract, and if competing creditors did not extract a similar right from the debtor, they have only themselves to blame. The point would be ripe for argument if it ever came before an English court.

CONCLUSION

The provisions of US law which were upheld in *Ultra Petroleum* so as to deny the creditors the right to a make-whole payment have no exact parallel in English law. However, despite English law's arguably more relaxed approach to clauses which alter the parties' rights on insolvency, there is a cogent basis for concluding that *Ultra Petroleum* would have been decided the same way, albeit for different reasons, if it had been decided by an English court. ■

1 *Ultra Petroleum Corp. et al. v Ad Hoc Committee of Unsecured Creditors of Ultra Resources, Inc. et al. (In Re Ultra Petroleum Corp)* Case No. 17-20793 (5th Cir. January 17, 2019)

2 Rian Matthews, "'Make-whole' provisions under New York and English law" (2015) 2 JIBFL 93.

3 [2015] UKSC 67.

4 at [12] to [15].

5 at [32].

6 [2016] EWHC 100 (Comm).

7 [2016] EWCA Civ 412 at [7].

8 Insolvency Rules 2016, rr 14.23(1) and 14.1(3).

9 Section 189 of the Insolvency Act 1986; Insolvency Rule 14.23(7).

10 See, for example, *Re Lehman Brothers International (Europe) (In Administration)* [2017] UKSC 38.

11 *Re Lehman Brothers International (Europe) (In Administration)* [2017] UKSC 38 at [124] to [127].

12 Case No. 18-12341 (SMB), 18 March 2019.

13 Insolvency Rules 2016, r 14.2(1).

14 [2011] UKSC 38 at [172] to [174].

15 *British Eagle International Airlines Ltd v Cie Nationale Air France* [1975] 1 WLR 758.

Further Reading:

- "Make-whole" provisions under New York and English law (2015) 2 JIBFL 93.
- Belmont Park Investments and the anti-deprivation principle: wider implications? (2011) 9 JIBFL 574.
- LexisPSL: Banking & Finance Practice note: Debt securities payment provisions.