

April 2013

## *In re School Specialty, Inc.*: Enforceability of Make Whole Premiums In Bankruptcy

On April 22, 2013, the United States Bankruptcy Court for the District of Delaware (the “**Court**”) issued a decision enforcing a make-whole provision as a valid liquidated damages clause under New York law.

Approximately seven months before School Specialty, Inc. (“**School Specialty**”) commenced its Chapter 11 case, it entered into a term loan agreement (the “**Term Loan Agreement**”) with Bayside Finance, LLC (“**Bayside**”) pursuant to which Bayside made a \$67 million term loan (the “**Term Loan**”) to School Specialty. The Term Loan Agreement provided that upon either prepayment or acceleration of the Term Loan, School Specialty was required to pay an “Early Payment Fee.” If the prepayment or acceleration occurred during the first 18 months of the Term Loan, then the Early Payment Fee was equal to a “Make Whole Payment” calculated by reference to a negotiated formula.<sup>1</sup> As a result of the occurrence of an event of default under the Term Loan Agreement, Bayside and School Specialty entered into a forbearance agreement in January 2013 that provided for the acceleration of the Term Loan. Upon acceleration, Bayside claimed that it was owed approximately \$23.7 million in satisfaction of the Make Whole Payment. This amount constituted more than 35% of the principal amount of the Term Loan that was also due and owing.

Three weeks after entering into the forbearance agreement, School Specialty filed for Chapter 11 protection. Bayside sought payment of the full amount of the Make Whole Payment in addition to the principal and interest owed in School Specialty’s Chapter 11 case. The payment would be made from the debtor-in-possession financing provided by other stakeholders. The Unsecured Creditors’

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<sup>1</sup> The Make Whole Payment was calculated by discounting the future stream of interest payments between the date on which the principal is prepaid or accelerated and a conditional maturity date of December 31, 2015. The discount rate set forth in the agreement is the applicable Treasury rate plus 50 basis points.

Committee objected, but the Court overruled the objection and found that the Make Whole Payment was enforceable.<sup>2</sup>

The Court's analysis is favorable to lenders who have negotiated make-whole provisions in their loan documents:

1. Applying New York law, the Court analyzed whether the Make Whole Payment was an enforceable liquidated damages clause. The Court concluded that it was enforceable because the formula for calculating the Make Whole Payment properly reflected Bayside's obligation to keep funds available to School Specialty through 2015. The Court also found that the Term Loan was the result of an arm's-length negotiation.

2. Although the fact that the Make Whole Payment was more than 35% of the Term Loan gave the Court "pause," it found that the applicable standard is whether the Make Whole Payment is plainly disproportionate to the possible loss, and not whether the payment is disproportionate to the principal amount of the loan.

3. The Court did not want to disturb the parties' agreements because there was no evidence of fraud or other unconscionable conduct. Even though School Specialty was clearly in financial distress at the time the Term Loan was made, there was "no credible evidence in the record revealing that the relative strengths or weaknesses of the parties' respective bargaining positions was anything but common under the circumstances."

4. The Court also concluded that make whole payments are liquidated damages claims and not unmatured interest (claims for unmatured interest are disallowed under the Bankruptcy Code).

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<sup>2</sup> *In re School Specialty, Inc.*, Case No. 13-10125, slip op. at 2 (Bankr. D. Del. April 22, 2013).

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