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In re Doctors Hospital of Hyde Park, Inc.: Northern District of Illinois Disallows Yield Maintenance Premium as Unmatured Interest

On April 10, 2014, the United States Bankruptcy Court for the Northern District of Illinois (the "**Court**") held that a claim for the yield maintenance premium (the "**Premium**") due under a New York law governed loan agreement constituted unmatured interest that should be disallowed in the bankruptcy case of the guarantor, Doctors Hospital of Hyde Park, Inc. (the "**Guarantor**") under section 502(b)(2) of the U.S. Bankruptcy Code.[1]

Although on its face the Premium seemed to be similar to a make-whole payment that had been allowed in other cases as liquidated damages, the Court decided that the Premium constituted unmatured interest on the basis that:

(i) liquidated damages and interest are not mutually exclusive;

(ii) the Premium had the economic effect of interest, similar to original issue discount; and

(iii) the Premium did not become due until the loan was accelerated – several months after the Guarantor commenced its bankruptcy case.

Although the Court disallowed the claim as unmatured interest, the Court did not have sufficient facts to determine whether the lender was oversecured and, therefore, whether the interest could be allowed under section 506(b) of the Bankruptcy Code. Section 506(b) permits oversecured creditors to recover post-petition interest and reasonable fees, costs or charges provided for in the loan agreement or under state law.

This decision is potentially important for lenders because the Court seemed to expand the concept of "unmatured interest" to include any charges that "compensate the lender for lending," which could include nearly any payment under a loan agreement other than principal. The Court's treatment of the Premium as being no different than original issue discount missed the point that the unamortized portion of original issue discount is disallowed under section 502(b)(2) because the legislative history associated with section 502(b)(2)

[1] *In re Doctors Hosp. of Hyde Park, Inc.*, 00-BK-11520, 2014 WL 1424910 (Bankr. N.D. Ill. Apr. 10, 2014).

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The Court's decision could be read to expand significantly the concept of interest to include just about any payment (other than principal), including make-whole payments, lender fees and other liquidated damages, due under a loan agreement that compensates a lender for lending. As a result, there is a risk that such amounts could be disallowed under the US Bankruptcy Code if they do not mature until after the commencement of the bankruptcy case.

describes it as "prepaid interest." By referring to it as merely compensation, however, the Court expanded the concept of "unmatured interest" beyond that contemplated by the plain meaning or the legislative history of section 502(b). As a result, if other courts follow this Court's reasoning, claims for liquidated damages, lender fees and other amounts (other than principal) due under a loan agreement may be subject to disallowance as unmatured interest if they are not due as of the commencement of the bankruptcy case.

Finally, this case highlights the importance of lenders (and their counsel) understanding the interplay of various provisions of the applicable loan documents and the outcome of different scenarios should the borrower or guarantors fall into financial distress or bankruptcy. In this case, the Court's decision seemed to rest also in part on the fact that the Premium did not become due until long after the Guarantor filed for bankruptcy. If the loans had been accelerated and the Premium due upon the Guarantor's filing for bankruptcy, there may have been a different outcome in this case.

In analyzing the economic effect of the Premium, the Court determined that it replicated the interest that would have been due under the loan agreement and, in compensating the lender for changes in interest rates, is "part of the price of the money loaned now in terms of money to be paid back in the future." The Court concluded its analysis by stating, "[i]f original issue discount is interest, then so is a yield maintenance premium."

Background

In August, 1997, HPCH, LLC ("**HPCH**") borrowed approximately $50 million from Nomura Asset Capital Corp. (the "**Loan**"). The Loan was secured primarily by a mortgage on real estate owned by HPCH. It was also guaranteed by the Guarantor. The Loan was subsequently transferred to LaSalle Bank National Association ("**LaSalle**").

The loan agreement, governed by New York law, contained a yield maintenance premium that provided that, *upon acceleration*, HPCH would pay an amount that, when added to amounts otherwise due upon acceleration, would equal the amount required to purchase U.S. treasury notes sufficient to replicate the scheduled principal and interest payments under the loan agreement until the optional prepayment date.

HPCH defaulted on the Loan and some time thereafter the Guarantor commenced its Chapter 11 case on April 17, 2000. However, the loan agreement did not provide for automatic acceleration in such circumstances. It was only when LaSalle filed a foreclosure complaint against HPCH on July 12, 2000, several months after the Guarantor commenced its Chapter 11 case, that the Loan was accelerated and the Premium became due.

The Objection

The Chapter 11 trustee in the Guarantor's bankruptcy case objected to LaSalle's claim for the Premium on the grounds that:

(i) the Premium was unenforceable as a penalty; and

(ii) the Premium constituted unmatured interest that was to be disallowed under section 502(b)(2) of the Bankruptcy Code.

The Decision

The Court dismissed LaSalle's argument that the Premium was a penalty. New York law characterizes such payments as liquidated damages rather than penalties and liquidated damages are acceptable where (i) actual damages would be difficult to estimate at the time of entering into the agreement and (ii) the damages are not disproportionate to the possible loss. The Court found that liquidated damages were appropriate in this instance and the clause was sufficiently certain that a court could determine the quantum of liquidated damages payable thereunder.

The Court then considered whether the Premium constituted unmatured interest that should be disallowed pursuant to section 502(b)(2) of the Bankruptcy Code. The Court began its analysis by considering whether the Premium constituted interest. Relying on *In re Public Service Co. of New Hampshire,*[2] the Court focused on the economic effect of the Premium rather than its form in determining whether amounts paid thereunder constitute interest for the purposes of section 502(b)(2).

In analyzing the economic effect of the Premium, the Court determined that it replicated the interest that would have been due under the loan agreement and, in compensating the lender for changes in interest rates, is "*part of the price of the money loaned now in terms of money to be paid back in the future*."[3] The Court concluded its analysis by stating, "[i]*f original issue discount is interest, then so is a yield maintenance premium*."[4] The Court, however, ignored that the Second Circuit in *Chateauguay* concluded that original issue discount constituted interest based on the legislative history of section 502(b)(2), which clearly sets forth the view of Congress that original issue discount is "prepaid interest." If original issue discount is interest under section 502(b)(2) because it is "prepaid interest," then the Premium is not similar to original issue discount and should not be treated as interest. Indeed, the Court acknowledged in the earlier part of its decision that the Premium is a liquidated damages provision that resembles more closely the make-whole premiums that have been allowed in other cases.[5] The Court, however, held that liquidated damages and interest are not mutually exclusive and therefore the determination that the Premium constituted liquidated damages did not prevent it from falling within section 502(b)(2).

The Court, however, ignored that the Second Circuit in *Chateauguay* concluded that original issue discount constituted interest based on the legislative history of section 502(b)(2) which clearly sets forth the view of Congress that original issue discount is "prepaid interest." If original issue discount is interest because it is "prepaid interest," then the Premium is not similar to original issue discount and should not be treated as interest.

2 114 B.R. 800,803 (D.N.H. 1990); *see also In re Chateauguay Corp*. 961 F.2d 378, 380 (2d Cir. 1992).

3 *In re Doctors Hosp. of Hyde Park, Inc.*, 2014 WL 1424910, at *6.

4 *Id.*

5 *See In re Trico Marine Servs., Inc.,* 450 B.R. 474, 480-81 (Bankr. D. Del. 2011); *Noonan v Fremont Fin. (In re Lappin Elec. Co.)*, 245 B.R. 326 (Bankr. E.D. Wisc. 2000); *In re Outdoor Sports Headquarters, Inc.,* 161 B.R. 414, 424 (Bankr. S.D. Ohio 1993); *In re Skyler Ridge*, 80 B.R. 500, 508 (Bankr. C.D. Cal. 1987).

The Court went on to consider cases that had previously determined that make-whole provisions did not fall within the ambit of section 502(b)(2). The Court focused on the time at which the make-whole provisions in those cases had been triggered and distinguished them on the basis that they were fully matured when the relevant bankruptcy case was commenced, thereby falling outside section 502(b)(2). However, in this instance, the Loan was not accelerated until after the commencement of the Guarantor's bankruptcy case and the Premium was therefore unmatured at the time the bankruptcy petition was filed.

Impact

The Court's decision could be read to expand significantly the concept of interest to include just about any payment (other than principal), including make-whole payments, lender fees and other liquidated damages, due under a loan agreement that compensates a lender for lending. As a result, there is a risk that such amounts could be disallowed under section 502(b)(2) of the Bankruptcy Code if they do not mature until after the commencement of the bankruptcy case. If a creditor is undersecured and therefore unable to recover such amounts under section 506(b) of the Bankruptcy Code, there is a risk that lenders will not receive the benefit they bargained for.

The interplay between the provisions of the loan documents and the timing of the Guarantor's bankruptcy was subject to scrutiny in this case. If the loans had been accelerated and the Premium due upon the Guarantor's filing for bankruptcy, there may have been a different outcome. This case highlights the importance of ensuring that loan documents provide sufficient protection should any obligor under a loan agreement fall into financial distress or bankruptcy.

This publication is intended merely to highlight issues and not to be comprehensive, nor to provide legal advice. Should you have any questions on issues reported here or on other areas of law, please contact one of your regular contacts, or contact the editors.

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