ALERTS

Third Circuit Enforces Post-Acceleration Make-Whole Premium

November 18, 2016

The U.S. Court of Appeals for the Third Circuit held on Nov. 17, 2016 that a debtor's refinancing of its first and second lien notes during its Chapter 11 case triggered the obligation to satisfy the "make-whole" payments contemplated to be more than $431 million by at least one of the indentures. *In re Energy Future Holdings Corp.*, No. 16-1351, 2016 U.S. App. LEXIS 20601, at *3, 7 (3d Cir. Nov. 17, 2016) ("*Energy Future*"). Reversing the lower courts, the Third Circuit held that the debtors had effectuated optional redemptions entitling the lenders to receive their contractual make-whole payment despite the automatic acceleration of the notes upon the bankruptcy filing. *Id.* at *13-17. This decision may have a profound impact on Energy Future Holdings' "E-side" reorganization plan because of the huge liability now imposed on the debtors.[1] The decision is also at odds with recent cases finding that so-called "make-whole premiums" are only due if the governing indenture clearly provides for them.[2]

Facts

The *Energy Future* debtors had entered into separate indentures, each governed by New York law, for their first-priority secured notes ("First Lien Notes") and second-priority secured notes ("Second Lien Notes," and collectively, the "Notes"). *Id.* at *4-5. The First Lien Indenture required the debtors to pay a redemption price of 100 percent of the outstanding principal balance plus the "Applicable Premium" (the make-whole) if the First Lien Notes were redeemed at the debtors' option before Dec. 1, 2015. *Id.* at *3. The Second Lien Indenture similarly required a make-whole payment if the debtors made an optional redemption prior to May 15, 2016

or March 1, 2017 (depending on the maturity of the notes redeemed). *Id.* at *4. Each indenture provided for automatic acceleration of the debt upon the borrower's bankruptcy filing. *Id.* at *4-5.

Seeking to take advantages of lower interest rates, the debtors disclosed in an 8-K filed with the Securities and Exchange Commission their intention to file Chapter 11 petitions and refinance their outstanding notes "without paying any make-whole amount." *Id.* at *5. Six months later, the debtors commenced their Chapter 11 cases in Delaware, and thereafter sought and obtained bankruptcy court approval to obtain post-petition financing to refinance the First Lien Notes and a portion of the Second Lien Notes without paying the make-whole premiums. *Id.* at *5-7. The indenture trustees for each of the First Lien Notes and Second Lien Notes sued, asserting an entitlement to the make-whole premiums.

Lower Courts

The bankruptcy court held that the debtors' bankruptcy filing had automatically accelerated the Notes, so that the bankruptcy filing date became the new maturity date for the Notes. *In re Energy Future Holdings Corp.*, 527 B.R. 178, 191-95 (Bankr. D. Del. 2015); *In re Energy Future Holdings Corp.*, 539 B.R. 723, 729-733 (Bankr. D. Del. 2015). Relying on recent make-whole decisions from other circuits, the court found that the post-acceleration repayment of the Notes was not an "optional redemption" and that the indentures did not include "clear and unambiguous" language requiring payment of the make-whole following acceleration. *Id.* The district court affirmed. *In re Energy Future Holdings Corp.*, No. CV 15-1011, 2016 WL 1451045 (D. Del. April 12, 2016).

Decision

Optional Redemption of Notes

The Third Circuit first posed three specific questions regarding the First Lien Notes: (1) was there a redemption; (2) was it optional; and (3) if yes to both, did it occur before Dec. 1, 2015?[3] *Energy Future,* at *13.

First, the court found that New York and federal law deem a "redemption" to include repayments of debt occurring both prior to or after maturity. *Id.* at *13-14. Thus, the refinancing of the First Lien Notes was a redemption. *Id.* at *14.

Second, the refinancing was optional because the debtors had voluntarily sought Chapter 11 protection and could have chosen to reinstate the Notes rather than paying them off. *Id.* at *14-15. The court also noted the debtors' statements in its SEC filings that outlined their intention to redeem the Notes despite being "under no obligation" to do so. *Id.* at *15. Further, the court said the debtors redeemed the Notes "over the Noteholders' objection." *Id.* at *16.

Third, the repayment of the First Lien Notes had occurred prior to Dec. 1, 2015, the trigger date in the indenture. *Id.*

The Third Circuit then rejected the debtors' argument that the acceleration provision in the indenture conflicted with its optional redemption provisions. *Id.* at *16-19. According to the court, the two sections "simply address different things." *Id.* at *16. Moreover, the holding of *In re AMR Corp.*, 730 F.3d 88 (2d Cir. 2013) was inapplicable because the indenture in that case explicitly said that upon acceleration, the make-whole would not become due. *Id.* at *17. [4]

Second Lien's Entitlement to Make-Whole

While the above reasoning also applied to the Second Lien Notes, the court reasoned that the Second Lien Indenture's make-whole provision was even more "explicit" because the acceleration clause provided that "all principal of *and premium, if any,* ... " became immediately due and payable upon the bankruptcy filing.[5] *Id.* at *19-20. Relying on the *Momentive* decisions out of the Southern District of New York, [6] the debtors argued that the reference to "premium, if any," was not "specific enough" to require payment of the make-whole upon acceleration, but the Third Circuit said there was no reason to "demand such exactness."[7] *Id.* at *20.

The burden was on the debtors, not the noteholders, to make the indenture language clearer, noted the court. *Id.* at *29. If the debtors wanted their "duty to pay the make-whole on optional redemption to terminate on acceleration of its debt," they should have made it clear that the acceleration language primed the optional redemption provisions. *Id.*

"Redemption" versus "Prepayment"

The Third Circuit also rejected the debtors' argument that "courts must close their eyes to make-whole provisions once a debt's maturity has accelerated." *Id.* at *21. Instead, it relied heavily on *NML Capital v. Republic*

of Argentina, in which the New York Court of Appeals held that the borrower had to continue to make interest payments on its debt after acceleration and maturity. 952 N.E.2d 482, 492 (N.Y. 2011) ("*NML Capital*"). As the *NML* court explained, while "acceleration advances the maturity debt of the debt … [it was] unaware of any rule of New York law declaring that other terms of the contract not necessarily impacted by acceleration … automatically cease to be enforceable after acceleration." *NML Capital*, at 492. Thus, reasoned the Third Circuit, the "optional redemption" provision applied "no less following acceleration of the Notes' maturity than it would to a pre-acceleration redemption." *Energy Future,* at *23-24.

The Third Circuit differentiated between a "prepayment," which "could not take effect after the debt's maturity" and a "redemption," which "would be unaffected by acceleration of a debt's maturity." *Id.* at *25. Thus, "if parties want a 'prepayment' premium to survive acceleration and maturity, they must clearly state it." *Id.* at *27. Because nothing in the acceleration language of the indentures "negate[d] the premium … [b]y avoiding the word 'prepayment' and using the term 'redemption' … the make-whole would apply without regard to the Notes' maturity." *Id.*

The Third Circuit rejected the debtors' further argument that the make-whole was "in substance a prepayment premium," instead giving effect to the "'words and phrases' the parties chose." *Id.* The court also distinguished the *Northwestern* case[8] relied on by the debtors, for in that case, the lender had foreclosed on his collateral and sought a prepayment premium. In *Energy Future*, though, the Noteholders had not sought immediate payment. *Energy Future*, at *28.

Criticism of Momentive

The Third Circuit also criticized the *Momentive* decisions, finding them to be unpersuasive. *Id.* at *21. The indentures in the *Momentive* case had also required payment of a make-whole upon the occurrence of an optional redemption (not a prepayment) before a particular date. *Id.* at *26. The *Momentive* courts held that the words "premium, if any," were not specific enough to require payment of a make-whole. *Id.* at *20. The Third Circuit disagreed, finding that "the result in *Momentive* conflicts with that indenture's text and fails to honor the parties' bargain." *Id.* at *21. The *Momentive* decision is currently on appeal in the Second Circuit. *In re MPM Silicones, L.L.C.*, No. 15-1682.

Takeaways

The Third Circuit gave a clear warning to borrowers who think Chapter 11 will help them avoid their obligations to pay make-whole premiums. As the court noted, a different outcome may result if the make-whole is characterized as a "prepayment" (as opposed to a "redemption"). Further, given lower court decisions like *Momentive*, drafting a clear right to a post-acceleration make-whole is still a lender's best bet.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] Energy Future Holdings' "E-Side" plan of reorganization, whose confirmation hearing is scheduled to begin Dec. 1, 2016, requires the make-whole obligations be disallowed prior to the effective date. See No. 14-10979 (Bankr. D. Del.) [DKt. No. 9612].

[2] See, e.g., *In re MPM Silicones, LLC*, No. 14-22503, 2014 WL 4436335, at *13 (Bankr. S.D.N.Y. Sept. 9, 2014), *aff'd*, 531 B.R. 321 (S.D.N.Y. 2015); *In re Calpine Corp.*, 2010 WL 3835200, at *4 (S.D.N.Y. Sept. 15, 2010) (breach of no-call provision was unenforceable after bankruptcy filing accelerated debt and plain language of debt instruments did not provide for payment of premiums after acceleration).

[3] Like the lower courts, the Third Circuit presumed the debtors were solvent and did not "consider whether insolvency might have affected [the Debtors'] obligations." *Id.* at *8-9.

[4] The indenture trustees had also sought stay relief to rescind the acceleration of the debt, which the bankruptcy court denied. *Id.* at *6, 8,9. Because it had already held that the noteholders were entitled to the make-whole, the Third Circuit did not address rescission. *Id.* at *30.

[5] In contrast, the First Lien Indenture provided that, upon the bankruptcy filing, "all outstanding Notes" would automatically become due and payable. *Id.* at *4.

[6] In *Momentive*, the court denied payment of a make-whole premium upon a voluntary note redemption after the notes were automatically accelerated by virtue of the borrower's bankruptcy filing. *In re MPM Silicones, LLC*, No. 14-22503, 2014 WL 4436335, at *13 (Bankr. S.D.N.Y.

Sept. 9, 2014), *aff'd*, 531 B.R. 321 (S.D.N.Y. 2015). Absent clear and unambiguous language to the contrary, the acceleration had advanced the maturity date so that the debt repayment was not an elective redemption. *Id.* The decision is currently on appeal in the Second Circuit.

[7] EFIH had argued the make-whole would only be payable post-acceleration if more specific language had been used such as "a premium owed under section 3.07" or a specific reference to the "Applicable Premium" and "Optional Redemption." *Id.* at *20.

[8] *Nw. Mut. Life Ins. Co. v. Uniondale Realty Assocs.*, 816 N.Y.S.2d 831, 836 (N.Y. Sup. Ct. 2006) ("*Northwestern*").

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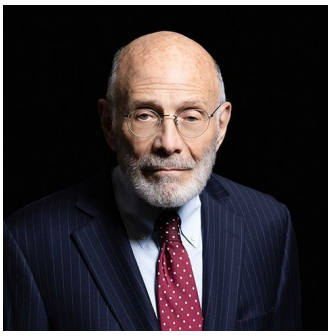

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