Third Circuit Finds Noteholders Have Right to Payment of Make-Whole Premium After Bankruptcy Acceleration

November 28, 2016

Decision Is Inconsistent With Some Prior Holdings and Injects Uncertainty

On November 17, the U.S. Court of Appeals for the Third Circuit, based in Philadelphia, held that noteholders were entitled to payment of an optional redemption premium at the make-whole price as a result of the repayment of their notes in a bankruptcy proceeding.[1] When a make-whole is triggered in connection with a redemption, in addition to paying principal and accrued and unpaid interest, the issuer is required to pay an additional amount based on the discounted value of the stream of future interest payments, thereby making noteholders whole for the loss of the future income stream bargained for when the notes were purchased. A number of other courts had previously held that make-wholes were only payable in connection with an optional redemption and that a repayment following an acceleration in bankruptcy would not be optional and therefore not lead to the payment of a redemption premium absent explicit language to that effect. Together with the recent *Cash America* decision by the U.S. District Court for the Southern District of New York,[2] which required payment of a make-whole premium as damages after a default by the issuer, this case introduces significant uncertainty into what issuers must pay upon default or acceleration in bankruptcy, and should encourage issuers and underwriters to address the uncertainty through explicit indenture language.

Background

Between 2010 and 2012, Energy Future Intermediate Holding Company LLC (EFIH) and a subsidiary issued first lien secured notes due 2020 and two series of second lien secured notes due 2021 and 2022. The indentures contained customary optional redemption provisions and customary provisions for automatic acceleration of the maturity of the notes upon a bankruptcy filing. The optional redemption provisions provided for the payment of a make-whole premium for any redemption of the first lien notes before December 2015, and for the second lien notes, before May 2016 and March 2017. After commencing chapter 11 proceedings (in part in an effort to refinance its debt without paying the make-wholes), EFIH sought to repay the first lien notes with the proceeds of debtor-in-possession financing at a lower interest rate, and also later refinanced a portion of its second lien notes. The trustees for both the first lien and second lien notes opposed the refinancing and sought payment of the make-wholes, as well as permission from the bankruptcy court to rescind the automatic acceleration of the notes upon the bankruptcy filing. The Bankruptcy Court approved both refinancings and denied the requests for permission to rescind the automatic acceleration, but also held that the refinancings would not prejudice the noteholders' rights in their separate adversary proceedings seeking payment of the make-wholes. Following the refinancings, the Bankruptcy Court held in both separate adversary proceedings that no make-whole premium was owed. The U.S. District Court for the District of Delaware subsequently upheld both decisions. The trustees appealed to the Third Circuit, which reversed.

The Third Circuit's Analysis

The Third Circuit first considered three questions related to the optional redemption language in the indentures: (1) was there a redemption?; (2) was it optional?; and (3) if yes to both, did it occur while the make-whole premium was payable? The court answered all three queries in the affirmative. The Third Circuit then examined the acceleration provisions of the indentures and considered case law interpreting the interplay of acceleration provisions with optional redemption provisions. It concluded based on its review of legal precedent and the indentures that EFIH was wrong to assert that an automatic

acceleration provision controls over an optional redemption provision with respect to a noteholder's right to payment of a make-whole premium upon a repayment post-acceleration. According to the Third Circuit, an optional redemption could occur post-acceleration, because the terms of the EFIH indentures did not expressly limit optional redemptions to those occurring pre-acceleration.

Optional Redemption Is Not Limited to Pre-Maturity Payment

First considering the meaning of "redemption," which was not defined in the indentures, the appellate panel concluded that redemptions occurred even though EFIH refinanced the notes after the automatic bankruptcy acceleration. This reversed the conclusion of the lower courts that no redemptions had occurred, because acceleration brought forward the maturity date and a "redemption" by definition was a repayment *prior* to maturity. The Third Circuit instead found that New York and federal courts deemed redemption to include both pre- and post-maturity repayments of debt.

The Third Circuit then analyzed the circumstances under which the notes were repaid by EFIH, to determine whether these actions were "optional." The appellate panel concluded that despite the automatic nature of acceleration under the indentures, EFIH's note repayments were voluntary, particularly because the noteholders had sought to rescind the acceleration and did not want to be repaid. The opinion noted in support of its finding that EFIH filed its chapter 11 petition of its own volition. For the third and final part of the optional redemption analysis, the Third Circuit observed that the refinancings occurred during the time that the make-whole premiums were payable under the indentures.

Automatic Acceleration Does Not Cut Off Optional Redemption

The Third Circuit disagreed with the lower courts that the operation of the automatic acceleration provisions under the indentures mooted applicability of the optional redemption provisions. In its ruling, the Third Circuit declined to follow the 2014 *Momentive* decision by the Bankruptcy Court for the Southern District of New York[3] and other similar cases that treated make-wholes as applicable only to a *pre*payment, and thus required a clear and express statement for a make-whole premium to be required in connection with a repayment after an automatic acceleration.

In a reversal of the drafting guidance arising out of *Momentive*, the Third Circuit placed the onus on the issuer to make it clear in the indenture that an optional redemption provision was *not* applicable following acceleration. "[I]f EFIH wanted its duty to pay the make-whole on optional redemption to terminate on acceleration of its debt, it needed to make clear" in the indenture that acceleration cuts off the optional redemption provision.

Cash America

In Re Energy Future Holdings Corp. is the second recent decision that has required payment of a make-whole premium in the context of a default. In *Wilmington Savings Fund Society, FSB* v. *Cash America International, Inc.*, decided in September 2016, the U.S. District Court for the Southern District of New York held that noteholders were entitled to payment of the make-whole premium as a remedy for a breach under the indenture. The trustee alleged that a spin-off by Cash America of 80% of the shares of a wholly-owned subsidiary breached a covenant in the indenture and sought to enforce a prepayment of the notes (with payment of the make-whole premium) under the indenture, rather than accelerate the maturity date and allowing repayment of the notes at par value, and ultimately prevailed. *Cash America* is significant because the court found that noteholders could seek specific performance of the make-whole premium as a remedy for a "voluntary" non-bankruptcy default even though no choice to redeem the notes was made by the issuer.

Takeaways

The Third Circuit's interpretation of New York law is not controlling in other circuits, and the U.S. Court of Appeals for the Second Circuit, based in New York City, is currently considering similar questions in an appeal of the *Momentive* make-whole decision. The Third Circuit's decision gives credence to an

interpretation of optional redemption under New York law-governed indentures that is welcome to the distressed investor community, but likely does not reflect the commercial understanding in the new issue market. In that regard, we note that since the decision in the *Momentive* case calling for specific language reflecting intent to enforce a make-whole payment post-bankruptcy, we are aware of only a small number of public company indentures for new bond offerings that specifically require a make-whole payment in these circumstances.

Following the *Cash America* decision and the Third Circuit's decision in *In Re Energy Future Holdings Corp.*, we would expect to see healthy issuers seeking to include language in their indentures that forecloses any obligation to pay a make-whole premium following a default or an acceleration in bankruptcy. (We have in fact already seen issuers successfully include such language in their indentures.) In the provision of financing to distressed borrowers, however, we have seen, and expect to continue to see, lenders seek to explicitly provide that the make-whole premium will be due following an acceleration due to bankruptcy or other default during the make-whole period.

---

[1] *In Re Energy Future Holdings Corp.*, No. 16-1351 (3d. Cir. Nov. 17, 2016).

[2] 2016 WL 5092594 (S.D.N.Y. Sept. 19, 2016).

[3] *In Re MPM Silicones, LLC*, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014), *aff'd* 531 B.R. 321 (S.D.N.Y. May 4, 2015).

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Joseph A. Hall	**212 450 4565**	**joseph.hall@davispolk.com**
Sophia Hudson	**212 450 4762**	**sophia.hudson@davispolk.com**
Marshall S. Huebner	**212 450 4099**	**marshall.huebner@davispolk.com**
Michael Kaplan	**212 450 4111**	**michael.kaplan@davispolk.com**
Brian M. Resnick	**212 450 4213**	**brian.resnick@davispolk.com**
Richard D. Truesdell, Jr.	**212 450 4674**	**richard.truesdell@davispolk.com**
Eli J. Vonnegut	**212 450 4331**	**eli.vonnegut@davispolk.com**
Nicole Green	**212 450 3042**	**nicole.green@davispolk.com**
Bradley A. Schecter	**212 450 3143**	**bradley.schecter@davispolk.com**

© 2016 Davis Polk & Wardwell LLP | 450 Lexington Avenue | New York, NY 10017

This communication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. This may be considered attorney advertising in some jurisdictions. Please refer to the firm's **privacy policy** for further details.