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December 9, 2016

# Third Circuit Court of Appeals Does Not Follow *Momentive* and Enforces Make-Whole Payments Resulting from Redemption of Notes

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On November 17, 2016, the Third Circuit Court of Appeals issued an opinion holding that claims for "make-whole" amounts were valid and enforceable as "redemption premiums" under New York law despite the automatic acceleration of the underlying debt upon the issuer filing for chapter 11 bankruptcy protection. See In re Energy Future Holdings Corp., No. 16-1351 (3d Cir. Nov. 17, 2016) (the "EFH Decision"). The EFH Decision directly clashes with a decision of the bankruptcy court for the Southern District of New York (the "NY Bankruptcy Court") (and the order of the District Court for the Southern District of New York affirming such decision) in the same context which held that "make-whole"[1] amounts, whether pre-payment or redemption premiums, were unenforceable under New York law. See In re MPM Silicones, LLC, 2014 WL 4436335, No. 14-22503 (Bank. S.D.N.Y. Sept. 9, 2014) ("Momentive"), aff'd, 531 B.R. 321 (S.D.N.Y. 2015) ("Momentive District Court Opinion"). The EFH Decision is significant to anyone considering a restructuring of its funded debt and may portend how the Third Circuit may rule on other issues such as "cram-down" interest rates and enforceability of subordination provisions, which were also part of Momentive. The Momentive District Court Opinion is on appeal to the Second Circuit Court of Appeals and it remains to be seen whether the EFH Decision will have an impact on its disposition.[2]

## Background

In 2010, Energy Future Intermediate Holding Company LLC and EFIH Finance Inc. (collectively, the "Borrowers" or the "Debtors") issued notes, due 2020, secured by a first lien on all of their assets (the "1st Lien Notes"). In 2011 and 2012, the Borrowers issued two additional series of notes, due 2021 and 2022, secured by a second lien on all of their assets (the "2nd Lien Notes" and together with the 1st Lien Notes, the "Notes"). The indentures governing the Notes had identical language providing for their redemption at the Borrowers' option prior to specific dates at 100 percent of the principal amount of the notes to be redeemed plus an "Applicable Premium."[3] See EFH Decision at 7. As noted by the Third Circuit, the Applicable Premium contains the quantum of the "make-whole" amount. Id.

The Notes contained different language for the acceleration of the Notes. The acceleration provision of the indenture governing the 1st Lien Notes made "*all outstanding Notes . . . due and payable immediately*" if the Borrowers filed for bankruptcy. The acceleration provisions of the indentures governing the 2nd Lien Notes

[1] As articulated by the Third Circuit, a "make-whole" is a "contractual substitute for interest lost on Notes redeemed before their expected due date." EFH Decision at 7.

[2] As of the writing of this article, the Debtors are reportedly evaluating their appeal rights, and are also evaluating whether to commence a solvency phase of the trial. The Third Circuit noted that the parties had not challenged the Debtors' solvency, however a ruling that the Debtors are insolvent might impact the entitlement of the noteholders to make-whole payments.

[3] In the case of the 1st Lien Notes the optional redemption deadline was December 1, 2015. In the case of the 2nd Lien Notes due 2021, the optional redemption deadline was May 15, 2016. In the case of the 2nd Lien Notes due 2022, the optional redemption deadline was March 1, 2017.

provided that upon the Borrowers' bankruptcy filing, "*all principal of and premium, if any, interest . . . [,] and any other monetary obligations on the outstanding [2nd Lien Notes] shall be due and payable immediately*." Id.

On April 29, 2014 (the "Commencement Date"), the Borrowers filed for chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the District of Delaware (the "Delaware Bankruptcy Court"). As set forth in the EFH Decision, the Borrowers filed for bankruptcy for the purpose of redeeming their high interest bonds and replacing them with lower interest bonds, while avoiding payment of the make whole premiums contemplated in the indentures. After the Commencement Date, the Debtors sought to refinance the 1st Lien Notes by borrowing new money to "pay them off and offer a settlement to [the holders of 1st Lien Notes] who agreed to waive their right to the make-whole." Id.

The trustee of the 1st Lien Notes filed an adversary proceeding seeking a declaration that the Debtors' refinancing of the 1st Lien Notes entitled its holders to payment of the make-whole. On June 19, 2014, the Delaware Bankruptcy Court authorized the Debtors to refinance the 1st Lien Notes without paying $431 million of the contractual make-whole claim or ruling on the trustee's adversary proceeding.

At about the same time, the trustees for the 2nd Lien Notes commenced their own adversary proceeding seeking a declaration that a make-whole would be payable if the Debtors refinanced their debt. On March 10, 2015, the Delaware Bankruptcy Court authorized the Debtors to refinance a portion of the 2nd Lien Notes without paying the make-whole.[4]

Subsequently, the Delaware Bankruptcy Court ruled that the Debtors did not have to pay a make-whole to the holders of the Notes when their debt was refinanced. Adopting the reasoning applied in Momentive, the Delaware Bankruptcy Court ruled that the holders of the Notes were not entitled to payment of a make-whole because the acceleration clauses in the indentures did not specifically provide for it. In Momentive, the court explained that parties to a New York law governed note can amend the "perfect tender" rule

> *to provide for a specific right on behalf of the borrower to prepay the debt in return for agreed consideration that compensates the lender for the cessation of the stream of interest payments running to the original maturity date of the loan. Without that contractual option, under the New York rule of perfect tender the borrower/issuer would be precluded from paying the debt early. . . . It is also well-settled law in New York that a lender forfeits the right to such consideration for early payment if the lender accelerates the balance of the loan. The rationale for this rule is logical and clear: by accelerating the debt, the lender advances the maturity of the loan and any subsequent payment by definition cannot be a prepayment. In other words, rather than being compensated under the contract for the frustration of its desire to be paid interest over the life of the loan, the lender has, by accelerating, instead chosen to be paid early. . . . The [relevant exception to that rule], is when a clear and unambiguous clause calls for the payment of a*

[4] The trustees for the 1st Lien Notes and the 2nd Lien Notes also argued, among other things, that the Bankruptcy Court should have lifted the automatic stay to permit rescission of the notes' acceleration provisions. In light of its ruling that the noteholders were entitled to the make-whole, the Third Circuit did not rule on these additional arguments.

> *prepayment premium or make-whole even in the event of acceleration of, or the establishment of a new maturity date for, the debt.*

Momentive at 33-5 (citations omitted). Thus, according to the NY Bankruptcy Court, the right of the holders of the notes to payment of a make-whole hinged on whether the indentures and notes provided with sufficient clarity for its payment after the maturity of the notes had been accelerated. Id. at 36.

**Analysis**

The Third Circuit succinctly stated its holding:

> *Our "primary objective . . . is to give effect to the intent of the parties as revealed by the language of their agreement." The language of the First Lien Indenture requires EFIH to pay a make-whole if it redeems the First Lien Notes at its option before December 1, 2015, and the Second Lien Indenture requires the same for redemptions of Second Lien Notes before May 15, 2016 or March 1, 2017 (depending on the initial maturity date of the particular debt instruments). EFIH redeemed the First Lien Notes at its option on June 19, 2014 and redeemed a portion of the Second Lien Notes on March 10, 2015. Redemptions, not prepayments, occurred here, they were at the election of EFIH, and they occurred before the respective dates noted. Statements of New York law by its highest Court and the federal Circuit Court in New York reinforce our conclusion that EFIH must pay the make-whole per the Indenture language before us.*

EFH Decision at 27 (citations omitted). The Third Circuit took a different approach than the NY Bankruptcy Court in its analysis of make-wholes and acceleration provisions. Specifically, the Third Circuit concluded that (a) acceleration provisions do not negate "make-whole" claims stemming from redemptions and (b) redemptions and pre-payments are different and which tool the issuer chooses to use will determine whether a make-whole is payable. Indeed, the Third Circuit criticized the NY Bankruptcy Court for not honoring the parties bargain. EFH Decision at 20.

1. Acceleration of the Notes Does Not Negate Make-Whole Claims for Redemptions

The Third Circuit first focused on the provisions of the indenture that entitled the holders of the 1st Lien Notes to payment of a make-whole in the event of an optional redemption by the Debtors. The Third Circuit rejected the Debtors' argument that (a) redemption can only occur prior to maturity and (b) acceleration of the debt upon the bankruptcy filing makes payment of a make-whole a legal impossibility. Instead, the Third Circuit relied upon New York state and federal cases finding that redemptions can occur either pre or post maturity. See EFH Decision at 14-15 (citations omitted).[5]

The key to the Third Circuit's decision was its analysis of the interplay of the indentures' acceleration provision on the make-whole (or "premium") contained in the optional redemption provision. As a starting point, the Third

[5] The Third Circuit similarly concluded that the redemption was at the option of the Debtors and occurred prior to the December 1, 2015 optional redemption deadline. See EFH Decision at 16.

Circuit analyzed whether the acceleration provision of the 1st Lien Notes, which did not reference a premium at all, foreclosed payment of the make-whole. The Third Circuit stated:

> *In our case, [the acceleration provision] makes no mention of the make-whole. [The Debtors] argued that this silence saps [the optional redemption provision's] effect. On a general note, that reading would cross cords with our duty to "give full meaning and effect to all of [the Indenture's] provisions." "Contracts are . . . to be interpreted to avoid inconsistencies and to give meaning to all [their] terms." More specifically, [the Debtors'] interpretation conflicts with the New York Court of Appeals' statement that "[w]hile it is understood that acceleration advances the maturity date of the debt," there is no "rule of New York law declaring that other terms of the contract not necessarily impacted by acceleration . . . automatically cease to be enforceable after acceleration." Accordingly, [the optional redemption provision] stands on its own, unswayed by the Indenture's other provisions.*

EFH Decision at 18 (citations omitted).

The Third Circuit separately analyzed the acceleration provision of the 2nd Lien Notes which, unlike the 1st Lien Notes, created a link between acceleration and the optional redemption, but concluded that the result was the same. Id. at 19 ("*all principal of and premium, if any, interest . . . [,] and any other monetary obligations on the outstanding [2nd Lien Notes] shall be due and payable immediately*."). The Third Circuit found that the reference in the acceleration provision of the 2nd Lien Notes to "*premium, if any*" could only mean the make-whole (*i.e.* section 3.07 "Applicable Premium" of the indentures governing the 2nd Lien Notes). Moreover, rejecting the specificity requirement of the NY Bankruptcy Court, the Third Circuit found it unnecessary for the drafters to have written "Applicable Premium" in order for the note holders to be entitled to payment of the make-whole, especially where, as in this case, the indentures make no reference to any other type of premium. Id. at 20. Relying upon the New York Court of Appeals decision in *NML Capital v. Republic of Argentina*, 952 N.E.2d 482 (N.Y. 2011), the Third Circuit specifically rejected the Debtors' argument that it is legally impossible to pay a make-whole after the debt has been accelerated. See EFH Decision at 21 ("the New York Court of Appeals held that 'in New York the consequences of acceleration of the debt depend on the language chosen by the parties in the pertinent loan agreement.' 'Had Argentina . . . intended that its responsibility to pay interest twice a year cease upon maturity, it could easily have clarified that intent in any number of ways.'")(citations omitted).

2. Pre-Payments and Redemptions are Not the Same Thing

The Third Circuit drew a technical distinction between make-wholes payable upon a "pre-payment" versus a "redemption." Id. at 25 (stating that court must give effect to the words and phrases the parties chose in the indentures). The Third Circuit acknowledged that it may not be possible for a make-whole to be due upon a "pre-payment" after acceleration. Id. at 24. But, a make-whole may be due for a "redemption" occurring before or after maturity (*i.e* acceleration). "By avoiding the word 'prepayment' and using the term 'redemption,' [the parties] decided that the make-whole would apply without regard to the Notes' maturity." Id.

The Court criticized both the NY Bankruptcy Court and the Delaware Bankruptcy Court for combining the concepts of "pre-payments" and "redemptions" in their respective analyses.

> *The [NY Bankruptcy Court], however, disallowed the lenders' claim for a make-whole, declaring it "well-settled law in New York" that a make-whole, like a prepayment premium, will only be due on a default and acceleration "when a clear and unambiguous clause calls" for it. The Delaware Bankruptcy Court followed the same line, declining to enforce the make-whole provision because "an indenture must contain express language requiring payment of a prepayment premium upon acceleration; otherwise, it is not owed."*
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> *By denying the make-whole after the Notes' acceleration, the [Delaware] Bankruptcy Court pushed [non-persuasive New York trial court authority] beyond its language and underlying policy concerns.*

EFH Decision at 25 (emphasis added) (citing *Northwestern Mut. Life Ins. Co. v. Uniondale Realty Assocs.,* 816 N.Y.S.2d 831, 834(N.Y. Sup. Ct. 2006)).

**The Impact of the EFH Decision**

The fight over allowance of make-whole claims is about value shifting. When make-whole claims are allowed, the holders of such claim are entitled to receive more value from the debtor (whether its new notes, equity or cash) on account of such claim. When make-whole claims are disallowed, that value shifts to claims junior in priority. The EFH Decision will play an important role in determining those outcomes.

First, there can be no doubt that any borrower who has funded debt with significant make-whole claims will carefully analyze not only the terms of its notes and indentures, but also its venue options prior to filing for chapter 11 in order to ascertain which jurisdiction will give it the best chance of eliminating any claim for a premium in the event the funded debt is restructured. Whether a bankruptcy strategy needs to be implemented will depend on whether the borrower and its lenders have an agreement for the consensual restructuring of the debt obligations. But, if there is no agreement, the borrower may try to avail itself of venue in the Southern District of New York to try to take advantage of the favorable decision of Momentive. If Delaware is the only plausible option for the borrower, to the extent possible under the documents, the issuer may try to avoid re-financing its debt through a "redemption" and seek to refinance its debt using a "pre-payment" or some other mechanism that will not trigger payment of the make-whole under the EFH Decision. Conversely, in consensual restructurings, lenders may insist that their borrowers file for chapter 11 in Delaware to take advantage of the EFH Decision and avoid Momentive.

Second, the EFH Decision may be a preview into how the Third Circuit may rule if faced with similar issues found in some of the other sub-decisions in Momentive. In addition to its "make-whole" ruling, the NY Bankruptcy Court (a) adopted the "formula approach" advocated in *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004) (i.e. Treasury Note rate plus a small risk premium) to calculate the cram-down interest rate under 11 U.S.C. § 1129(b)(2)(A)(i); and (b) declined to enforce certain subordination provisions

contained in the indentures because, much like its rationale for refusing to enforce make-whole claims, the subordination provisions lacked specificity. The NY Bankruptcy Court's cramdown interest rate analysis was premised on reinstating debt but removing all of the lender's profit. And its disallowance of the subordination provision paralleled its reasoning for make-wholes that any subordination must be stated with specificity. The Third Circuit's reasoning to allow the make-wholes was clearly intended to give the parties (and in particular the lenders) the benefit of their bargain. If that reasoning were to be applied consistently, it seems unlikely that the Third Circuit would adopt a cram-down interest rate that eliminates the lender's profit. Additionally, having just ruled that there was no need for "exactness" or a requirement that the words "Applicable Premium" appear in an acceleration provision, it seems unlikely that the Third Circuit will require "magic language" to enforce subordination provisions.

Finally, the Second Circuit Court of Appeals has yet to decide the appeal of the Momentive District Court Decision. The EFH Decision will surely be read by the Second Circuit and may impact whether it affirms or reverses the Momentive District Court Decision.

For more information please contact one of the lawyers listed below.


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