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Memorandum

Third Circuit Holds That Noteholders in a Bankruptcy Are Entitled to a Make-Whole Premium, Rejecting Approach of the Southern District of New York in *Momentive*

December 5, 2016

Introduction

On November 17, 2016, the Third Circuit Court of Appeals (the "**Court**") held that a refinancing during the pendency of the issuer's bankruptcy proceeding of notes issued prior to the bankruptcy filing constituted an optional redemption that triggered an obligation to pay make-whole premiums under the relevant indentures.[1] This holding reversed the decision of the District Court for the District of Delaware (the "**District Court**"),[2] which had affirmed the decision of the Bankruptcy Court for the District of Delaware (the "**Bankruptcy Court**").[3] The Bankruptcy Court had held that (i) the issuer was not required to pay the make-whole premiums because the notes had been automatically accelerated upon the issuer's bankruptcy filing (and hence, there was no optional redemption or prepayment) and (ii) the noteholders were prevented from rescinding such automatic acceleration due to the automatic stay. The Court's decision not only overturned the decisions of the District Court and the Bankruptcy Court, but it also criticized the decision and reasoning of the Bankruptcy Court in the Southern District of New York in the *Momentive* case which is now pending appeal in the Second Circuit Court of Appeals.[4]

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[1] *Delaware Trust Co. v. Energy Future Intermediate Holding Company LLC (In re Energy Future Holding Corp.)*, Case No. 16-1351 (3rd Cir. Nov. 17, 2016) ("***EFIH***").

[2] *In re Energy Future Holdings Corp.*, No. CV 15-620 RGA, 2016 EL 627343 (D. Del. Feb. 16, 2016) and *In re: Energy Future Holdings Corp.*, No. CV 15-1011-RGA, 2016 WL 1451045 (D. Del. Apr. 12, 2016).

[3] *In re Energy Future Holdings Corp.*, 527 B.R. 178 (Bankr. D. Del. 2015) and *In re Energy Future Holdings Corp*, 539 B.R. 723 (Bankr. D. Del. 2015).

[4] *In re MPM Silicones, LLC*, No. 14-22503-RDD, 2014 WL 4436335, at *13 (Bankr. S.D.N.Y. Sept. 9, 2014), *aff'd*, 531 B.R. 321 (S.D.N.Y. 2015) ("***Momentive***").

Background

Energy Future Intermediate Holding Company LLC and EFIH Finance Inc. (collectively, "**EFIH**") issued approximately $4 billion of first lien 10% notes due 2020 (the "**First Lien Notes**") in 2010 and approximately $2.15 billion of second lien 11% notes due 2021 and 11.75% notes due 2022 (the "**Second Lien Notes**" and together with the First Lien Notes, the "**Notes**") in 2011 and 2012, respectively. The indenture for the First Lien Notes (the "**First Lien Indenture**") and the indenture for the Second Lien Notes (the "**Second Lien Indenture**" and together with the First Lien Indenture, the "**Indentures**") each contained "optional redemption" and "automatic acceleration" provisions, and each Indenture was governed by New York law.

Optional Redemption Provision

The First Lien Indenture optional redemption provision stated that:

> [a]t any time prior to December 1, 2015, [EFIH] may redeem all or a part of the Notes at a redemption price equal to 100% of the principal amount of the Notes redeemed plus the Applicable Premium [the make-whole amount] . . . and accrued and unpaid interest.

The Second Lien Indenture optional redemption provision contained substantially similar language.

Automatic Acceleration Provisions

The First Lien Indenture automatic acceleration provision (i) stated that "all outstanding Notes [are] . . . due and payable immediately" if EFIH files a bankruptcy petition, and (ii) gave the First Lien noteholders (the "**First Lien Noteholders**") the right to "rescind any acceleration [of] the Notes and its consequences." However, the automatic acceleration provision in the First Lien Indenture did not reference any premium, including a make-whole premium, being due in the event of an acceleration upon bankruptcy.

The automatic acceleration provision in the Second Lien Indenture differed from the provision in the First Lien Indenture and provided that if EFIH files a bankruptcy petition, "all principal of and *premium, if any*, interest . . . [,] and any other monetary obligations on the outstanding Notes shall be due and payable immediately." (emphasis added). The Second Lien noteholders (the "**Second Lien Noteholders**" and together with the First Lien Noteholders, the "**Noteholders**") also had the right to "rescind any acceleration [of] the Notes and its consequences."

Pre- and Post-Bankruptcy Actions

Six months prior to filing for bankruptcy, EFIH filed a Current Report on Form 8-K with the Securities and Exchange Commission announcing a restructuring proposal through which "EFIH would file for bankruptcy and refinance the [First Lien Notes] without paying any make-whole amount." After filing for bankruptcy on April 29, 2014, EFIH filed a motion with the Bankruptcy Court to enter into a new debtor-in-possession

financing to pay off the First Lien Notes without paying the make-whole premium. The First Lien Noteholders filed an adversary proceeding in which they sought a declaration that the refinancing would trigger the make-whole premium and a motion for relief from the automatic stay to allow them to rescind the automatic acceleration of the First Lien Notes. The Bankruptcy Court approved the refinancing and ruled that its approval of the refinancing would not prejudice the rights of the First Lien Noteholders to litigate whether the make-whole premium was due.

On February 12, 2015, EFIH filed a motion requesting approval to use a substantial portion of its remaining debtor-in-possession financing to make a partial repayment the Second Lien Notes. The Second Lien Noteholders sought a declaration by the Bankruptcy Court that EFIH's partial repayment of the Second Lien Notes would trigger the make-whole premium and relief from the automatic stay to allow them to rescind the automatic acceleration of the Second Lien Notes. The Bankruptcy Court once again approved the pay down and held that the partial repayment would not prejudice the rights of the Second Lien Noteholders to litigate whether the make-whole premium was due.

Relying on *Momentive* and similar cases, the Bankruptcy Court held that EFIH was not obligated to pay the make-whole premium to the Noteholders. The Bankruptcy Court reasoned that the redemption of the Notes was not optional because the Notes had been automatically accelerated as a result of EFIH's bankruptcy filing, and were due and payable. Thus, no make-whole premium was owed.[5] In reviewing the request to lift the automatic stay, the Bankruptcy Court determined that there were genuine disputes of material fact as to whether "cause" existed to lift the stay. Even if EFIH was solvent—which was assumed by the Bankruptcy Court, the District Court and the Court— that was insufficient to demonstrate that cause existed to lift the stay and permit the rescission of the automatic acceleration of the Notes. After the District Court affirmed the decisions of the Bankruptcy Court, the trustees for the Noteholders appealed and consolidated their cases.

Analysis

The *EFIH* Court framed the issue before it and its conclusion as follows:

> Does the premium, meant to give the lenders the interest yield they expect, fall away because the full principal amount is now due and the noteholders are barred from rescinding the acceleration of debt? We hold no.

The Court began its analysis of the First Lien Indenture by setting out three questions:

> i. Was there a redemption?

[5] *In re Energy Future Holdings Corp.*, 527 B.R. at 191-5 (First Lien Notes decision); *In re Energy Future Holdings Corp.*, 539 B.R. at 733 (Second Lien Notes decision).

ii. Was it optional? and

iii. If yes to both, did the optional deadline occur prior to the deadline set forth in the Indentures?

The Court began by noting that the First Lien Indenture[6] did not define the term "redemption." The Court went on to note that New York and federal courts, however, "deem 'redemption' to include both pre- and post-maturity repayments of debt."[7] The Court distinguished between a premium for a "prepayment" and a "redemption." Prepayment penalties are "the price of an option voluntarily to prepay the loan and terminate the mortgage before the maturity." If a loan is accelerated, the maturity date is advanced "so that payment thereafter is not prepayment but instead payment made after maturity, and logically the option to prepay can no longer be exercised after maturity." Redemption, on the other hand, "may occur at or before maturity." The Court found that "while it is understood that acceleration advances the maturity date 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." The Court criticized the Bankruptcy Court, the *Momentive* Bankruptcy Court[8] and other courts for having "stretched" the rules regarding prepayments to include redemptions. Accordingly, the Court held that the post-maturity refinancing and pay down of the Notes was a redemption.

Next, the Court had to determine whether the redemption was optional. The Court stated that the bankruptcy refinancing was optional because EFIH chose to refinance the First Lien Notes in accordance with "the path laid out six months before in its SEC 8-K filing." As an alternative, the Court noted that EFIH could have sought to reinstate the First Lien Notes pursuant to the Bankruptcy Code. Accordingly, the Court held that the redemption of the Notes was optional. Lastly, the Court noted that the optional redemption occurred prior to December 1, 2015, the last day the make-whole premium would have been payable. As such, the Court found that EFIH was required to pay the make-whole premium.

Next, the Court addressed the relationship between the make-whole and automatic acceleration provisions. The Court dismissed the argument that the provisions were two alternative "pathways;" rather, the Court gave effect to both provisions. The Court noted that although the First Lien Indenture's automatic acceleration clause did not specifically reference the make-whole provision, the absence of such a cross-

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[6] The Court analyzed the First Lien Indenture in detail and noted that other than the acceleration provision of then Second Lien Indenture, the Indentures were substantially similar.

[7] Citing *Chesapeake Energy Corp. v. Bank of N.Y. Mellon*, 773 F.3d 110, 116 (2d Cir. 2014) (in interpreting New York law, to "redeem" is to "repay[] . . . a debt security . . . at or before maturity" (quoting Barron's Dictionary of Finance and Investment Terms 587 (8th ed. 2010)); *Treasurer of New Jersey v. U.S. Dep't of Treasury*, 684 F.3d 382, 388 (3d Cir. 2012) (discussing regulations permitting bondholders to "present . . . long-matured savings bond[s] for redemption"); *Fed. Nat'l Mortg. Ass'n v. Miller*, 473 N.Y.S.2d 743, 744 (N.Y. Sup. Ct. 1984) ("debtor may redeem" mortgage by "pay[ing] . . . accelerated debt"); *see also* N.Y. U.C.C. § 9-623, Official Comment No. 2 ("To redeem the collateral . . . of a secured obligation [that] has been accelerated, it would be necessary to tender the entire balance.").

[8] The indenture in *Momentive*, for example, used the term "Redemption," not prepayment.

reference did not invalidate the make-whole upon an acceleration. The Court distinguished the automatic acceleration provision cited by EFIH in *AMR Corp.*[9] because that provision explicitly provided that the make-whole premium was not payable if there was an acceleration.[10] The Court stated that "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." Rather, a "premium tied to a redemption would be unaffected by acceleration of a debt's maturity." The Court determined that the fact that the First Lien Indenture automatic acceleration clause did not explicitly reference the make-whole premium did not "silence" the application of the make-whole provision.

The automatic acceleration provision of the Second Lien Indenture contained language included the make-whole provision in the automatic acceleration clause ("all principal of *and premium, if any*" was due and payable upon acceleration (emphasis added)). The Court found that the "premium, if any" language in the automatic acceleration clause of the Second Lien Indenture unambiguously included the make-whole premium because that "most naturally read to reference" the make-whole premium.

The Court noted that the indenture in *Momentive* contained language ("premium, if any") similar to the Second Lien Indenture. In *Momentive,* the Bankruptcy Court for the Southern District of New York held that such language was not specific enough to require the payment of a make-whole premium. The Court disagreed with and rejected the *Momentive* decision because the holding "conflict[ed] with that indenture's text and fail[ed] to honor the parties' bargain."

The Court did not reference the recent decision of the District Court for the Southern District of New York, *Wilmington Savings Fund Society, FSB v. Cash America Int'l, Inc.*[11] In that case, the court determined that a spin-off by the issuer of a significant subsidiary violated the "merger covenant" and accordingly resulted in an event of default under the indenture governing the notes. The court held that the indenture permitted the trustee to require payment of a make-whole premium by the issuer as a remedy for a voluntary breach by the issuer without requiring the trustee to accelerate the notes.

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9 *In re AMR Corp.*, 730 F.3d 88 (2d Cir. 2013).

10 The indenture at issue in *AMR Corp.* provided:
[I]f an Event of Default referred to in . . . Section 4.01(g) [i.e., the voluntary filing of a bankruptcy petition] . . . shall have occurred and be continuing, then and in every such case the unpaid principal amount of the Equipment Notes then outstanding, together with accrued but unpaid interest thereon and all other amounts due thereunder *(but for the avoidance of doubt, without Make–Whole Amount)*, shall immediately and without further act become due and payable . . . .
(emphasis added).

11 Case No. 15-CV-5027 (JMF), 2016 WL 5092594 (S.D.N.Y. Sept. 9, 2016).

Conclusion

The question of whether premiums are due following an acceleration upon bankruptcy or merely after an event of default without an acceleration has now been recently addressed by three courts in *EFIH*, *Momentive* and *Cash America*, and these opinions call into question the interpretation of customary indenture provisions. It should be noted that the indenture language in *EFIH* and *Momentive* were substantially similar, and the Third Circuit rejected the approach taken by the Southern District of New York in the *Momentive* opinion. *Momentive* is currently on appeal to and under advisement with the Second Circuit. The parties adverse to the payment of the make-whole premium in the *Momentive* appeal have stressed in a post-argument submission to the Second Circuit that although the language in the *Momentive* indenture and *EFIH* Indentures are similar, Momentive was insolvent, whereas EFIH was presumed to be solvent. The *EFIH* Court explicitly noted that it did not consider the effect insolvency might have had on its decision.[12] All eyes are now on the Second Circuit to see if it distinguishes the Third Circuit's *EFIH* decision based on solvency when reviewing substantially similar indenture language or, if it simply creates a circuit split on an issue that arises in many corporate bankruptcy cases.

For new indentures, parties are advised to consider including clear language in the indenture that expresses the intentions of the parties. Language could be included to make clear whether or not redemption premiums – a make-whole premium or a fixed premium – are payable in circumstances other than when an issuer affirmatively elects to prepay the subject securities pursuant to prepayment redemption provisions prior to maturity, making it clear that such redemption premiums would not be payable in other circumstances, including upon a "refinancing" following an automatic acceleration in bankruptcy and/or after an event of default has occurred, whether or not the noteholders or the trustees have elected to accelerate the notes.

[12] In other areas of the law, such as the entitlement of unsecured creditors to post-petition interest, the entitlement to a payment (in that case, post-petition interest) turns on the solvency of the debtor. *See e.g.*, *In re Fesco Plastics Corp.*, 996 F.2d 152,155 (7th Cir. 1993) (noting that post-petition interest is due to creditors when the debtor is solvent and a creditor is oversecured) (citing *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 246 (1989)); *In re Ky. Lumber Co.*, 860 F.2d 674, 676-77 (6th Cir. 1988) (noting award of post-petition interest may be permitted in cases "where the alleged bankrupt proves solvent").

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