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Feature

By Sabina Jacobs[1]

Possible Makeover for Make-Wholes After *EFH* Decision

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A dispute in the *Energy Future Holdings* bankruptcy cases has yielded some predictability in the Third Circuit about the enforceability of make-whole premiums that are triggered by optional redemption. In *Delaware Trust Co. v. Energy Future Intermediate Holding Co. LLC (In re Energy Future Holdings Corp.)*,[2] the Third Circuit held that Energy Future Intermediate Holding Co. LLC and EFIH Finance Inc. (EFIH) cannot escape a make-whole obligation that arose when EFIH opted to redeem outstanding notes as part of its post-petition refinancing, notwithstanding the fact that the notes were automatically accelerated by the bankruptcy filing.[3] The highly anticipated ruling turned on the distinction between a redemption premium and a prepayment premium where the agreement does not explicitly nullify a redemption premium in the event of acceleration.

Background

Prior to the bankruptcy proceeding, EFIH issued a set of first-lien notes due in 2020 and two sets of second-lien notes due in 2021 and 2022, respectively.[4] The redemption provision in the indentures governing the first- and second-lien notes requires the payment of a make-whole premium if EFIH opts to redeem the notes before a certain date.[5] The acceleration provision in both indentures makes all outstanding notes immediately due and payable without further action or notice if EFIH files a bankruptcy petition.[6] In late 2013, EFIH filed a Form 8-K with the Securities and Exchange Commission disclosing its proposal to file for bankruptcy, and to refinance the first- and second-lien notes without paying the make-whole premiums.[7]

Bankruptcy Court Disallowed Make-Whole Obligation

In April 2014, EFIH filed a chapter 11 petition in the U.S. Bankruptcy Court for the District of Delaware,[8] thereby triggering the automatic-acceleration provisions in both indentures. With the bankruptcy court's approval, EFIH refinanced all of the first-lien notes and a portion of the second-lien notes within less than two months of its petition date.[9] The holders of the first- and second-lien notes each commenced adversary proceedings, seeking orders to compel EFIH to pay the applicable make-whole premium on account of the refinanced notes.[10] The bankruptcy court ultimately disallowed the make-whole obligation,[11] and the district court affirmed.[12]

Third Circuit Reversed and Reinstated Make-Whole Obligation

On appeal, the Third Circuit reversed the bankruptcy and district court decisions and held

1 The views and opinions expressed in this article are those of the author and do not reflect the views of Gibson, Dunn & Crutcher LLP.
2 No. 16-1351, --- F.3d ---, 2016 WL 6803710 (3d Cir. Nov. 17, 2016) (Ambro, J.). As of the publication date, the court granted EFIH's request for additional time to file a petition for rehearing *en banc*.
3 *Id.* at *10.
4 *Id.* at *1.
5 *Id.* at *4. Specifically, a premium is due with respect to (1) the first-lien notes if they are redeemed prior to Dec. 1, 2015, and (2) the two sets of second-lien notes if they are redeemed prior to May 15, 2016, and March 1, 2017, respectively. In each case, the applicable premium decreases annually on a sliding scale as the optional redemption date approaches the notes' respective maturity date. *See id.*
6 *Id.* at *1. However, the acceleration provision respecting the second-lien notes explicitly provides that "all principal of *and premium, if any* ... on the outstanding Notes shall be due and payable immediately" if EFIH files for bankruptcy. *Id.* (emphasis in original; citation omitted; internal quotation marks omitted). The Third Circuit acknowledged this additional language, noting that it made the acceleration and redemption provisions "not merely compatible but complementary," but held that the make-whole obligation was equally enforceable under both indentures (with or without the additional language) because the make-whole premium in each is triggered by the optional redemption provision (not the acceleration provision). *Id.*
7 *Id.* Suffice it to say that this filing did not escape the Third Circuit's attention. *Id.* at *1-2 and 5.
8 *Id.* at *2.
9 *Id.*
10 *Id.*
11 *Id.* at *2-3.
12 *Id.* at *3.

that holders of the refinanced first- and second-lien notes are entitled to the make-whole premiums.[13] At issue was approximately $431 million on account of the first-lien notes and an undisclosed amount on account of the second-lien notes.[14] In short, the court found the express text of the relevant provision to be dispositive: "Any duty to pay the make-whole comes from § 3.07 [the redemption provision]."[15] Accordingly, the court analyzed whether the circumstances were sufficient to activate the redemption provision (*i.e.*, was there an optional redemption before the specified date?). The answer was "yes."

The court explained that EFIH's post-petition refinancing constituted an "optional" redemption because EFIH (1) voluntarily accelerated the notes by filing for bankruptcy, (2) elected not to reinstate the accelerated notes in its chapter 11 plan, and (3) opted to refinance and redeem the notes, all while the holders sought to *rescind the acceleration* and reinstate the notes.[16] In the court's view, "Logic leaves no doubt this redemption of the Notes was 'Optional' under § 3.07."[17]

Dismissing the debtor's argument to the contrary, the court noted that "New York and federal courts deem 'redemption' to include both pre- and post-maturity repayments of debt."[18] Therefore, because EFIH opted to redeem the notes before the call date specified in the applicable redemption provision, the court concluded that "§ 3.07 on its face requires that EFIH pay the Noteholders the yield-protection payment."[19]

Acceleration Did Not Negate the Make-Whole Redemption Premium

The Third Circuit found that the automatic acceleration of the notes, triggered by EFIH's bankruptcy petition in accordance with the acceleration provision, did not insulate EFIH from the reach of the redemption provision. The court explained that the acceleration and redemption provisions in the indentures are not incompatible because "[t]he two sections simply address different things: § 6.02 [the acceleration provision] causes the maturity of EFIH's debt to accelerate on its bankruptcy, and § 3.07 [the redemption provision] causes a make-whole to become due when there is an optional redemption before [a certain date]."[20] Stated differently, "Nothing in § 6.02 negates the premium [that] § 3.07 requires if an optional redemption occurs before a stated date. Acceleration ... has no bearing on *whether and when* the make-whole is due."[21]

Redemption Premiums vs. Prepayment Premiums

In further support of its conclusion, the Third Circuit differentiated between the enforceability of a "redemption" premium versus that of a "prepayment" premium, in each case following acceleration.[22] The court explained that "*prepayments* cannot occur when payment is now due by acceleration of the debt's maturity."[23] The court further noted that "[u]nlike prepayment, however, 'redemption' of 'a debt security' may occur '*at* or before maturity.'"[24] For this reason, the court found that "while a premium contingent on 'prepayment' could not take effect after the debt's maturity, a premium tied to a '*redemption*' would be *unaffected by acceleration* of a debt's maturity."[25]

The court concluded that "[b]y avoiding the word 'prepayment' and using the term '*redemption*,' [the parties in *Energy Future*] decided that the make-whole would apply without regard to the Notes' maturity."[26] In other words, the indentures tether the make-whole premium to the specified *redemption dates* and did not state that acceleration would nullify the availability of this premium.[27]

Citing New York's highest state court in *NML Capital v. Republic of Argentina*,[28] the Third Circuit clarified that "in New York, the consequences of acceleration of the debt *depend on the language* chosen by the parties in the pertinent loan agreement."[29] Thus, where a make-whole premium is contingent on *prepayment*, the burden is on the party seeking the make-whole premium to show that the make-whole obligation survives acceleration. Stated differently, if the "parties want to mandate a 'prepayment' premium following acceleration, they must *clearly state it in their agreement*."[30] In contrast, where a make-whole premium is triggered by *redemption*, the burden is on the borrower to show that the make-whole obligation terminates upon acceleration because the "parties that want obligations to cease when accelerated should say so in their agreement."[31] The Third Circuit described the Second Circuit's decision in *In re AMR Corp.*[32] as an "easy" example because the acceleration provision in AMR's indenture "addressed outright whether a make-whole would be due following acceleration,"[33] and it specifically carved out the make-whole premium from AMR's note obligations following acceleration precipitated by a bankruptcy filing.[34]

However, the indentures in *Energy Future* do not provide that acceleration terminates the availability of the optional redemption premium. The Third Circuit reasoned that

13 *Id.* at *10.

14 *Id.* Following the Third Circuit's decision, EFIH filed an amended chapter 11 plan and disclosure statement to address the allowance of approximately $800 million in make-whole claims. *See In re Energy Future Holdings Corp.*, Case No. 14-10979 (CSS) (Bankr. D. Del. Dec. 1, 2016).

15 *Id.* at *4.

16 *Id.* at *5. Although the indentures governing the redeemed notes provide holders with the right to rescind any acceleration (*see id.* at *1), a lender may not unilaterally rescind an automatic acceleration without violating the automatic stay. *See, e.g., In re Solutia Inc.*, 379 B.R. 473, 485 (Bankr. S.D.N.Y. 2007). Here, the bankruptcy court denied the holders' motions to lift the stay and allow deceleration, and the Third Circuit did not revisit this decision on appeal. *See Energy Future*, 2016 WL 6803710, at *3, 10 n.4.

17 *Id.* If the holders had insisted on repayment (which they did not) such that EFIH would not have redeemed the notes on a "non-consensual basis," the Third Circuit could have concluded that the redemption would not have been "optional" and thereby would not have triggered the make-whole redemption premium. *See id.*

18 *Id.* at *4.

19 *Id.* at *5. Notably, the Third Circuit assumed (as did the bankruptcy court) that EFIH was "solvent and able to pay all allowed claims of [its] creditors in full" (*id.* at *3, n.1), and did not address the effect (if any) of § 502(b)(2) or 506(b) of the Bankruptcy Code.

20 *Id.*

21 *Id.* at *9 (emphasis added).

22 *Id.*

23 *Id.* (emphasis added).

24 *Id.* at *8 (quoting *Chesapeake Energy Corp. v. Bank of N.Y. Mellon*, 773 F.3d 110, 116 (2d Cir. 2014) (emphasis in original)).

25 *Id.* (emphasis added).

26 *Id.* at *9 (emphasis added). The court declined to adopt EFIH's argument that "even though § 3.07 [the redemption provision] does not use the word 'prepayment,' the make-whole is in substance a prepayment premium." *Id.* Rather than straying from the "words and phrases" in the indentures, the Third Circuit explained that it must "give effect to the intent of the parties as revealed by the language of their agreement." *Id.* Citing New York law, the court emphasized that "[i]t is the role of the courts to enforce the agreement made by the parties — not to add, excise or distort the meaning of the terms they chose to include, thereby creating a new contract under the guise of construction." *Id.* at *4 (citation and internal quotation marks omitted).

27 *See id.* at *10.

28 952 N.E.2d 482 (N.Y. 2011).

29 *Id.* at *8 (quoting *NML Capital*, 952 N.E.2d at 492) (internal quotation marks omitted; emphasis added).

30 *Id.* at *9 (emphasis added).

31 *Id.* at *6 (emphasis added) (citing *NML Capital*, 952 N.E.2d at 490).

32 730 F.3d 88 (2d Cir. 2013), *cert. denied sub. nom., U.S. Bank Trust Nat'l Assn. v. AMR Corp.*, 134 S. Ct. 1888 (2014).

33 *Energy Future*, 2016 WL 6803710, at *5.

34 *Id.* at *6 (citing *In re AMR*, 730 F.3d at 99).

"if EFIH wanted its duty to pay the make-whole on optional redemption to terminate on acceleration of its debt, it needed to make clear that § 6.02 [the acceleration provision] trumps § 3.07 [the redemption provision],"[35] which EFIH did not do. Therefore, the court concluded that under New York law, "contract terms like § 3.07 that are applicable before acceleration remain so afterward."[36]

The Third Circuit Rejected the *Momentive* Decision

In 2015, the U.S. District Court for the Southern District of New York in *In re MPM Silicones LLC*[37] (hereinafter, *Momentive*) held that a make-whole premium is not enforceable following acceleration unless the acceleration provision "clearly and unambiguously call[s] for the payment of the make-whole premium in the event of an acceleration of debt."[38] The district court's decision in *Momentive* (and the bankruptcy court orders that it affirmed) relied heavily on *Northwestern Mutual Life Insurance Co. v. Uniondale Realty Associates*[39] (either directly or on case law citing *Northwestern*) for the proposition that "[c]ourts allowing make-whole payments ... have largely required the contract to provide explicitly for a make-whole premium in the event of an acceleration of debt or a default."[40]

The Third Circuit criticized the *Momentive* decision because it "stretched *Northwestern* beyond its language and applied its clear-statement rule to yield-protection payments *not styled as prepayment premiums*."[41] Notably, the facts in *Momentive* were substantially similar to those in *Energy Future*[42]: "Like the Indentures here, the *Momentive* indenture required [the] payment of a make-whole on optional redemptions occurring before a particular date."[43] Because *Momentive* disallowed the make-whole premium that was triggered by the debtor's optional redemption, the Third Circuit found that "the result in *Momentive* conflicts with that indenture's text and fails to honor the parties' bargain."[44] For this reason, the Third Circuit found *Momentive* unpersuasive.[45] Disagreeing with *Momentive*, the Third Circuit held that under New York law, an automatic-acceleration provision does not negate the effect of a make-whole redemption provision.[46]

Takeaways from *Energy Future*

The enforceability of the make-whole premiums in *Energy Future* turned on the fact that (1) the make-whole obligations at issue are styled as redemption (and not as prepayment) premiums, and (2) the indentures do not nullify the make-whole obligations following acceleration. It is noteworthy that this case presented a unique set of facts: A debtor elected to redeem notes over the holders' objections early in its bankruptcy case. Under these circumstances, the Third Circuit provides a default rule in *Energy Future* that relies on the distinction between make-whole premiums triggered by prepayment versus those triggered by redemption: Unless there is explicit language in the operative agreement to the contrary, a *redemption* premium *will* survive acceleration, whereas a *prepayment* premium *will not*. The Third Circuit also telegraphs that express language in the agreement that states *whether and when* a make-whole premium is due will trump this default rule.

It remains to be seen whether the Second Circuit will uphold *Momentive* or be persuaded by the Third Circuit's reasoning in this case, and whether other courts will follow or appeal *Energy Future*. For now, however, courts in the Third Circuit considering the enforceability of make-whole premiums must determine whether the debt documents contain explicit language that either preserves a make-whole *prepayment* premium or cancels a make-whole *redemption* premium in the event of acceleration. abi

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35 *Id.* at *9-10 (citations omitted).
36 *Id.* at *7 (citing *NML Capital*, 952 N.E.2d at 492).
37 531 B.R. 321 (S.D.N.Y. 2015). The appeal filed by U.S. Bank National Association is currently pending in the Second Circuit (Case No. 15-1771).
38 *Id.* at 336.
39 816 N.Y.S.2d 831 (N.Y. Sup. Ct. 2006).
40 *See Momentive*, 531 B.R. at 336-37; *In re MPM Silicones LLC*, No. 14-22503, 2014 WL 4436335, at *13-15 (Bankr. S.D.N.Y. Sept. 9, 2014), *aff'd*, 531 B.R. 321 (S.D.N.Y. 2015).
41 *Energy Future*, 2016 WL 6803710, at *9 (emphasis added). The Third Circuit also considered the policy concerns underpinning the *Northwestern* holding, explaining that "[t]he *Northwestern* Judge was concerned that lenders should not be able to seek immediate repayment and pile on by also receiving a premium." *Id.* at *9. However, these concerns did not apply to EFIH, which "voluntarily redeemed the Notes over the Noteholders' objection." *Id.*
42 *Id.*
43 *Id.* (citing *In re MPM*, 2014 WL 4436335, at *13).
44 *Id.* at *7.
45 *Id.*
46 *See id.* at *10.