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RESTRUCTURING AND FINANCE DEVELOPMENTS

Redemption Premiums in Bankruptcy – The Third Circuit's Decision in *EFH*

In recent years, chapter 11 debtors have frequently sought to retire pre-petition secured debt and replace it with lower-cost debt. As explained in a prior memo, that strategy can be highly beneficial to the debtor in cases—such as *American Airlines*—where the governing documents expressly permit refinancing in bankruptcy without payment of a "make whole" premium or similar fees.

In a decision arising out of the chapter 11 case of Energy Future Holdings (EFH), the Third Circuit has limited the circumstances in which a debtor can refinance a loan in bankruptcy without paying a premium. In *EFH*, the debtors filed for bankruptcy with a plan to repay a subsidiary's first-lien and second-lien debt, at the outset of the case, along with a settlement amount. Creditors resisted the settlement, arguing that, under the governing indentures, they were entitled to a redemption premium (in an amount exceeding $400 million on the first-lien debt). The indentures provided, in a section called "Optional Redemption," that the issuer could "redeem" the Notes before maturity, as long as it paid an "Applicable Premium" if the redemption occurred before a certain date. The indentures, however, also included an acceleration provision, which provided that the Notes would be automatically "due and payable" upon a bankruptcy. The second-lien indenture (but not the first-lien indenture) provided further that, in a bankruptcy, "all principal *and premium, if any*" would be due and payable.

After a trial, the bankruptcy court held that the debtors could repay the secured debt without any premium. The court concluded that, because the secured notes were being paid upon acceleration—namely, at the time they were due by virtue of the bankruptcy—they were not being redeemed at the borrower's option. The court also concluded that, under New York law, the phrase "premium, if any" in the second-lien indenture was insufficiently precise to compel payment of a make whole.

On appeal, the Third Circuit reversed. In reversing, the court distinguished between "redemptions," which can occur either before or after maturity, and "prepayments," which by definition occur before maturity. The court concluded that, unlike in cases involving "prepayment" premiums—or cases (such as *American Airlines*) where the acceleration provision explicitly precluded any premium—the "Optional Redemption" clause in *EFH* was applicable to the debtor's voluntary decision, announced prior to bankruptcy, to retire its debt rather than reinstating its original terms, as permitted by the Bankruptcy Code. With regard to the second-lien notes, the court concluded further that the phrase "premium, if any," although lacking "exactness," was most naturally read to require payment of a make whole premium in bankruptcy.

The *EFH* decision, aside from potentially affecting EFH's chapter 11 case, may well affect future cases, especially in the Third Circuit, by providing greater leverage to secured lenders and less flexibility to borrowers in refinancing secured debt. But whatever its ultimate impact, *EFH* shows that disputes regarding make whole provisions will often turn on a close parsing of contractual language. Lenders and borrowers alike are well-advised to devote careful attention to those provisions at the drafting and negotiation stage of a loan agreement.

Scott K. Charles
Richard G. Mason
Joshua A. Feltman
Emil A. Kleinhaus

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