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Getting a Make-Whole Premium Upon Bankruptcy?: Courts Say "Probably Not"

If repayment of debt is accelerated as a result of bankruptcy, are debtholders eligible to receive a make-whole premium? The answer from an increasing number of courts is, without specific language in the indenture, no. Indentures usually include specific language to protect investors by declaring that upon certain designated "bankruptcy events," all outstanding securities issued under that indenture become immediately due and payable (without further action from the holders of the securities). This automatic acceleration remedy is usually reserved solely for an event of default as a result of a bankruptcy.

The make-whole premium is an additional amount on top of the principal amount of the debt that becomes due on the date of redemption. These make-whole premiums are included to prevent companies from redeeming debt early to the detriment of debtholders. Unlike an

acceleration upon a bankruptcy event, optional redemption provisions are not automatic and become effective upon a decision by the issuer to redeem the debt early.

In a number of recent, high profile bankruptcy cases in New York and Delaware, trustees have argued, on behalf of debtholders, that acceleration as a result of an event of default arising out of a bankruptcy event should also be treated as an optional redemption. Their position is that the debtholders should be owed the applicable make-whole premium.[1]

In *MPM Silicones, LLC*, the Southern District of New York held against the noteholders, holding that the right to a make-whole premium upon bankruptcy must be clearly stated in the relevant indenture, as it is in most optional redemption provisions. Without language specifically stating that a make-whole premium would be due and owing following a bankruptcy default and acceleration, it would not be due in such case.

This precedent was recently followed in Delaware. As with *MPM Silicones, LLC*, upon the April 2014 bankruptcy filing of Energy Future Holdings Corp. ("EFH"), payments of certain first lien notes issued by Energy Future Intermediate Holding Company LLC ("EFIH") were automatically accelerated. EFIH sought permission for debtor-in-possession financing to repay the principal and accrued interest under the notes as required under the indenture. The indenture trustee, acting on behalf of the noteholders, objected, arguing that the acceleration and repayment as a result of a voluntary bankruptcy constituted an "optional redemption," which would require EFIH to pay the applicable make-whole premium. In June 2014, Judge Sontchi of the U.S. Bankruptcy Court for the District of Delaware granted EFIH permission to make the payments as required under the acceleration provision, but preserved the trustee's right to seek the make-whole premium.

[1] In re Energy Future Holdings Corp. et al., Case No. 14-10979 (D. Del. 2015); In re MPM Silicones LLC et al., Case No. 14-22503 (S.D.N.Y. 2014).

In a subsequent proceeding before Judge Sontchi, the trustee argued the noteholders were entitled to the make-whole amount using two different arguments. First, the trustee argued that EFH and EFIH made a voluntary decision to seek bankruptcy protection, in part, as an effort to avoid being required to pay any make-whole premium in connection with an optional redemption. As a result, the trustee argued, the decision to make the bankruptcy filing and thus cause an automatic acceleration should be construed by the court as an optional redemption.

The trustee also argued that although the event of default as a result of a bankruptcy led to an automatic acceleration, the indenture gave the noteholders the right to waive any default and therefore negate the acceleration. Under the indenture, "[t]he Holders of at least a majority in aggregate principal amount of the Notes by written notice to the trustee may on behalf of all the Holders waive any existing Default… and rescind any acceleration with respect to the Notes and its consequences (so long as such rescission would not conflict with any judgment of a court of competent jurisdiction)."[2]

[2] In re Energy Future Holdings Corp. at 25.

The resulting "deceleration" would therefore require the respective debtors to pay the make-whole premium upon the optional redemption, which they would need to effect to redeem the outstanding notes prior to maturity.

The court agreed with the holding under New York law that "an indenture must contain express language requiring payment of a prepayment premium upon acceleration; otherwise, it is not owed."[3] The court also noted that the parties could have bargained for such a provision, and that if such language had been included in the indenture, under New York case law, such provisions have been upheld.[4] In addressing the trustee's first claim, the bankruptcy court disagreed, holding that while seeking to avoid the make-whole premium may have been part of the reason for the company's decision to seek voluntary bankruptcy protection, EFH and EFIH had an unsupportable capital structure and the resulting liquidity crisis was a larger factor in the ultimate decision to file for voluntary bankruptcy protection. As a result, the court held that the bankruptcy was not designed to evade paying the make-whole premium. Furthermore, unlike some other indentures, there was nothing in the indenture that addressed a "voluntary default" as the trustee alleged the bankruptcy filing to be. Therefore, regardless of EFH and EFIH's reasons for making the bankruptcy filing, it would likely not have affected the court's decision. In addition, the indenture had distinct clauses for those cases in which there would be an automatic acceleration versus those situations which were deemed to be an optional redemption. The judge held that an optional redemption is "an act separate and apart from automatic acceleration"[5] and that the nature of EFIH's obligations under each provision was different. The optional redemption was a voluntary act while an acceleration was not.

[3] In re Energy Future Holdings Corp. at 18.

[4] In re Energy Future Holdings Corp. at 18-19.

[5] In re Energy Future Holdings Corp. at 22.

As a result, the court held the trustee could not impose the duties associated with one on to the other.

In addressing the second claim that the trustee had the option to waive the default and thus rescind the acceleration the court was more sympathetic. As described above, the indenture stated that the right to waive a default could not conflict with a judicial decision. In addition to reviewing the provision granting the trustee this right, the court also held that the automatic stay is an operation of law and not a judicial order or decision.[6] By this logic, if the rescission were made effective as of the date of the bankruptcy, any attempts by EFIH to repay the notes would be an optional redemption, subject to the make-whole premium. Despite the favorable holding, the court, however, concluded that any effort to rescind the acceleration would be a violation of the automatic stay imposed by the bankruptcy filing and therefore, a separate proceeding was necessary to determine whether there was "cause" to lift the stay to retroactively decelerate the notes.

The bankruptcy court presided over a three-day trial on the issue of "cause," which ended on April 22, 2015. In May 2015, the parties filed their post-trial briefs defending their respective positions. On July 8, 2015, Judge Sontchi ruled that cause does not exist to lift the automatic

[6] In re Energy Future Holdings Corp. at 26.

stay to allow the trustee to waive the default and decelerate the notes. The trustee filed its notice of appeal on July 17, 2015.

What is clear is that if investors wish to receive a make-whole premium upon a bankruptcy event of the issuer, definitive language should be included in the relevant indenture document. It remains to be seen whether, given this series of decisions, any issuers will modify their existing disclosure to specifically disclaim any responsibility to pay a make-whole premium upon a bankruptcy event.

Update: Chesapeake Energy on Hook for Make-Whole Amount…For Now

The June 2013 issue of *Baseload* included the article "A $400 Million Devil in the Details: The Cautionary Tale of the Chesapeake Par Call." We published an update to that article in the January 2015 issue. On July 10, 2015, the District Court for the Southern District of New York held that Chesapeake is required to pay the noteholders the make-whole amount.

In February 2012, Chesapeake Energy Corp. issued unsecured notes that contained an unusual optional redemption feature that allowed Chesapeake to redeem the notes, at par, for several months following issuance. Chesapeake argued that as long as it gave notice by the March 15, 2013 deadline found in the indenture, it could redeem the notes at par. However, in the trustee's view, the redemption needed to be *complete* by the March 15, 2013 deadline in order to take advantage of the par call.

Initially, the lower court agreed with Chesapeake. It ruled that the indenture was unambiguous in its requirement that notice only needed to be provided by March 15 to effectuate a redemption at par. However, on November 25, 2014, the Second Circuit U.S. Court of Appeals reversed the lower court's ruling and held that the redemption needed to be completed by the March 15 deadline. As a result, the Second Court remanded the case back to the lower court in order to determine the amount of compensation due to the noteholders.

On remand, Chesapeake argued that, since it had never intended to initiate a make-whole redemption, the court should rely on equitable principles and grant the noteholders a more limited, restitutionary remedy. Instead, the court required Chesapeake to pay the make-whole amount. The majority relied on the previously established principle that restitution remedies should only be used in the absence of an express agreement or, if there is a contract, only in "unusual and 'margin[al]' circumstances." In applying this rule to the facts of the case, the court reasoned that:

> The Supplemental Indenture is comprehensive as to the two types of redemptions that may occur with respect to the 2019 Notes. And it defines them by date: Redemptions on or before March 15, 2013 are Special Early Redemption, *see* §1.7(b); redemptions after the date are Make-Whole Redemptions, *see* §1.7(c). These provisions together cover the universe of dates on which a redemption can occur.[1]

[1] 13 Civ. 1582, at 21.

As a result, Chesapeake was ordered to pay $379.7 million to the noteholders, more than triple the roughly $100 million Chesapeake sought to distribute in "restitutionary" damages. Further, on July 16, Chesapeake was ordered to pay an additional $59.1 million, boosting the company's total payout to $438.7 million. U.S. District Judge Paul Engelmayer in Manhattan said the new payment reflects prejudgment interest at a 6.775 percent annual rate.

Counsel for Chesapeake filed a notice of appeal on July 27, 2015.

Newest Twist in Make-Wholes: Calculating Off the Par Call Date

Historically, investment grade debt with a make-whole provision was fairly straightforward. At any time during the life of the instrument, the issuer had the right to redeem the debt. But the price to be paid included the discounted value of the remaining payments of principal and interest over the life of the debt. Because the cost of paying the "make-whole" is often significant, issuers seldom redeem bonds when they are required to pay the make-whole price.

Over the past several years, "par calls" (at a price of 100% of the principal amount of the debt being redeemed plus accrued and unpaid interest) near the end of maturity have been relatively standard in investment grade utility debt. The duration of the par call varies depending on the tenor of the debt. A six-month par call is common for a 30-year bond, while a three-month par call is relatively market for a 10-year bond.

Over the past few months, another feature has become increasingly common in the investment grade debt world—calculating the make-whole price off of the par call date, rather than the maturity date. The idea is that the issuer will likely redeem the bonds on the par call date, rather than waiting until the ultimate maturity and as such, arguably it makes more sense to calculate the make-whole premium off of such earlier date. The necessary revisions to the underlying indenture documents as well as to the disclosure are relatively straightforward.

This modified calculation has the effect of saving issuers, upon make-whole redemption, an amount roughly equivalent to the discounted value of the interest, which, but for the par call, would have accrued between the par call date and the maturity date. Note too that the Treasury security selected by the investment banks to set the discount rate is also based on the par call date, rather than the final maturity date.[1]

[1] Typically six months of interest in the case of a 30 year instrument and three months of interest in the case of a 10 year instrument.

Canadian Wraps: More Changes Coming Soon

Two years ago, Canadian regulators took significant steps to reduce the need for international issuers to supplement the disclosure in their offering documents with a "Canadian wrapper". The Ontario Securities Commission ("OSC") created a temporary process whereby individual broker-dealers could apply to be exempt from the wrapper requirements; provided the foreign issuer and the transaction met certain requirements. On June 25, 2015, the Canadian Securities Administrators announced that rule amendments will codify the changes that were adopted by the OSC in 2013 (the "2015 Amendments").[1] The 2015 Amendments are similar to changes first adopted two years ago, but further clarify and streamline the offering process for non-Canadian issuers. The 2015 Amendments have been adopted across Canada and will come into force on September 8, 2015.

Under the new regulations, offerings of "eligible foreign securities" without a wrapper will be allowed provided that the security must be offered primarily in a foreign jurisdiction and either be a security (i) issued by an issuer that is (a) incorporated under the laws of a foreign jurisdiction, (b) not a reporting company in Canada and (c) has its head office outside of Canada with the majority of its officers and directors not being residents of Canada; or (ii) issued or guaranteed by the government of a foreign jurisdiction.

[1] *See* CSA Notice of Amendment to National Instrument 33-105 *Underwriting Conflicts* (2015), 38 OSCB 5773 *available at* http://www.osc.gov.on.ca/documents/en/Securities-Category3/csa_20150625_33-105_underwriting-conflicts.pdf; Amendment to Ontario Securities Commission Rule 45-501 *Ontario Prospectus and Registration Exemption and Form 45-106F1 Report of Exempt Distribution* (2015), 38 OSCB 5795 *available at* http://www.osc.gov.on.ca/documents/en/Securities-Category4/rule_20150625_45-501_prospectus-exemptions.pdf; Multilateral Instrument 45-107 *Listing Representation and Statutory Rights of Action Disclosure Exemptions* (2015) *available at* http://www.albertasecurities.com/Regulatory%20Instruments/5070122-CSA_Notice_final_MI_45-107_.pdf.

Consistent with the changes adopted in 2013, foreign securities sold using the exemption may only be sold to "permitted clients". [2] In addition, the US offering document delivered to Canadian purchasers must comply with US conflicts of interest disclosure, including applicable FINRA rules. In the adopting release for the 2015 Amendments, however, the OSC clarified that the exemption would apply to both registered and unregistered US offerings so long as the same conflicts of interest disclosure that is provided to US investors is also provided to Canadian investors. Therefore, it is our understanding that the wrapper exemption will apply for qualifying 144A offerings.[3]

Notably, the 2015 Amendments broaden the number of broker-dealers who may use the wrapper exemption. Unlike the 2013 process in which each broker-dealer had to apply to use the exemption, the 2015 Amendments make the wrapper exemption available to all registered dealers and international dealers.

[2] A permitted client is defined under Canadian securities law and the concept is similar to the U.S. QIB.

[3] For 144A offerings with registration rights, however, the subsequent exchange offer would be considered a second distribution of securities in Canada and therefore a similar analysis about whether the wrapper exemption applies will have to be done at the time of the exchange. Furthermore, an automatic prospectus exemption is available in Canada if the exchange is for securities of the same issuer, but not if the new securities will be issued by a different issuer.

As with the earlier use of the wrapper exemption, broker-dealers are still required to provide notice to permitted clients that they will be offering the securities using the wrapper exemption. Like the previous requirements, the notice requirement is a one-time event that is broker-dealer specific. The 2015 Amendments, however, give the broker-dealer three ways of complying with this notice requirement. Disclosure can be provided (i) in the offering document itself, (ii) in a separate document that accompanies the offering document or (iii) in the form of written notice. If the broker-dealer chooses to make the disclosure by way of written notice, it must include a statement to the effect that the disclosure will apply to all future distributions. A significant change resulting from the 2015 Amendments is that broker-dealers no longer need to obtain acknowledgement and consent from a Canadian purchaser that it has received the notice.

While the 2015 Amendments will end the obligation of broker-dealers to furnish a monthly report to the OSC stating how often they relied on the wrapper exemption, the obligation to provide post-closing trade reports remains. Any sales in Canada will still need to be reported within 10 days of the distribution date and any relevant fees must also be paid.

The 2015 Amendments will reduce the need for Canadian wrappers, but there will remain certain scenarios which will require issuers to consult with Canadian counsel and potentially prepare a wrapper.[4] For example, the wrapper exemption may not be available to limited partnerships, bank issuers, offerings that are not made to "permitted clients" or rights offerings.

Note: The foregoing is not intended as advice on Canadian law, and if an offering is made to Canadian offerees, Canadian counsel must be consulted on these and other issues.

[4] Issuers that do not have securities listed on a US exchange, but whose securities are traded on the U.S. over-the-counter market, may still need to consult with Canadian counsel if they are intending to sell outside of Alberta, British Columbia, Ontario and Québec.

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