LATHAM & WATKINS LLP

Buy-Side Briefs

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Refinancing of Notes Permitted by American Airlines Without Payment of Prepayment Premium

Indentures, such as those underlying three series of notes issued by American Airlines, Inc. (the Indentures), often contain a provision requiring payment of a prepayment premium, typically referred to as a Make Whole Amount, in the event of a voluntary refinancing before the notes become due. Indentures also typically provide that all obligations are automatically accelerated upon a bankruptcy filing. They may further provide for waiver of any Make Whole Amount upon repayment following such an event of default and acceleration. These concepts were recently set on a collision course with hundreds of millions of dollars at stake in the chapter 11 cases of American Airlines, titled *In re AMR Corp.*, Case No. 11-15463 (SHL) (Bankr. S.D.N.Y.).

On January 17, 2013, the US Bankruptcy Court for the Southern District of New York issued its decision authorizing the Debtors to refinance certain of their prepetition notes without payment of a Make Whole Amount.[1] The court ruled that (1) the express terms of the Indentures waived payment of a Make Whole Amount upon the bankruptcy filing and (2) the Indenture trustee was not entitled to relief from the automatic stay to waive continuing events of default (including the default caused by the bankruptcy filing), in order that the Make Whole Amount could be collected.

Background

On October 9, 2012, the Debtors sought court for authorization to incur $1.5 billion of new financing to be used, in part, to refinance approximately $1.3 billion in aggregate of prepetition debt under three series of notes (the Notes).[2] Based on the change in market terms since issuance of the Notes in 2009, the Debtors expected to save approximately $200 million of interest through the refinancing. The indenture trustee for the Notes (the Indenture Trustee) objected.

Nuances of Aircraft Financing

Financing arrangements secured by aircraft, as well as leases of aircraft, are entitled to special protection under the Bankruptcy Code through an exception from the automatic stay and any other applicable law that would interfere with exercise of remedies. Under section 1110 of the Bankruptcy Code, a debtor must cure all outstanding defaults (other than defaults arising solely from the bankruptcy filing) and elect to perform all obligations under an aircraft financing or lease (including payment obligations), or reach an alternative agreement with the aircraft lenders or lessors. If a debtor does not satisfy these criteria, generally speaking within 60 days of filing for bankruptcy, aircraft lenders or lessors are entitled to exercise their remedies.

Course of Litigation

The crux of the Indenture Trustee's arguments was that, because the Debtors were performing all obligations under the Notes under section 1110(a) of the Bankruptcy Code (including payment obligations), it would be unfair and contrary to the intent of the Notes and section 1110(a) of the Bankruptcy Code for the Indenture Trustee to be barred from taking enforcement action and also to excuse the Debtors from paying Make Whole Payments that were due upon a voluntary refinancing outside of the enforcement context. That is, notwithstanding the automatic acceleration upon the Debtors' bankruptcy filing and continuing event of default arising from the bankruptcy, the Debtors were performing on the Notes, and the Indenture Trustee was barred from enforcing remedies as if there were no default continuing. In that situation, the Indenture Trustee argued, the Notes should operate as if no events of default were continuing and require payment of the Make Whole Amount.

The Debtors relied primarily on a strict reading of the Indentures, which provided that the bankruptcy filing triggered automatic acceleration of the Notes and, in those circumstances, the Indentures expressly waived any requirement to pay a Make Whole Amount.

The Indenture Trustee contended that it could unilaterally waive the bankruptcy default and "decelerate" the Notes, thereby putting the Debtors into the same situation as they would be if they had sought to refinance the Notes before filing for bankruptcy. The Debtors retorted that the Indenture Trustee would first have to obtain relief from the automatic stay under section 362 of the Bankruptcy Code before taking such action.

Finally, the Indenture Trustee argued that, even if a Make Whole Amount was not due under the Indentures following a bankruptcy, such terms of an Indenture are an *ipso facto* clause that is unenforceable under section 365 of the Bankruptcy Code, and the court should read the bankruptcy default out of the Indentures.

The Bankruptcy Court's Ruling

Judge Lane issued an extensive opinion ruling in favor of a strict reading of the Indentures. The opinion contains at least three noteworthy elements:

1. **Terms of a contract control**: The court found that the express terms of the Indentures resulted in automatic acceleration of principal and accrued interest "(but for the avoidance of doubt, without Make-Whole Amount)" upon certain designated events of default, including a bankruptcy filing.[3]

2. **The automatic stay applies to waivers of defaults and deceleration**: Any attempt by the Indenture Trustee to decelerate the Notes, the court held, would be barred by the automatic stay because it would exercise control over the Debtors' rights under the Indentures.[4] The court then denied relief from the stay because "it is clear at this point that deceleration would serve only to increase the size of [the Indenture Trustee]'s claim."[5]

3. **Bankruptcy defaults may be enforceable outside of executory contracts**: Finally, the court rejected the Indenture Trustee's argument that waiver of the Make Whole Premium upon the Debtors' bankruptcy filing is an unenforceable *ipso facto* clause. The concept that bankruptcy defaults are unenforceable in many contexts has become so ingrained in bankruptcy jurisprudence that parties sometimes overlook that the most commonly used bar on *ipso facto* clauses, section 365(e)(1) of the Bankruptcy Code, applies only to executory contracts — that is, contracts with material performance outstanding for both parties — and unexpired leases. In this case, the parties admitted the Indentures are not executory contracts, and the bankruptcy default clauses were given full effect by the court.[6]

Endnotes

[1] *U.S. Bank, N.A. v. American Airlines, Inc. (In re AMR Corp.)*, Case No. 12-01932 (SHL), Docket No. 11 (the Opinion).
[2] Case No. 11-15463 (SHL) (Bankr. S.D.N.Y.), Docket No. 4959.
[3] See Opinion, pp. 6, 12-13.
[4] Opinion, pp. 19-20 (citing *In re Solutia, Inc.*, 379 B.R. 473 (Bankr. S.D.N.Y. 2007).
[5] Opinion, p. 20.
[6] See Opinion, pp. 21-23.

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