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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

A Lesson In Drafting Make-Whole Provisions

Law360, New York (April 11, 2013, 6:01 PM ET) -- Often, corporate bond instruments contain no-call provisions, make-whole or yield-maintenance premiums. These contract terms are designed to protect the noteholders' expectation of an uninterrupted stream of interest payments by either prohibiting early repayment or by requiring the borrower seeking to repay early to pay the bondholder a premium to compensate for the lost interest. While make-whole and other call protection provisions are generally considered to be enforceable outside of bankruptcy, their enforceability in bankruptcy is less clear.

Today's historically low interest rates provide debtors with the opportunity to use bankruptcy, at least in part, to refinance high-yield notes with lower interest debt while seeking to avoid paying any premium on the debt being refinanced. As a result, disputes surrounding noteholders' rights to make-whole amounts may occur with greater frequency. The recent decision in American Airlines[1] represents one such dispute and the indentures at issue in that case illustrate a potential drafting response designed to provide certainty to market participants.

Case Law on Enforceability of Make-Whole Premiums in Bankruptcy

The courts that have considered whether make-whole premiums are enforceable in bankruptcy have taken different analytical approaches; however, a few common themes have emerged.

- Language in the Contract. The express language of the debt instrument is the single most important factor in the analysis.[2] The courts that have disallowed a premium have done so largely due to inartful drafting that does not make clear whether the make-whole premium is due if the debt is repaid following an automatic acceleration resulting from a bankruptcy filing. A clear and unambiguous no-call or make-whole provision that explicitly covers payment following a bankruptcy acceleration (rather than generically providing for a premium if the notes are "redeemed" or repaid prior to "maturity") would support the allowance of a premium or contract damages following a bankruptcy filing.[3]

- Unmatured Interest/Solvency. A minority of courts have held that premiums are unmatured interest and therefore subject to disallowance under §502(b)(2) of the Bankruptcy Code. The majority of courts reject this position, particularly in cases involving solvent debtors.[4] To that end, the argument for a premium is generally much stronger in a solvent case because issues concerning prejudice to junior creditors no longer apply and otherwise valid contractual rights should be enforced. It can be argued that the same principle ought to apply to oversecured creditors because §506(b) of the Bankruptcy Code allows post-petition interest and reasonable fees, costs and charges as part of such creditors' secured claim (notwithstanding the insolvency of the debtor). However, a court might still deny a request to enforce a make-whole if it finds that the allowance of the premium comes at the expense of other creditors.[5]

- Proper Liquidated Damages Clause or Penalty. Finally, some courts have analyzed whether the premium amounts to an impermissible penalty.[6] This factor may be taken into consideration both with respect to unsecured and secured debt.[7] If the yield-maintenance formula results in an amount that significantly increases the size of the claim, it will be targeted by the debtor or other parties-in-interest, appealing to the equitable powers of the bankruptcy court. However, if a material purpose of the bankruptcy case is to avoid the payment of a premium, the arguments for disallowance (as a penalty or otherwise) will likely be much weaker.[8]

The American Airlines Decision

In 2009 and 2011, American Airlines negotiated three financing transactions (the "prepetition notes"), each of which was secured by designated aircraft. On Nov. 29, 2011, American filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code, and on Oct. 9, 2012, it sought authority to incur $1.5B of new financing to be used, in part, to refinance the prepetition notes. Because interest rates had become more favorable since the issuance of the prepetition notes, the company expected to save approximately $200M through the refinancing.

U.S. Bank, the indenture trustee and security agent for the prepetition debt, objected to the financing and asserted, among other things, that the payoff of the notes fell under the voluntary repayment section of the indentures, which required a make-whole premium to be paid. American argued that the notes had automatically accelerated as a result of American's bankruptcy filing and in that situation the indentures explicitly provided that no make-whole was due. The bankruptcy court agreed with the company's position.

A couple provisions in the governing indentures were critical to the court's decision. The first provided that in the event of a bankruptcy acceleration "the unpaid principal amount of the [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[.]" Furthermore, two of the governing indentures stated that "[n]o Make-Whole Amount shall be payable on the [notes] as a consequence of or in connection with an Event of Default or the acceleration of the [notes]."

Faced with this language, U.S. Bank contended that it could waive the bankruptcy default and deaccelerate the notes, thereby putting American in the position it would have been had it sought to refinance the notes before filing for bankruptcy. In addition, U.S. Bank argued that American's election under §1110(a) of the Bankruptcy Code — pursuant to which a debtor must cure all outstanding defaults (other than those arising solely from the bankruptcy filing) and perform all obligations under an aircraft financing — effectively deaccelerated the debt.

The court did not accept the principal that the §1110(a) election deaccelerated the prepetition notes because (i) §1110 does not require the debtor to cure a bankruptcy default and (ii) the statute was intended to be narrowly construed. The court further held that any affirmative attempt by U.S. Bank to deaccelerate the debt would be barred by the automatic stay because it would result in the assessment of a make-whole premium (which was not currently due) and frustrate American's rights under the indentures.

As to U.S. Bank's alternative request for relief from the stay, the court found it troubling that the noteholders only moved to lift the stay to serve a notice of rescission and deceleration after the issue was raised in oral arguments (late in the case). While the decision on stay relief may have been a harder one for the court if the noteholders had acted earlier to preserve their rights, it is questionable whether they would have been able to overcome the language in the indenture that provided for no make-whole following an event of default.

Going Forward

The American Airlines indenture is an example of contract drafting designed to provide clarity that no make-whole would be due under certain circumstances (which the court accepted). However, the parties to the contract would have been free to provide for a different result — particularly since the more favorable conditions in the capital markets that allowed American to refinance and take out the prepetition notes is precisely what noteholders should want to protect against when fashioning a make-whole provision.

The court in American Airlines concluded that under the plain language in the indentures, the debtors were not required to pay the make-whole amount in connection with the refinancing. Citing with approval the district court's decision in Calpine and the bankruptcy court's decision in Solutia, the American court emphasized that the contract must provide explicitly for a premium following an acceleration of the debt if one is to be recoverable. Accordingly, market participants should focus on the precise language that governs their right to a make-whole or other premium in deciding whether to invest.

Notably, make-whole and other premiums are generally tied to voluntary "redemption" rather than payment following acceleration. While this issue has not been squarely addressed in the case law, a debtor in a Chapter 11 case would likely argue that repayment of the notes following an acceleration (by a refinancing or otherwise) is not a "redemption" and therefore no make-whole or other premium is due. On the other hand, it can be argued that because both the filing for bankruptcy and the repayment are (usually) voluntary acts, any repayment following a bankruptcy acceleration is a redemption.

Where an interpretive issue like this is unsettled, one must always be mindful of the potential for a bankruptcy court to engage in results driven analysis — namely, deciding that a repayment is not a "redemption" simply because reducing the claim means greater value will be available for junior classes. Accordingly, at the inception of the financing, underwriters or arrangers' counsel should be vigilant with their language choices if the expectation is for the premium to be payable in connection with a refinancing during a Chapter 11 proceeding or repayment in connection with a plan. The American Airlines decision demonstrates the value of clear drafting in providing certainty to debtors, noteholders and the market.

—By Mark A. Broude and Melinda C. Franek, Latham & Watkins LLP

Mark Broude is a partner and Melinda Franek is an associate in the New York office of Latham & Watkins LLP.

Latham represents US Airways in the Chapter 11 proceedings of AMR Corporation.

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[1] In re AMR Corp., 2013 Bankr. LEXIS 239 (Bankr. S.D.N.Y. Jan. 17, 2013).

[2] In re Chemtura Corp., 439 B.R. 561, 600 (Bankr. S.D.N.Y. 2010); In re Premier Entm't Biloxi LLC, 445 B.R. 582, 626 (Bankr. S.D. Miss. 2010); Calpine III (infra), 2011 U.S. Dist. Lexis 62100 at *5 n. 3.

[3] Chemtura, 439 B.R. at 600-03; see also Premier Entm't, 445 B.R. at 634-36 (indenture stated all remedies were cumulative to the extent permitted by law, reflecting the agreement of the parties that common law damages were an available remedy for breach of the no-call provisions); In re Calpine Corp., 365 B.R. 392, 399 (Bankr. S.D.N.Y 2007) ("Calpine I") (lenders retain an unsecured claim for damages for debtors' breach of the agreement), aff'd by, claim disallowed by 2010 U.S. Dist. LEXIS 96792 (S.D.N.Y. Sept. 14, 2010) ("Calpine II"), and rev'd in part, vacated in part by 2011 U.S. Dist. Lexis 62100 (S.D.N.Y. June 7, 2011) ("Calpine III").

[4] Chemtura, 439 B.R. at 604 (analyzing the majority and minority views and noting that argument for disallowance as unmatured interest is potentially inapplicable in solvent debtor cases); In re Trico Marine Servs., Inc., 450 B.R. 474, 481 (Bankr. D. Del. 2011) (adhering to majority view); Calpine II, 2010 U.S. Dist. Lexis 96792 at *18-20 (adhering to minority view).

[5] Chemtura, 439 B.R. at 596.

[6] Chemtura, 439 B.R. at 601-02.

[7] Id. (involving unsecured bonds); In re Schwegmann Giant Supermarkets P'ship, 264 B.R. 823 (Bankr. E.D. La. 2001) (prepayment fee was not a "reasonable" charge under §506(b) of the Bankruptcy Code).

[8] See, e.g., Chemtura, 439 B.R. at 603 n. 186. This theory may be extremely difficult to prove in a complex case because of the multitude of factors that may lead a company to file a petition for relief under the Bankruptcy Code.

[9] In re AMR Corp., 2013 Bankr. LEXIS 239 at *7-8 (emphasis supplied).

[10] See Calpine II, supra.

[11] In re Solutia, 379 B.R. 473 (Bankr. S.D.N.Y. 2007).

[12] See, e.g., Solutia, 379 B.R. at 488-89 (bankruptcy filing effectively moved the maturity date to the acceleration date; thus, the notes were not being "prepaid").