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"Make-Whole" Provisions Are Enforceable In Bankruptcy According To The Third Circuit

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One of the most litigated provisions of indentures in Chapter 11 bankruptcy cases over the past several years has been the make-whole provision. (See our Client Alert dated March 31, 2016).

In *Energy Future Holdings* ("EFH")[1], the Third Circuit Court of Appeals interpreted a "make-whole" provision in an indenture governed by New York law and enforced it with respect to the refinancing of a secured bond issue, creating a split between how the courts in the Southern District of New York and those in the District of Delaware will deal with "make-whole" provisions under New York law. So long as interest rates remain low and until the law in this area is further settled, this new decision may affect the choice of venue for the filing of Chapter 11 cases.

Bond indentures frequently contain "make whole" or pre-payment provisions to compensate bondholders for the interest-spread they will lose in the event rates decline and the bonds are repaid prior to maturity or some other agreed upon date. If an issuer files for bankruptcy, thereby accelerating the bonds, the Bankruptcy Code does not allow a claim for interest that has not yet accrued. However, when the bonds are over-secured and the issuer proposes to refinance them at a lower interest rate and repay the holders the full principal and accrued interest on their bonds, the indenture trustee will claim that the contractually specified "make-whole" amount is a fully secured claim that must also be paid. The bankruptcy and district courts, while recognizing that in this circumstance "make-whole" amounts might theoretically be allowable claims (unlike unmatured interest generally), have been reluctant to allow such claims in practice. That has now changed in the Third Circuit.

Until the *EFH* Third Circuit Court of Appeals decision, the bankruptcy and district courts had focused on the automatic acceleration provision in bond indentures, which generally provide for principal, accrued interest and premium, if any, to become due upon a bankruptcy filing. Relying on that language, which typically makes no explicit reference to the "make-whole", they have found that the refinancing of secured bond debt in Chapter 11 did not require the payment of the "make-whole".

In re MPM Silicones, LLC[2], a decision in the Southern District of New York, illustrates this analysis. In that case, the issuer's reorganization plan provided for the issuance of new secured bonds in the amount of the accelerated principal and accrued interest, at a lower interest rate, but did not provide for the "make-whole" to be paid. The bankruptcy court confirmed the plan, finding no claim to exist for the make-whole because of the wording of the automatic acceleration clause in the indenture, which was governed by New York law. The district court affirmed the bankruptcy court's decision on appeal[3]. Those decisions are currently on appeal to the Second Circuit Court of Appeals, which recently held oral argument but has not yet ruled.

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[1] *In re Energy Future Holdings Corp.*, 842 F.3d 247 (3d Cir. 2016).
[2] 2014 WL 4436335 (Bankr. S.D.N.Y. September 9, 2014).
[3] *In re MPM Silicones, LLC*, 531 B.R. 321 (S.D.N.Y. 2015).

EFH, however, reached the opposite conclusion under a substantially similar worded indenture governed by New York law. In doing so, it reversed the Delaware bankruptcy and district courts, which had followed the reasoning of *MPM Silicones,* finding the reasoning of that case unpersuasive. The Third Circuit Court of Appeals, instead, found that the "make-whole" provision clearly expressed the parties' intention and was operative to create a claim, without regard to the automatic acceleration provision. As a result, New York law did not require the automatic acceleration provision to explicitly recognize a claim for the "make-whole" amount after acceleration. In any case, the Third Circuit Court of Appeals found the use of the term "premium" in the acceleration provision to be an adequate reference to the make whole amount.

Take Aways:

- *EHF* and *MPM Silicones* place the burden for showing whether a make-whole amount is due on acceleration under the indenture on different parties. Under *EHF*, the issuer has the burden to make clear that no make whole payment is due after acceleration.
- These decisions may influence where a Chapter 11 case involving significant amounts of fully secured bond debt is filed. For the time being, Creditors with the benefit of a make-whole will clearly prefer Delaware, but the Debtor will prefer New York.

Post-Script on Motion for Rehearing: Last week, the EFH debtors asked the Third Circuit Court of Appeals to rehear the case and, on rehearing, to certify the underlying question of New York law to the New York Court of Appeals for final determination. If the motion is granted, New York's highest state court will decide the correct interpretation of a "make-whole" under New York

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