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February 2014

Second Circuit Affirms AMR's Bankruptcy Court Judgment That Payment of Accelerated Prepetition Debts Does Not Necessarily Trigger Make-Whole Premium

American Airlines emerged from bankruptcy court protection on December 9, 2013, culminating in its merger with US Airways. This Client Alert looks at the Circuit Court ruling that upheld the enforceability of ipso facto clauses in nonexecutory contracts and interpreted the requirements applicable to a debtor's §1110(a) election.

On September 12, 2013, the Court of Appeals for the Second Circuit, in affirming the decision of the bankruptcy court overseeing the reorganization of American Airlines and its affiliates including its parent, AMR Corporation (collectively, "American"), concluded that American's voluntary petition for bankruptcy triggered a default under the terms of certain secured note indentures (the "Indentures"), which accelerated the debt but, under the terms of the indentures, did not require payment by American of a "Make-Whole Amount"[1]. In reaching its conclusion, the court ruled that (1) a contractual ipso facto clause triggering a debtor's default upon the filing of a voluntary bankruptcy petition and providing for automatic debt acceleration, when contained in a non-executory contract such as each Indenture, is not rendered unenforceable under the US Bankruptcy Code and (2) American complied with its §1110(a) elections to perform under the Indentures by making regularly scheduled principal and interest payments and was not required to immediately repay all of the outstanding accelerated debt.

Background

In order to finance a number of aircraft, American entered into three transactions with US Bank Trust National Association ("US Bank") in 2009 and 2011: a secured notes financing ("Notes") and two enhanced equipment trust certificate (EETC) financings. Each such financing was secured by a separate group of aircraft and was documented by, inter alia, certain Indenture and Security Agreements made between American and US Bank as trustee. Each Indenture provided for mandatory and voluntary redemptions of, respectively, the Notes and the equipment notes underlying the EETCs ("Equipment Notes") and, under certain circumstances, in the event of a voluntary redemption (but not a mandatory redemption), a Make-Whole Amount would be required to be paid in addition to outstanding principal and accrued interest. Further, each Indenture provided that an Event of Default

[1] U.S. Bank Nat'l Ass'n v. AMR Corp. (*In re* AMR Corp.), 730 F.3d 88 (2d Cir. 2013).

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would result from American's filing of a voluntary petition in bankruptcy, upon which all outstanding principal and accrued but unpaid interest would "immediately and without further act become due and payable".

On November 29, 2011, American filed a voluntary petition for bankruptcy, triggering the automatic bankruptcy Event of Default and acceleration of the maturity of the Notes/Equipment Notes.

With the court's authorization, the debtors made elections under Bankruptcy Code §1110(a) "to perform all obligations of the Debtors under the [Indentures] with respect to the Aircraft Equipment" and to cure any non-bankruptcy-related defaults. Under §1110(a), unless a debtor makes (and the bankruptcy court approves) such elections and performs such obligations and cures such defaults, the automatic stay against creditor enforcement actions and collection measures that arises upon the filing of a bankruptcy petition will cease to apply against a secured party, lessor or conditional vendor in respect of qualified aircraft and equipment. Thereafter American made regularly scheduled principal and interest payments.

In October 2012, the debtors sought court approval to obtain favorable postpetition financing, the proceeds of which they intended to use, among other things, to repay the debt under the Indentures but without payment of any Make-Whole Amount.

The Case

US Bank filed objections arguing (among other things) that (1) American could only "voluntarily" redeem the notes by paying all secured obligations, plus the Make-Whole Amount; (2) filing for bankruptcy did not automatically accelerate the debt, and any clauses that so dictated were unenforceable ipso facto clauses; (3) if the debt was accelerated under a bankruptcy Event of Default, US Bank should be allowed relief from the automatic stay to waive the Event of Default and decelerate the debt; (4) the §1110(a) election and regular principal and interest payments should prevent American from later attempting to repay such debt without any Make-Whole Amount; and (5) assuming the debt was accelerated, American had failed to comply with its §1110(a) elections by not paying the full accelerated amount. Accordingly, argued US Bank, the automatic stay should not be in force and US Bank should have the right to waive the bankruptcy Event of Default and decelerate the debt, which would then require payment of a Make-Whole Amount in connection with the proposed redemption.

In its January 17, 2013 decision, the bankruptcy court granted American's motion to secure the favorable new financing and repay its outstanding obligations under the Indentures without paying any Make-Whole Amount. In its decision, the bankruptcy court concluded that:

1. As a matter of contract, American's bankruptcy filing triggered an Event of Default that *automatically* accelerated the debt (rather than acceleration by action of the trustee) and that in such circumstances a Make-Whole Amount did not apply under the Indentures.

2. The Bankruptcy Code's automatic stay barred US Bank from waiving the Event of Default and decelerating the debt.

3. Although Bankruptcy Code §365(e)(1) prohibits enforcement of an ipso facto clause contained in an executory contract or an unexpired lease, an indenture is neither executory (in this case, for example, because US Bank had fully performed and all that remained were American's duties thereunder) nor a lease, and therefore an ipso facto clause contained therein is not unenforceable.

4. With respect to §1110, the Event of Default at issue was caused by the breach of a provision relating to the commencement of a bankruptcy case, which a debtor is not required to cure pursuant to §1110(a)(2)(B) and, therefore, American complied with the conditions of its §1110(a) elections by making its regularly scheduled principal and interest payments; American was not required to repay the full, accelerated debt because the acceleration was a result of the exempt bankruptcy default; the effect of making the election was merely to temporarily keep the automatic stay in force, not to effect the assumption or reinstatement of the Indentures, which remained breached; consequently American was not estopped from subsequently paying the still accelerated debt as a "post-maturity date repayment" (rather than a prepayment) and, because the debt to be paid had matured, payment of the Make-Whole Amount was not required.

On appeal, the Second Circuit resolved two main issues:

First, whether the Indenture clauses declaring debtor's Event of Default ipso facto upon the filing of a voluntary bankruptcy petition and providing for automatic debt acceleration are unenforceable under Bankruptcy Code §365(e)(1) and

Second, the requirements and consequences of a §1110(a) election when the only outstanding default is an ipso facto default that triggered automatic acceleration of the debt.

The Second Circuit upheld the bankruptcy court decision that, as per the express terms of the Indentures, American's voluntary bankruptcy petition triggered an Event of Default that accelerated the debt and therefore, the Make-Whole Amount payment was not required and, specifically as to the two above issues:

1. The ipso facto clauses in question, triggering an automatic default upon the filing of a bankruptcy petition of American, were not unenforceable under §365(e)(1)—because the Indentures containing them were not executory contracts or leases—or under " any other Bankruptcy Code provisions identified by US Bank"; contrary to US Bank's argument, there is no categorical prohibition on the enforceability of such clauses and
2. To satisfy the conditions of its §1110(a) elections to "perform all of its obligations under the Indentures and cure any non-exempt defaults" and thereby continue to enjoy the benefits of the automatic stay, American needed only to make its regularly scheduled principal and interest payments on its Notes/Equipment Notes; American was not required to immediately repay the fully accelerated debt where the acceleration was triggered by an Event of Default that is exempt from the cure requirement (in this case, its voluntary bankruptcy filing). The court appears to have equated full payment of the accelerated debt with "cure" of the default triggered by bankruptcy. In the words of the court, §1110(a)(2)(B) permits a debtor to "postpone the consequences" of a breach that is exempt from cure. The court nonetheless permitted American to take advantage of the automatic acceleration of maturity to avoid payment of the Make Whole Amount.

We note that in the admittedly short period following the decision by the Second Circuit, we have not observed a tendency among the parties to similar financings to renegotiate the typical provisions that deal with whether a Make-Whole Amount would be required when the debt is automatically accelerated pursuant to a borrower's bankruptcy filing.