Client Alert | Capital Markets

Recent Cases Restrict Issuers' Ability to Avoid Paying Premiums

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Authors: David Johansen, Gary Kashar, Owen Pell, Paul Clews, Jill Concannon, Matt Danforth, Jeb Byrne, Michael Lee, Brian Dearing

Indentures governing high yield and investment grade notes typically provide for a make-whole or other premium to be paid if the issuer redeems the underlying notes prior to maturity. The premiums are intended to compensate the investor for the loss of the bargained-for stream of income over a fixed period of time.[1] Generally, though, under New York law, a make-whole or other premium is not payable upon acceleration of notes after an event of default absent specific indenture language to the contrary. However, in the Second Circuit's seminal 1982 decision in *Sharon Steel*, the court crafted an exception to this rule by holding that a make-whole premium was payable where the issuer's voluntary actions led to the event of default.

Since *Sharon Steel,* district courts in the Second Circuit have interpreted this exception to apply only where it was shown that the issuer had a bad-faith intent to avoid payment of the make-whole premium, *i.e.*, the issuer defaulted to avoid the premium rather than for a legitimate business reason. However, two recent federal cases involving indentures governed by New York law, more closely following the ruling in *Sharon Steel*, did not require a showing of bad faith or intent to avoid paying the premium. Instead, these decisions focused on the voluntary nature of the issuer's actions and held that, in those cases, the issuer could not limit noteholder remedies (and its repayment obligation) to principal and interest. In *Wilmington Savings Fund Society, FSB v. Cash America International, Inc.*[2] ("*Cash America*"), decided by the U.S. District Court for the Southern District of New York (the "Southern District"), the court applied *Sharon Steel* to require a make-whole payment where the issuer violated the covenant in the indenture prohibiting transfers of assets. In *In re Energy Future Holdings Corp.*[3] ("*EFIH*"), the U.S. Court of Appeals for the Third Circuit (the "Third Circuit") held that an issuer that voluntarily filed for bankruptcy could not avoid the make-whole premium upon an advantageous refinancing of the notes. These decisions should limit the ability of issuers to avoid make-whole payments when it is the issuer's action that triggers a default.

The Cash America Case

In 2013, Cash America International, Inc. ("Cash America") issued US$300 million of 5.75% Senior Notes due 2018 under an indenture, which, in relevant part, provided that:

(1) subject to certain exceptions, Cash America could not sell or otherwise dispose of property exceeding 10% of the company's "Consolidated Total Assets";

(2) a breach of the prohibited transaction covenant constituted an event of default and, in that event and absent a bankruptcy, the trustee *may*, but was *not required* to, accelerate the notes and "declare the principal and accrued interest" to be immediately due and payable;

(3) Cash America had the option to redeem the notes prior to maturity at a price that included a "make-whole" premium; and

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1 See Sharon Steel Corp. v. Chase Manhattan Bank, 691 F.2d 1039, 1053 (2d Cir. 1982).

2 Case No. 15-cv-5027 (JMF), 2016 WL 5092594, 2016 VL 30797 (S.D.N.Y. Sept. 19, 2016).

3 Case No. 16-1351 (3d Cir. Nov. 17, 2016).

(4) the trustee could pursue any remedy available to "collect the payment of principal of and interest on the [notes] or to enforce the performance of any provision of the [notes] or the [indenture]."

In November 2014, Cash America spun-off the wholly-owned subsidiary that conducted its substantial e-commerce business. After the spin-off, Wilmington Savings Fund Society, FSB ("Wilmington"), the indenture trustee, sued to seek specific performance of the redemption provisions, seeking principal and accrued and unpaid interest, plus the make-whole premium.

The Southern District Decision

The Southern District granted summary judgment to Wilmington.[4] As an initial matter, the court first determined that Cash America breached the indenture by effecting the spin-off transaction.

The Southern District then analyzed the remedies available to noteholders–specifically, whether noteholders could recover the make-whole premium even though Cash America did not opt to redeem the notes. Cash America argued that upon an event of default, the noteholders' sole remedy is to accelerate repayment, in which case noteholders would be entitled to principal and accrued interest, but not the make-whole premium. Cash America further asserted that the optional redemption clause is intended to be used exclusively by the company in the event it decides to redeem the notes early, rather than by the noteholders seeking specific performance. The trustee argued, however, that noteholders should be paid the make-whole premium as the breach was the result of "optional" actions taken by the company.

Citing *Sharon Steel*, the Southern District agreed with the trustee. In its ruling, the court focused on (1) the voluntary nature of Cash America's breach (*i.e.*, Cash America chose to pursue the prohibited transaction) and (2) that the acceleration clause was not exclusive and the noteholders could seek any remedy provided by the indenture.[5]

In reaching this conclusion, the Southern District specifically rejected the argument that the *Sharon Steel* exception required a finding of bad-faith or intent to avoid the premium.[6] First, the court noted that *Sharon Steel* itself contained no holding as to intent, and that such a holding would have made no sense given the procedural posture of the issues there on appeal. Rather, the intent "requirement" had arisen only in *dicta* in lower court cases citing *Sharon Steel.* As important, the court found it unlikely that the Second Circuit in *Sharon Steel* would have introduced into the contract damage analysis the factual issue of subjective intent or bad faith, which concepts generally do not apply to ordinary contract damages. Finally, the Southern District rejected Cash America's argument that this interpretation of *Sharon Steel* would destroy the application of acceleration provisions in indentures, noting that parties have the ability to contract around the application of *Sharon Steel*.

The EFIH Case

In 2010, Energy Future Intermediate Holding Company LLC and EFIH Finance Inc. (collectively, "EFIH") issued US$4 billion of secured first-lien notes under an indenture (the "First Lien Indenture"). The First Lien Indenture provided that EFIH could make an optional redemption of the first-lien notes prior to December 15, 2015, at a price that included a make-whole premium. The First Lien Indenture also provided that, if EFIH files bankruptcy, the first-lien notes are automatically accelerated and become due and payable immediately, but also provided that a majority of holders could rescind the acceleration. In 2011-12, EFIH issued two series of secured second-lien notes under an indenture (the "Second Lien Indenture" and, together with the First Lien Indenture, the "EFIH Indentures"). The Second Lien Indenture contained similar make-whole and acceleration provisions to the First Lien Indenture. However, the Second Lien Indenture provided that "all principal *and premium*, if any," as well as interest and other monetary obligations became due and payable if EFIH files bankruptcy.

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[4] To the extent the Cash America case is appealed to the U.S. Court of Appeals for the Second Circuit, New York state law (22 NYCRR § 500.27) allows a federal appellate court (whether on the suggestion of a party or of the court itself) to certify a question of New York law to the New York Court of Appeals (New York's highest court) for a definitive ruling. A ruling by the Court of Appeals on New York contract law would be a binding and definitive, including as to a case pending in federal court.

[5] Id. at 15-16.

[6] Id. at 17-18.

In 2014, EFIH and other members of its corporate family filed chapter 11 bankruptcy petitions in Delaware Bankruptcy Court, after disclosing in securities filings its proposal to file for bankruptcy and to refinance the first-lien and second-lien notes without paying the make-whole premiums that would be due in a refinancing outside of bankruptcy. Once in bankruptcy, EFIH sought to refinance the notes and asked the Bankruptcy Court for leave to borrow funds for the refinancing. In response, the trustees under the EFIH Indentures filed separate adversary proceedings seeking to rescind or lift the automatic acceleration of the notes caused by EFIH's bankruptcy without violating the automatic stay of creditor actions following a bankruptcy filing and a declaration that the repayment of the first-lien and second-lien notes would include a make-whole payment. The Bankruptcy Court, however, refused to lift the automatic stay to allow the trustees to rescind the acceleration and allowed EFIH to refinance the existing notes at significantly lower interest rates and without paying any make-whole premiums. These holdings were affirmed by the U.S. District Court for the District of Delaware, and the indenture trustees appealed to the Third Circuit.

The Third Circuit Decision

The Third Circuit reversed and held EFIH liable for the make-whole premiums, in part because the acceleration provisions of the EFIH Indentures did not expressly preclude recovery of a make-whole. As in *Cash America*, the court applied well-settled rules of New York contract law and focused on the voluntary nature of the issuer's actions.

The Third Circuit first analyzed whether an optional redemption had taken place by considering three factual questions: (1) was there a redemption; (2) was it optional; and (3) if yes to both, did it occur during the make-whole period?" The court determined that, although a redemption usually occurs before the maturity date, absent contractual language to the contrary, a redemption can occur before or after maturity.[7] Next, the court held that the redemption was optional and during the make-whole period because (1) EFIH voluntarily filed for chapter 11 protection[8]; (2) the automatic acceleration of the notes upon bankruptcy did not *require* repayment as EFIH had the option to continue performing on the notes by reinstating them in the reorganization proceedings; and (3) EFIH used the bankruptcy to block the trustees from rescinding the acceleration and proceeded with the redemption of the notes "on a non-consensual basis" during a time when the notes could otherwise have been optionally redeemed with a make-whole premium.[9] As in *Cash America*, the Third Circuit saw no need to consider the issuer's bad-faith or subjective intent, instead focusing only on the voluntary or optional nature of EFIH's actions in triggering an event of default.

EFIH further argued that the optional redemption and acceleration provisions were separate and distinct, and because the acceleration provision specifically applied to a bankruptcy-default situation, it alone should govern the consideration payable upon a bankruptcy acceleration. The Third Circuit rejected this, holding that the indenture provisions addressed different circumstances, did not conflict, and could both be given meaning by being applied concurrently.[10] EFIH also argued that acceleration of the debt's maturity foreclosed application of the make-whole. This too was rejected, with the Third Circuit holding that nothing in the acceleration clause by its terms disabled any other indenture provision such that, absent specific language to the contrary, EFIH's obligations to pay the make-whole continued after the acceleration of the debt.[11] The Third Circuit also determined that the "premium, if any" language supported the conclusion that the EFIH Indentures permitted the payment of the make-whole premium.[12]

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7 *EFIH* Op. at 14.

8 Indeed, EFIH had announced its intention to use a bankruptcy filing to complete a refinancing without making the make-whole payments. Id. at 15-16.

9 Id. at 16. Indeed, the Third Circuit viewed this tactic as placing the trustees in "a Catch-22." Id. at 11.

10 Id. at 16-18.

11 Id. at 25-26.

12 Id. at 19-20. In so holding, the Third Circuit refused to follow a Southern District decision in *In re MPM Silicones, LLC* 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014), aff'd, 531 B.R. 321 (S.D.N.Y. 2015) ("*Momentive*"). Decided prior to *Cash America*, in *Momentive*, indenture trustees attempted to enforce a make-whole against a debtor in bankruptcy ("MPM Silicones"). In analyzing the trustees' claims, the Southern District first stated that the general rule under New York law is that a lender forfeits any rights to make-whole payments if the debt is accelerated. The Southern District then noted two exceptions to that rule: (i) if the debtor "intentionally defaults in order to evade the prepayment premium or make-whole" or (ii) if a clear and unambiguous clause calls for the payment of a prepayment premium or make-whole in the event of acceleration. The Southern District determined that the debt was automatically accelerated under the indenture when MPM Silicones entered bankruptcy, and therefore one of the two exceptions had to apply. The trustees then conceded that the debtor had not defaulted just to avoid the prepayment, nor was the

Implications

EFIH and *Cash America* are significant for several reasons. First, both cases reject the idea that, in enforcing contractual remedies, lenders or trustees must take on the added burden of showing subjective intent or bad faith by an issuer in attempting to avoid a make-whole payment. Rather, both cases place the burden on the issuer to show that specific language in the indenture limits the applicability of otherwise unrestricted make-whole provisions. Second, both decisions see nothing in standard make-whole provisions that conflicts with acceleration clauses that, by their terms, either are not exclusive or which may be rescinded by a majority of holders. The decisions give substance to standard indenture clauses that give noteholders the ability to pursue any and all remedies—including in the wake of an event of default. These decisions also highlight that issuers wanting to limit the scope of make-whole payments bear the burden of doing so expressly in the indentures they negotiate.

In response to these decisions, we have begun to see some issuers request inclusion of language in the indenture explicitly barring application of any make-whole premium in connection with or after any event of default. It will be important to closely monitor the cases described above as they make their way through the courts, as well as the response of the debt markets to these provisions.

White & Case LLP
1155 Avenue of the Americas
New York, New York 10036-2787
United States

T +1 212 819 8200

White & Case LLP
5 Old Broad Street
London EC2N 1DW
United Kingdom

T +44 20 7532 1000

bankruptcy filing a "tactical device" to deprive the holders of their make-whole claim. The Southern District also did not find the second exception applicable, because the indenture did not include specific language that upon automatic acceleration a make-whole would be paid. As such, the court there limited make-whole payments to prepayment scenarios. The Third Circuit expressly rejected *Momentive*, which is on appeal to the Second Circuit, suggesting that *Momentive* ignored certain key principles of New York contract law, especially with regard to the nature of redemptions and to the extent that the acceleration clauses at issue did not by their terms cancel out operation of other indenture provisions. *EFIH* Op. at 24-26. *Momentive* also is called into question by *Cash America* to the extent that it placed a burden on the trustees to show bad faith or some subjective intent by the issuer to avoid the make-whole provision.