



## Bankruptcy & Financial Restructuring ADVISORY ■

**NOVEMBER 21, 2016**

### Third Circuit Recognizes Validity of Prepayment Premiums with Automatic Acceleration in Its Reversal in *Energy Future Holdings*

In *In re Energy Future Holdings Corp. (EFH)*, issued on November 17, 2016, the Third Circuit Court of Appeals held that contractual provisions providing for yield-maintenance or make-whole premiums to noteholders are enforceable on a debt accelerated by a bankruptcy filing. In *EFH*, the debtor *redeemed* certain notes containing two related provisions: an acceleration clause that made all outstanding notes due and payable immediately upon filing of the bankruptcy and a redemption provision that allows the borrower to redeem the notes at 100% of the principal value plus an applicable premium comprising accrued and unpaid interest. The ruling in *EFH* clarifies the relationship between clauses providing for make-whole yield maintenance/prepayment premiums and acceleration clauses and provides guidance on how noteholders can protect their interests in recovering through careful drafting of contractual provisions. The ruling also criticized the legal analysis of the bankruptcy courts in both *EFH* and *In re MPM Silicones LLC ("Momentive")* from the Southern District of New York.

In *EFH*, the Delaware bankruptcy court held that the provision providing the yield-maintenance premium was not applicable. As a result of this ruling, the debtor was able to redeem and refinance the notes without paying the make-whole premium and saved "\$13 million in interest per month" and avoided payment of the "make-whole [of] approximately \$431 million." In reaching this conclusion, the bankruptcy court determined that language in the contract accelerating the debt blocked entitlement to payment of the prepayment premium. The Third Circuit rejected this reasoning, concluding that any alleged gaps in the language should have been corrected by *EFH* as the borrower, but that the language was sufficiently clear on the entitlement to the prepayment premium. As the court explained, "... if *EFH* wanted its duty to pay the make-whole on optional redemption to terminate on acceleration of its debt, it needed to make clear that [acceleration bars payment of a make-whole premium]... The burden to make that showing is with *EFH*. To place it on the Noteholders for *EFH*'s decision to redeem the Notes is a bridge too far."

Bankruptcy courts have previously relied on the New York Supreme Court of Nassau County's decision in *Northwestern Mutual Life Insurance Co. v. Uniondale Realty Associates* in barring a right to yield maintenance absent express language allowing it with an acceleration. Under the *Northwestern* holding, any prepayment premium following an acceleration of debt must be clearly stated in the agreement (the "*Northwestern*

Rule”). In *Momentive*, for example, the New York bankruptcy court cited the *Northwestern* Rule in disallowing a lender’s make-whole claim, reasoning that it was not provided for in a clear and unambiguous clause. Similarly, in *EFH*, the bankruptcy court in Delaware declined to enforce the make-whole provision because it concluded, incorrectly, that because the contract did not contain the “express language requiring payment of a prepayment premium upon acceleration,” the redemption provision could not be enforced. The Third Circuit noted that *Northwestern*, as a trial court decision, conflicted with decision of New York’s highest court in *NML Capital v. Republic of Argentina* that rejected an argument that the absence of language in a bond requiring the payment of interest after acceleration or maturity precluded the continued obligation to pay such interest. The Third Circuit’s ruling in *EFH* addresses rulings that stretched the *Northwestern* Rule “beyond its language and underlying policy concerns.” In approaching the contract construction issue under New York law, the court made clear that the indentures presented no linguistic tension as nothing in Section 6.02 (the Redemption Provision) negated the premium due under Section 3.07 (the Acceleration Provision). As opposed to being required to choose “one path” to the make-whole, the indentures allowed either path to be applicable and the court held that neither provision negated the other. In essence, the decision turned on contract construction and ensuring that each provision of the indenture was given its full force and effect, to the extent not inconsistent with the other provisions.<sup>1</sup>

The Third Circuit’s ruling in *EFH* is instructive to lenders on the importance of including clear and unambiguous language in drafting loan documents with prepayment premiums or make-whole yield-maintenance provisions.

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<sup>1</sup> In this regard, it should also be noted that the Third Circuit directed that the matter was to be remanded to the bankruptcy court for further proceedings consistent with the opinion and that “any future appeals shall return to this panel.”

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