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Bondholders Encounter Unexpected Turbulence

Second Circuit Grounds Make-Whole Provision in AMR

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Bond indentures and credit agreements often contain "make-whole" provisions, which require issuers and borrowers to pay premiums if they redeem bonds or prepay loans before maturity. These make-whole premiums are intended to compensate for, among other things, the loss of the bargained-for rate of return.[1]

A line of recent cases interpreting make-whole provisions continued the trend of emphasizing the importance of specific contractual language in deciding whether to allow claims for make-whole premiums. Two of the most recent cases, *GMX Resources* and *School Specialty*, allowed claims for make-whole premiums because the courts found that the governing agreements clearly provided for them.[2] The U.S. Court of Appeals for the Second Circuit's recent decision in *AMR Corp.*[3] followed the trend of strictly interpreting the contracts, but reached the opposite result because the governing indentures precluded recovery of a make-whole premium. Earlier cases have also generally allowed or disallowed make-whole premiums based on the contractual language, but their interpretation of the language is not always free from debate.[4] The key is whether the contract requires make-whole payments, even upon post-acceleration *re*payment or only upon pre-maturity *pre*payment, a distinction that is not always clear from the contractual provisions.

The Contract Controls

Bond indentures and credit agreements typically provide that the issuers' and borrowers' bankruptcy filing is an event of default that automatically accelerates debt.[5] This offers bondholders and lenders certain advantages: It crystallizes their claims at the outset of bankruptcy and avoids automatic-stay issues that any post-petition attempt to accelerate it would raise.[6]

Acceleration clauses can disadvantage bondholders, however, if an agreement provides for make-whole premiums only upon voluntary prepayment. If the debt is accelerated on the petition date, courts have found that the petition date then becomes the maturity date, and any subsequent payments are thus post-maturity *re*payments, not *pre*payments that would incur a make-whole payment.[7] Several recent cases grappled with this interaction between acceleration and prepayment.[8]

For example, in *GMX* and *School Specialty*, the governing agreements specifically included make-whole payments among the obligations that would be due upon a bankruptcy default and acceleration. In both cases, the claimants successfully asserted their claims for make-whole premiums because the governing agreements provided that make-whole payments were due upon almost *any* repayment that occurred before the stated maturity, including payments pursuant to bankruptcy default and acceleration.[9]

In contrast, in *AMR*, the relevant indentures specified that American Airlines's bankruptcy filing constituted an event of default that automatically accelerated the debt, but specifically *excluded* the obligation to pay make-whole premiums from the obligations that would be accelerated by a bankruptcy filing. The Second Circuit relied on this language in affirming the bankruptcy court's decision allowing American Airlines to redeem the bonds without paying a make-whole premium.[10] Moreover, bankruptcy courts seem to disfavor allowing make-whole premiums in situations other than when contracts clearly require it, making it important for drafters to specifically include make-whole payments among the obligations that would be accelerated, if that is the business agreement.[11]

1 *See, e.g., In re S. Side House LLC*, 451 B.R. 248, 267 (Bankr. E.D.N.Y. 2011).

2 *See* Transcript of Proceedings at 31, *In re GMX Resources Inc.*, No. 1311456 (Bankr. W.D. Okla. Aug. 27, 2013); *In re Sch. Specialty*, 2013 WL 1838513, at *6 (Bankr. D. Del. April 22, 2013).

3 *U.S. Bank Trust Nat'l Ass'n v. AMR Corp. (In re AMR Corp.)*, 2013 WL 4840474 (2d Cir. Sept. 12, 2013).

4 *See, e.g., U.S. Bank Nat'l Ass'n v. S. Side House LLC (In re S. Side House)*, 2012 WL 273119, at *7 (E.D.N.Y. Jan. 30, 2012), *affirming In re S. Side House LLC*, 451 B.R. 248 (Bankr. E.D.N.Y. 2011) (disallowing lender's claim for "prepayment consideration" after default and acceleration); *Premier Entm't Biloxi LLC v. U.S. Bank Nat'l Ass'n (In re Premier Entm't Biloxi LLC)*, 445 B.R. 582, 627, 31-32, 36 (Bankr. S.D. Miss. 2010) (disallowing noteholders' secured claim for a prepayment premium but allowing unsecured claim for damages when notes were redeemed before contractual no-call period ended); *HSBC Bank USA, Nat'l Ass'n v. Calpine Corp. (In re Calpine Corp.)*, 2010 WL 3835200 (S.D.N.Y. Sept. 15, 2010) (disallowing noteholders' claims for prepayment premiums).

5 The *AMR* bankruptcy court also held that regardless of any specific contractual language, the filing of a bankruptcy petition accelerates all of a debtor's obligations by operation of law. *U.S. Bank Trust Nat'l Ass'n v. American Airlines Inc. (In re AMR Corp.)*, 485 B.R. 279, 289 n.7 (Bankr. S.D.N.Y. 2013). The Second Circuit declined to reach this issue. *AMR Corp.*, 2013 WL 484074, at *6 n.14.

6 *See, e.g., In re Solutia*, 379 B.R. 473, 484 (Bankr. S.D.N.Y. 2007) ("It [is] entirely appropriate to provide for automatic acceleration in [an indenture] since the giving of a notice of acceleration post-petition would violate the automatic stay.").

7 *See AMR Corp.*, 2013 WL 484074, at *9 ("Prepayment can only occur prior to the maturity date." (citing *Solutia*, 379 B.R. at 488)).

8 *See, e.g., S. Side House*, 2012 WL 273119, at *7; *Biloxi*, 445 B.R. at 627, 31-32; *Calpine*, 2010 WL 3835200, at *4; *Solutia*, 379 B.R. at 488.

9 *See* Transcript of Proceedings at 26, 31, *In re GMX Resources Inc.*, No. 1311456 (Bankr. W.D. Okla. Aug. 27, 2013); *In re Sch. Specialty Inc.*, 2013 WL 1838513, at *1 and *6 (Bankr. D. Del. April 22, 2013).

10 *AMR Corp.*, 2013 WL 484074, at *6, *9 and *11.

(Reasonable) Liquidated Damages or Unmatured Interest?

Even if a make-whole premium is payable under the documents, an additional question exists as to whether claims for make-whole payments are allowed under the Bankruptcy Code. Some bankruptcy courts construing make-whole provisions have characterized make-whole payments as unmatured interest rather than liquidated damages.[12] Were make-whole premiums viewed as unmatured interest, claims for such payments could be disallowed under § 502(b)(2).[13] However, most courts have concluded that make-whole premiums are properly construed as liquidated damages and thus allowable under the Code.[14]

Also, in both *GMX* and *School Specialty*, the creditors' committees argued that even if construed as liquidated damages, the claims for make-whole payments should be disallowed because the make-whole premiums were plainly disproportionate to the claimants' possible loss.[15] The courts rejected this argument in both cases.[16]

Trying to Unring the Bell: Automatic Acceleration, *Ipso Facto* Provisions and Deceleration

Creditors faced with contractual language that fails to provide for make-whole payments upon acceleration have attempted creative arguments to stop or reverse the acceleration. For example, the indentures in *AMR* had acceleration clauses that precluded recovery of make-whole payments, so U.S. Bank, the bonds' indenture trustee, argued that American Airlines's payment obligations remained unaccelerated by the bankruptcy filing because (1) acceleration was not automatic (and U.S. Bank never elected to accelerate the debt); and (2) if automatic, the acceleration clauses were unenforceable *ipso facto* provisions; or (3) U.S. Bank should be allowed to waive American Airlines's default and decelerate the debt.[17] Thus, American Airlines's redemption of the bonds would be a voluntary prepayment requiring a make-whole payment. The Second Circuit rejected each of these arguments.

Automatic Acceleration Clauses Operate Automatically

Despite the indentures' plain language providing that American Airlines's bankruptcy filing would automatically accelerate the bond debt, U.S. Bank argued that under New York law, acceleration was a remedy that lenders must affirmatively choose to invoke. The Second Circuit rejected U.S. Bank's argument, noting that "numerous courts applying New York law have enforced automatic acceleration provisions."[18] The Second Circuit distinguished the two cases that U.S. Bank cited;[19] those cases dealt with "bare bones acceleration clauses" that failed to specify whether the nondefaulting creditor was required to take any action to accelerate the debt. In contrast, the relevant indentures in *AMR* specified that the debt would be accelerated without further action.[20]

Ipso Facto Automatic Acceleration Clauses May Be Enforced

To escape the acceleration clauses' effects, U.S. Bank also argued that the automatic acceleration clauses were *ipso facto* provisions unenforceable pursuant to § 365(e)(1).[21] The *GMX* creditors' committee made the same argument trying to disallow the portion of the bondholders' claim attributable to a make-whole premium.[22] Neither were successful.

Section 365(e)(1) provides that a debtor's executory contracts and unexpired leases (including any obligations thereunder) may not be terminated or modified after the commencement of a bankruptcy case solely because of a provision in such contract or lease that is conditioned on, *inter alia*, (1) the debtor's insolvency or financial condition during the case or (2) the commencement of the bankruptcy case.[23] The Second Circuit agreed that the automatic acceleration clauses were *ipso facto* — they modified the contracting parties' relationship due to the bankruptcy filing — but rejected the argument that they were unenforceable. By its terms, § 365(e)(1) renders unenforceable only *ipso facto* clauses contained in *executory* contracts and unexpired leases, and the parties admitted that the indentures were neither.[24] The court held that U.S. Bank failed to identify a Bankruptcy Code provision requiring *per se* prohibition of *ipso facto* clauses, and the absence of textual support was fatal to U.S. Bank's position that courts should categorically refuse to enforce *ipso facto* clauses.[25]

Automatic Stay Prevents Bondholders' Decelerating the Issuer's Obligations

Finally, U.S. Bank argued in the alternative that if the bond debt was accelerated by American Airlines's bankruptcy filing, U.S. Bank should be allowed to waive the event of default and decelerate the debt, as provided for in the inden-

11 *See, e.g., S. Side House*, 2012 WL 273119, at *7 ("Where, as here, the [governing agreements] do not unambiguously require a payment premium upon acceleration and default, a claim for prepayment consideration must be disallowed.").

12 *See In re Trico Marine Servs. Inc.*, 450 B.R. 474, 480 (Bankr. D. Del. 2011) (noting that minority of courts have found that make-whole premiums constitute unmatured interest, but concluding that make-whole premiums were properly construed as liquidated damages).

13 Section 502(b)(2) provides that if an objection to a claim is filed, the court shall determine the amount of such claim and allow it, "except to the extent that … such claim is for unmatured interest." *See* 11 U.S.C. § 502(b)(2).

14 *See* Transcript of Proceedings at 22, *GMX Resources*; *Sch. Specialty*, 2013 WL 1838513, at *5.

15 Under New York law (applied in both cases), courts have upheld liquidated damages provisions when (1) actual damages may be difficult to determine and (2) the liquidated damages amount is not plainly disproportionate to the possible loss. The "reasonableness of damages" is determined as of the time that the parties entered into the agreement, not at the time of the breach. *See* Transcript of Proceedings at 14, *GMX Resources*; *Sch. Specialty*, 2013 WL 1838513, at *2 (citing *Walter E. Heller & Co. v. Am. Flyers Airline Corp.*, 459 F.2d 896, 898-99 (2d Cir. 1972)).

16 *See* Transcript of Proceedings at 20, *GMX Resources*; *Sch. Specialty*, 2013 WL 1838513, at *4. The *School Specialty* court also held that because the make-whole payment was not "plainly disproportionate," it would meet § 506(b)'s reasonableness standard, assuming that it applied. *See id.* at *4-*5.

17 U.S. Bank likewise raised arguments relating to § 1110 of the Bankruptcy Code, which provides protections specifically for aircraft financiers and lessors. U.S. Bank argued that because of the debtors' election to perform under the relevant indentures and cure all nonbankruptcy defaults pursuant to § 1110(a)(2), (1) the debtors were required to comply with all of the indentures' terms, including the obligation to pay make-whole premiums; (2) the debt, if accelerated, was decelerated by the debtors' post-election regular principal and interest payments; and (3) were the debt not decelerated, the debtors had failed to cure defaults as required by § 1110(a)(2) and thus were not entitled to the automatic stay's protection. The Second Circuit rejected these arguments.

18 *AMR Corp.*, 2013 WL 4840474, at *7. New York courts have recognized that in "rare cases," automatic acceleration clauses may be unenforceable on equitable grounds. *See Fifty States Mgmt. Corp. v. Pioneer Auto Parks Inc.*, 46 N.Y.2d 573, 577 (N.Y. 1979); *Key Int'l Mfg., Inc. v. Stillman*, 103 A.D.2d 475, 477 (N.Y. App. Div. 1984).

19 *Wurzler v. Clifford*, 36 N.Y.S.2d 516 (Sup. Ct. 1942); and *Tymon v. Wolitzer*, 39 Misc. 2d 504 (N.Y. Sup. Ct. 1963).

20 *AMR Corp.*, 2013 WL 4840474, at *7.

21 *See id.* at *11.

22 *See* Transcript of Proceedings at 22-23, *GMX Resources*.

23 *See* 11 U.S.C. § 365(e)(1).

24 *AMR Corp.*, 2013 WL 4840474, at *12. Some courts have declined to enforce *ipso facto* clauses in nonexecutory contracts. For a discussion of this topic, *see* Paul Rubin, "Not Every *Ipso Facto* Clause Is Unenforceable in Bankruptcy," 327 *Am. Bankr. Inst. J.* 12, 58 (August 2013). As applied to bond indentures or loan agreements, however, even if such agreements were executory, the *ipso facto* acceleration clauses would likely still be enforceable because § 365(e)(2) provides that § 365(e)(1) does not apply to "contract[s] to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor." 11 U.S.C. § 365(e)(2)(B).

25 *AMR Corp.*, 2013 WL 4840474, at *12-*13.

tures. The Second Circuit agreed with the bankruptcy court that the automatic stay barred U.S. Bank from waiving the default and decelerating the debt. Noting that the bankruptcy estate comprises all of the debtor's legal or equitable interests in property — including contractual rights — as of the petition date, the Second Circuit held that "U.S. Bank's efforts here represent a direct attempt to get more property from the debtor and the estate, either through a simple increase in the amount of a *pro rata* plan distribution or through recovery of a greater amount of the collateral which secures the claim."[26] Having concluded that the automatic stay applied, the Second Circuit held that it could find "no abuse of discretion in the bankruptcy court's conclusion that lifting the automatic stay would serve only to increase the size of U.S. Bank's claim (to an amount greater than that to which it is entitled pursuant to the Indentures), harming the estate and American's other creditors."[27]

Takeaways

The Second Circuit's *AMR* decision, like the recent *GMX* and *School Specialty* decisions, highlights that courts will enforce a contract's clear and unambiguous terms governing when make-whole premiums are payable. When debt is accelerated by a bankruptcy filing — whether pursuant to an agreement or by operation of law — any post-petition payments will be deemed repayments, not prepayments. If, as in *GMX* and *School Specialty*, the governing agreement provides for make-whole payments upon any repayment that occurs before the stated maturity date (even pursuant to acceleration), claims for make-whole payments are likely to succeed. But, as in *AMR*, if the governing agreement provides for make-whole payments only upon voluntary prepayment, they may be impossible to collect post-bankruptcy. Finally, despite creative creditors' arguments to the contrary, *AMR* shows that attempts to undo the effects of a clearly drafted automatic acceleration clause will probably be grounded before takeoff. abi

26 *Id.* at *9 (quoting *U.S. Bank Trust Nat'l Ass'n v. American Airlines Inc. (In re AMR Corp.)*, 485 B.R. 279, 294 (Bankr. S.D.N.Y. 2013); and *In re Solutia Inc.*, 379 B.R. 473, 485 (Bankr. S.D.N.Y. 2007) (internal quotation marks omitted)).
27 *Id.* at *17.