CLIENT ALERT

Call Premiums in Bankruptcy — Maturities' Finale or a Case of Arrested Development?

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Call premiums payable upon optional redemption are often used in bond and other debt financings, and provide benefits both to issuers and investors. By paying their debt prior to the specified final due date, issuers gain flexibility to take strategic, necessary or advantageous actions, such as refinancing debt to take advantage of interest rates or retiring debt in connection with acquisitions or mergers, which would otherwise be restricted or prohibited by the covenants contained in the debt documents. Absent such provisions, there is no certainty that the desired or required amount of debt could be redeemed in a timely manner, nor of the cost to the issuer of any redemption. In exchange, investors receive a premium designed to compensate them for lost and expected yields.

The enforceability of bondholders' entitlement to bargained-for call premiums, such as "make-whole" premiums, once again recently made headlines in connection with the bankruptcy of LSP Energy and the resulting litigation. Although the parties appear to have settled the issue, the proceedings in LSP highlight the risks and acrimony when sophisticated parties in stressed circumstances have conflicting ideas of their respective benefits and bargains.

Standard default clauses provide that upon the filing of a bankruptcy by an issuer, an issuer's/debtor's bonds will be automatically accelerated to the date of the filing, without any action required by the noteholders. Outstanding amounts are then due and payable, allowing noteholders/creditors to assert the full amount of their claims in bankruptcy. Optional redemption clauses, whether referred to in shorthand as "no call" (though usually after a date certain there will be a declining premium), "make-whole," or "yield maintenance," provide that despite prohibitions on an issuer's ability to redeem, or "call," its debt prior to the date on which it is due, that issuer may do so at certain times by compensating noteholders agreed amounts. Athough the concepts of final maturity, acceleration upon bankruptcy, and call premiums are well-established, the legal meaning and effect of maturity is far from settled and have been treated differently, even by different judges in the same bankruptcy court. In the absence of careful and precise drafting in the context of a particular transaction, the applicability and amount of a call premium if an issuer enters a voluntary bankruptcy may be and often is disputed.

In *LSP Energy Limited Partnership*, Case No. 12-10460 (MFN), a case pending in the United States Bankruptcy Court for the District of Delaware, for instance, the debtor filed a complaint against the indenture trustee and an informal group of bondholders. In that case, the debtor sought a declaratory judgment that the make-whole premium provision included in the indenture pursuant to which four series of senior secured notes were issued was inapplicable because (i) as a result of the bankruptcy filing and acceleration of the maturity, the debtor would be paying, or "redeeming" (so the issuer argued), the bonds *after* maturity, and (ii) the indenture did not contain a provision providing for payments of a "make-whole" premium upon acceleration due to the bankruptcy filing. In opposition, the noteholders asserted the amounts due and owing included the "make-whole" premium because the filing of the bankruptcy petition and payment on the notes does not change their "maturity," and thus any action having the effect of "calling" or "redeeming" the notes would trigger payment of the "make whole" premium as it would be before the final maturity date.

When facing similar arguments, some courts have chosen to award damages based on prepayment premium amounts. For instance, in *In re Calpine*, the United States Bankruptcy Court for the Southern District of New York considered the lenders' claim for a prepayment premium, or "make-whole" damages, upon repayment in full of principal and accrued interest prior to the stated maturity date provided for in the notes. In that case, six of the seven tranches of debt contained clauses that purported to bar repayment of the debt prior to the final maturity unless done so after specified dates and under specified circumstances. None of the agreements governing the secured debt provided for a separate "make-whole" premium for prepayment prior to such dates. As no specific prepayment premium was due in the period in which the Calpine refinancing was to be completed, the court turned to the "dashed" expectations of lenders regarding their future interest income as a means of awarding unsecured damages. Relying on the as-yet-untriggered prepayment premiums as "reasonable proxies" for the damages incurred by the breach of the agreement—in effect reading a "make-whole" premium into the notes.

In contrast, the same bankruptcy court rejected the lenders' claims for a make-whole premium in *In re Solutia, Inc.*, reasoning that acceleration moved the original maturity date to the petition date and in effect redefining the term "maturity" as the new maturity date. Thus, although the notes contained prepayment provisions and acceleration occurred automatically on the petition date, the court determined this was not a situation that involved a "prepayment" because the notes had matured as a result of the bankruptcy filing. In reaching its conclusion, the bankruptcy court disagreed with the decision in *Calpine* for reading "make-whole" premium provisions into an indenture entered into between "sophisticated parties" where there were no such explicit provisions.

Three years after *Solutia*, in *In re Chemtura Corporation*, the same bankruptcy court suggested a two part analysis to determine whether "make-whole" provisions entitled bondholders to damages. The court's analysis was in the context of the reasonableness of a settlement in connection with confirmation of the debtor's plan of reorganization. The significance of *Chemtura's* suggested analysis is that the bankruptcy court first looked to state law to determine whether, as a matter of contractual interpretation, there was a breach of the call premium. In doing so, it interpreted whether the maturity date could be deemed to have changed as a result of the bankruptcy filing, by acceleration or otherwise. If state law triggered a bondholder entitlement, the court would determine the amount of the appropriate damages for a violation of the call premium, including whether it should possibly be reduced or even disallowed as a penalty. Because the indenture had separate definitions for "Maturity Date," "Stated Maturity," and "Maturity," the bankruptcy court found the bondholders had a strong argument that acceleration in bankruptcy did not change the contractual definition of "Maturity Date," and thus the repayment of the notes in bankruptcy was a prepayment prior to such date.[1] The court distinguished that case from *Solutia* based on the specific language drafted in the indenture.

While the parties in *LSP Energy* appear (subject to approval by the bankruptcy court) to have settled their "make-whole" premium dispute by allowing the claim to be paid out of the proceeds of the sale of assets, these cases illustrate the difficulty courts continue to have in grappling with provisions that, while important to all involved, may receive inadequate attention in negotiations and drafting, resulting in potential ambiguity and differing interpretations.

Whether it is by adding clear and explicit language reflecting mutual agreement on the applicability of call premiums in the event of a voluntary bankruptcy filing, or applying reasoned arguments based on relevant case law to existing indenture provisions in dispute, we can help both issuers and noteholders mitigate, if not completely eliminate, the bankruptcy risks associated with call premiums.

[1]The *Chemtura* court suggested that a party filing for Chapter 11 with the intent to avoid make-whole liability would be a different matter and would thus incur increased scrutiny. Indeed, the defendants in *LSP Energy* included this argument in presenting their case.

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