Hogan Lovells

Business Restructuring and Insolvency Alert

7 February 2022

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Delaware Bankruptcy Court issues key new decision regarding redemption premiums: Language matters!

Loan agreements and bond indentures often prohibit a borrower or issuer from prepaying a loan or bond prior to its stated maturity without paying a "make-whole premium" or "redemption premium," which is a sum of money, paid in addition to the principal repaid, to compensate the lender for damages in connection with the early termination of the loan or bond. As "redemption premiums" can be in the tens or even hundreds of millions of dollars, the validity of redemption provisions is frequently litigated in the context of chapter 11 bankruptcy cases, with a split of authority around the country.

The two leading cases on the issue in the context of publicly-traded bonds, *In re Energy Future Holdings Corp.*, 842 F.3d 247 (3d Cir. 2016) ("*EFH*") and *MPM Silicones, L.L.C.* 874 F.3d 787 (2nd Cir. 2017) ("*MPM*"), have taken different approaches to treatment of these obligations in the chapter 11 context. In *EFH*, the Court of Appeals for the Third Circuit held, based on the specific language in the relevant indenture, that even though certain senior notes were automatically accelerated by the debtor's chapter 11 filing, the debtor could not avoid paying an optional redemption premium when the notes were refinanced because the debtor had voluntarily filed for chapter 11, and the indenture required payment of a redemption premium if the notes were optionally redeemed prior to a specific date. In contrast, in *MPM*, the Court of Appeals for the Second Circuit held that senior noteholders were not entitled to the redemption premium provided for in an indenture's optional redemption clause because the chapter 11 filing had accelerated the maturity date of the notes, and thus there could be no prepayment or early redemption of the notes, as the language of the indenture required a premium prior to "maturity" as opposed to a specific date.

In a very recent opinion, I*n re The Hertz Corp., et al.*, 2021 WL 6068390 (Bankr. D. Del. Dec. 22, 2021) ("*In re Hertz*"), Judge Walrath of the United States Bankruptcy Court for the District of Delaware (the "Bankruptcy Court" or "Court") (which lies within, and is bound to follow the decisions of, the Third Circuit) applied the *EFH* decision and held that, in bankruptcy, whether a lender is entitled to a redemption payment depends at least in part on the contractual language of the indenture.[1]

In *In re Hertz*, Wells Fargo Bank, N.A. in its capacity as indenture trustee ("Indenture Trustee") for four series of unsecured notes (the "Senior Notes") issued prepetition by Hertz Corporation and/or its debtor affiliates ("Hertz" or the "Debtors") filed a complaint seeking a declaratory judgment that, among other things, in addition to the principal and prepetition interest paid to holders of the Senior Notes (the "Senior Noteholders") on the effective date of the chapter 11 plan, the Debtors must also pay approximately US$272 million of a redemption premium under the Senior Notes. The Senior Secured Notes were governed by four indentures, the 2022 Notes Indenture, 2024 Notes Indenture, 2026 Notes Indenture, and the 2028 Notes Indenture (together, the "Indentures"), whose redemption premium provisions differed in certain

[1] In private debt markets (for example, private placement notes or private loans), make-whole provisions often state explicitly that a make-whole premium is due upon acceleration (including automatic acceleration due to bankruptcy) of the loan or bond prior to its stated maturity date and that any repayment of the bond or loan in such circumstances will be deemed to be a voluntary redemption. In contrast, make-whole provisions in publicly issued bonds are often less explicit, which may give rise to greater scope for argument as to the application of the make-whole clause in this context. For example, in the long-running Ultra Petroleum make-whole litigation (see *In re Ultra Petroleum*, 624 B.R. 178, 182 (Bankr. S.D. Tex. 2020), the parties did not dispute that the indentures' contractual language required the debtor to pay make-whole premiums in the context of Ultra Petroleum's bankruptcy. Rather, the dispute in the bankruptcy court, on appeal to the Fifth Circuit and on remand to the bankruptcy court) focused entirely on whether payment of the make-whole premium was prohibited by law.

respects. The Indenture Trustee sought a declaratory judgement that the Debtors must pay the redemption premium of all series of the Senior Notes because they all were redeemed prior to their maturity through the bankruptcy plan. The Debtors filed a motion to dismiss the complaint, arguing that no redemption premium was required under the language of the Indentures and that, in any case, any claim for a redemption premium must be disallowed under section 502(b)(2) of the Bankruptcy Code, which disallows claims for unmatured interest (i.e., future interest payments that are not due and payable at the time of filing of the bankruptcy petition). The Bankruptcy Court declined to dismiss the counts of the complaint seeking payment of the redemption premium with respect to the 2026/2028 Senior Notes, but granted the motion to dismiss with respect to the 2022/2024 Senior Notes.

Redemption premium provisions govern

First, the Bankruptcy Court addressed whether the acceleration clauses in each of the Senior Notes Indentures were the operative provisions in determining whether the redemption premium is due. The Bankruptcy Court relied on Third Circuit precedent in *EFH*, and held that the acceleration clauses in the Indentures were not the operative provisions to determine whether a redemption premium was due. In *EFH*, the Third Circuit held that the issue of whether a redemption premium was due "depended not on the terms of the acceleration clause, but on the terms of the redemption provision" and that a redemption provision is the "only provision that specifically addresses redemption" (citing *EFH*, 842 F. 3d at 257-60, 256), and the Bankruptcy Court held the same principle applied in this case.

Bankruptcy as voluntary redemption

Relying on the Second Circuit's decision in *MPM*, the Debtors also argued that for any redemption premium to be due under the Notes, the redemption had to be voluntary, and the automatic acceleration meant that the redemption was not voluntary. The Bankruptcy Court rejected this argument, as it directly conflicted with the binding precedent from *EFH*. Even though the Debtors had acted in good faith effort to fulfill their fiduciary duty to shareholders and creditors by filing for bankruptcy, their decision to do so was nonetheless voluntary. Accordingly, the Indenture Trustee stated a plausible claim that the Senior Notes had been voluntarily redeemed by the Debtors.

Terms of the Indentures

The Debtors also argued that even if redemption was voluntary, no redemption premium was due under the terms of the Indentures because the Senior Notes matured upon the bankruptcy filing. The terms of the Indentures governing the Debtors' obligation to pay a redemption premium differed between the Senior Notes, so the Bankruptcy Court considered the terms separately.

2022 and 2024 Senior Notes

The applicable redemption provision, section 6(a) in the 2022 and 2024 Notes Indentures, provided that the "[senior] notes will be redeemable, at the Company's option, in whole or in part, at any time and from time to time on or after [a specified date] and prior to maturity thereof at the applicable redemption price set forth below." The Debtors contended that since the provision used the phrase "prior to maturity" instead of the defined term "Stated Maturity," prior to maturity had a different meaning than the Stated Maturity date. The Bankruptcy Court agreed with the Debtors' view, and found that the undefined term of "maturity" in the provision "refer[s] to the common meaning of maturity, which under the terms of the Senior Notes includes upon the acceleration caused by a bankruptcy filing." Therefore, the Bankruptcy Court held that the Indenture Trustee failed to state a claim that a redemption premium was due under the 2022 and 2024 Notes, because these Notes were redeemed after the initial period, but not prior to the maturity that occurred as a result of the bankruptcy filing, and granted the motion to dismiss with respect to these Notes.

2026 and 2028 Senior Notes

In contrast, the 2026 and 2028 Notes Indenture included the same section 6(a) as the 2022 and 2024 Notes, as well as section 6(c), which provided that "[a]t any time prior to [a specified date], the [senior notes] may also be redeemed (by the Company or any other person) in whole or in part, at the Company's option, at…the redemption price…" The Debtors argued that this additional section had no effect on the Indenture Trustee's rights to a redemption premium because section 6(a) controlled the question. The Bankruptcy Court disagreed, stating that to ignore section 6(c) would not give meaning to all sections of the contract. The Bankruptcy Court interpreted section 6(c) to mean that there was no requirement for redemption to occur before maturity -- and the language focusing on whether a redemption occurred prior to a specific date (which had not yet occurred) and if so, a premium would apply, controlled -- and therefore denied the Debtors' motion to dismiss with respect to the 2026 and 2028 Notes.

Question of economic equivalent of interest

Additionally, the Bankruptcy Court preliminarily addressed the Debtors' argument that even if the language of the Indentures required payment of a redemption premium, a claim for a redemption premium due on or after a chapter 11 filing would be disallowed as unmatured interest under section 502(b)(2) of the Bankruptcy Code. The Third Circuit previously characterized a redemption premium as "the contractual substitute for interest lost on Notes redeemed before their expected due date," but had not determined whether such redemption premium should be treated as unmatured interest. *EFH*, 842 F. 3d at 251. The Bankruptcy Court held that the determination of whether a redemption premium is the economic equivalent of unmatured interest is not a question of law, but one of fact; specifically, whether the redemption provision in the Indenture at issue is actually the economic equivalent of unmatured interest. The Indenture Trustee argued that the redemption premium was not simply the present value of unmatured interest under the 2026 and 2028 Notes, but was in fact tied to the Treasury rate. Without deciding the issue (as no evidence had been presented and the procedural context was a motion to dismiss), the Bankruptcy Court held that the Indenture Trustee stated a plausible claim, and therefore would not dismiss the redemption premium claim at the pleading stage.

Takeaways

Disputes over whether language in an indenture entitles a lender or bondholder to a redemption premium in the event of bankruptcy can be mitigated with careful drafting. For example, in *In re Ultra Petroleum*, whether the language in the indentures entitled the indenture trustees and holders to the redemption premium was not at issue. 624 B.R. 178, 182 (Bankr. S.D. Tex. 2020). Instead, the Bankruptcy Court only considered whether the redemption premium was proper as a matter of law. Investors and lenders who want to maximize the likelihood that a redemption or make-whole premium will apply in the event of a bankruptcy acceleration have used various language in loan agreements and indentures to specify clearly the applicability of the premium in the event of a bankruptcy.

If you would like to discuss this issue and how it impacts your business or transactions, please contact Ronald Silverman, Matthew Schernecke, or David Simonds.

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