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Attack on the make-whole

Baker McKenzie lawyers consider how a relatively innocuous feature of corporate bonds is causing a stir due to recent litigation and new regulations

1 MINUTE READ

Recently, make-wholes have come under attack from a number of directions in the international financial markets. This article by Baker McKenzie lawyers in the US and UK focuses on three recent challenges and their potential implications:

- **High yield issuers circumventing make-whole payments by voluntarily defaulting;**
- **US court rulings on the enforceability of make-whole claims in a US bankruptcy proceeding; and**
- **Whether a make-whole provision turns a corporate bond into a Priip.**

Significantly, international high yield bonds and straight debt capital markets instruments provide for the ability to redeem the bonds prior to maturity, but at a 'make-whole' premium designed to compensate an investor for the principal, premium and interest the investor would have been entitled to receive had the instrument been redeemed on its first call date (or at maturity). A make-whole payment made to an investor is typically equal to the net present value (NPV) of these future payments calculated based on the market discount rate. The make-whole provision is a yield-maintenance provision typically included in the bond indenture, credit agreement, or other forms of debt documents.

For example, an indenture may provide for an optional redemption that states when the make-whole premium is due:

"At any time prior to first call/maturity, the company may redeem all or a part of the notes at a redemption price equal to 100% of the principal amount of the notes redeemed plus the applicable premium . . . and accrued and unpaid interest."

'Applicable premium' is the make-whole, or yield-protection.

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- High yield issuers circumventing make-whole payments by voluntarily defaulting;
- US court rulings on the enforceability of make-whole claims in a US bankruptcy proceeding; and
- Whether a make-whole provision turns a corporate bond into a Priip [Packaged retail and insurance-linked investment product].

The default end-around

High yield and straight corporate bonds generally provide that, following an event of default (other than bankruptcy), holders can accelerate bonds or the bonds can accelerate automatically (such as upon filing for bankruptcy), depending on the language used in the indenture, making them immediately due and payable at par value plus accrued and unpaid interest. Practically, this means that if a borrower defaults during the make-whole period and acceleration occurs, the applicable premium may not be payable. This proposition has been challenged over the years in court in the context of voluntary defaults during the make-whole period.

The Sharon Steel case

In *Sharon Steel v Chase Manhattan Bank*, in 1982, the case that recognised the 'default end- around' tactic, the dispute arose around the interpretation of the acceleration and redemption provisions of notes issued by UV Industries (UV) pursuant to multiple indentures. UV initiated a voluntary liquidation of its business, of which the last action was transferring all of UV's remaining assets to Sharon Steel and making Sharon Steel the successor obligor under the indentures. The District Court found that the assumption of the debt breached the underlying indentures thereby triggering an event of default, but found that the make-whole premium was not payable upon acceleration. The rationale of the District Court was that, on their face, the indentures provided that, in a case of acceleration, such premium was not payable.

The Court of Appeals reversed, however, on the basis that "the acceleration provisions of the indentures are explicitly permissive and not exclusive of other remedies" and that "the purpose of the premium is to put a price upon the voluntary satisfaction of a debt before the date of maturity". The court went beyond the plain words of the indentures and found that due to the bad faith voluntary nature of the default, the make-whole premium was payable. In doing so, the Court of Appeals created an exception to the redemption at par upon acceleration in circumstances in which issuers (in bad faith) voluntarily defaulted as a 'default end-around' on the basis that "it undermines the plain purpose of the redemption provisions to allow a liquidating debtor to avoid their terms simply by failing to take the steps necessary to redeem the debentures, thereby creating a default".

The Cash America case

More recently, in *Wilmington Savings Fund Society, FSB v Cash America International, Inc.* in 2016, the District Court found that Cash America, by spinning off its e-commerce business, Enova, breached the consolidation, merger and asset sale covenant of the indenture governing its outstanding senior notes. This covenant breach constituted an event of default under the indenture, and the noteholders accelerated the notes. The question, as in *Sharon Steel*, was whether the make-whole premium was payable in the context of acceleration.

The District Court here again sided with the noteholders finding that the default, like the default in *Sharon Steel*, was not due to bankruptcy, but to the company's 'voluntary' actions, and that the noteholders were therefore entitled to receive the make-whole premium. Though resulting in a like verdict, the court in *Cash America* went further by removing the subjective bad faith intent element from the 'voluntary' action analysis by simply distinguishing between defaults arising from 'voluntary' actions (e.g., liquidations or spin-offs) versus involuntary actions (e.g., bankruptcies).

> **Cash America potentially leaves open the question of what type of action is 'voluntary'**

Voluntary actions

Cash America potentially leaves open the question of what type of action is 'voluntary'. One reading is that a voluntary action is when the issuer voluntarily undertakes actions that result in an event of default (regardless of intent to cause such event of default). If we interpret the rule in such a way, any action undertaken by the issuer that results in an event of default (regardless of intent to cause such event of default) would trigger the exception and require the payment of the make-whole premium.

Another reading of the rule is that the make-whole is triggered when the issuer undertakes actions that voluntarily result in an event of default (requiring the intent to cause such event of default). This second reading of the rule is much narrower (and closer to *Sharon Steel*'s rule) as it focuses on the intent of the issuer to cause an event of default (though removing the *Sharon Steel* bad faith element).

Though the District Court in *Cash America* set out examples (liquidation, spin-off or bankruptcies) intended to assist in the analysis of what actions are voluntary or involuntary, it is not entirely clear whether the intent prong applies to the action that leads to the event of default or to the event of default itself. This distinction is critical as, if the rule applies broadly (to any actions that, regardless of intent, lead to an event of default), the make-whole premium would be payable upon any acceleration (other than bankruptcy, which the court explicitly carved out as involuntary).

Further actions

In *Cash America*, the court underlines that parties are free to include provisions directing what will happen in the event of default, supplying specific terms if those events occur. Effectively, the court is giving notice to parties entering into New York law-governed agreements that they will be subject to the *Cash America* rule unless specific terms to the contrary are included.

In the wake of *Cash America*, certain indentures were drafted to explicitly set out that the make-whole premium would not be payable in the context of an event of default/acceleration. Due to investor pushback, that clarifying language only survived for a short period, and as a consequence the market standard is still to remain silent, effectively relying on the *Cash America* and *Sharon Steel* rules. Similarly, in limited bond restructuring transactions, language has been added to clarify that a make-whole should be paid on a default, but to date these transactions are limited.

The circuit split on the enforcement of make-whole provisions in a US bankruptcy

An extended version of this section is available on Baker McKenzie's global restructuring and insolvency blog.

A recent appellate court case in the US, *In re Ultra Petroleum Corporation*, has reopened the debate on the enforceability of a make-whole premium claim in a US bankruptcy proceeding. Notably, with the new decision, three US circuit courts of appeal have addressed make-whole claims and issued conflicting decisions on the nature of these claims and their allowance under the US Bankruptcy Code. The conflicting views and their potential implications are discussed below.

US bankruptcy courts have struggled with whether to give effect to the make-whole provision in circumstances where plans of reorganisation fail to provide for economic compensation to holders of make-whole claims. In addressing this question, courts have arrived at different conclusions:

- The Second Circuit, in *Momentive* (*Momentive Perf. Materials Inc., et al. v BOKF, NA, et al.* in 2017, decided that filing for bankruptcy does not trigger the obligation to pay a noteholder the make-whole premium because the debtor did not exercise a voluntary redemption of the note;
- The Third Circuit, in *EFH* (*In re Energy Future Holdings Corp*), however, held that a debtor's decision to file for bankruptcy was a voluntary act that triggered the redemption provision of the indentures and required payment of the make-whole premium; and
- The Fifth Circuit, in *Ultra Petroleum* (*Ultra Petroleum Corp v Ad Hoc Comm. of Unsecured Creditors of Ultra Res., Inc.* (2019), avoided the redemption-vs.-accelerated maturity argument instead noting that make-whole premiums are the economic equivalent of unmatured interest, and thus disallowed under § 502(b) of the Bankruptcy Code.

> **Industry uncertainty…has led to issuers and their advisers taking the more cautious, risk-minimising approach**

Make-whole premiums are unenforceable

In *Momentive*, the plan of reorganisation issued replacement notes to the senior-lien noteholders, which did not account for the make-whole premium. These noteholders contended that the failure to include the premium violated the applicable indentures' make-whole provisions for three reasons: (i) they were entitled to the make-whole under the applicable indentures' optional redemption clauses because the debtor redeemed the notes at its option prior to maturity; (ii) they were entitled to it under the applicable indentures' acceleration clauses; and (iii) even if the indentures did not allow for a make-whole premium upon acceleration, they should not have been permanently barred from exercising their contractual right to rescind acceleration and thereby obtain the make-whole premium.

The bankruptcy court held that acceleration brought about by a bankruptcy filing changed the maturity date of the accelerated notes to the date of the petition. Therefore, any payment of the accelerated notes would be a post-maturity payment and not a redemption. The Second Circuit agreed, holding that the make-whole premiums were not enforceable because the filing of a voluntary bankruptcy petition did not trigger the indentures' optional redemption clauses. The indentures provided for make-whole premiums only if Momentive "opted to redeem the notes prior to maturity". The court also noted that "a payment made mandatory by operation of an automatic acceleration clause is not one made at [Momentive's] option".

In *Ultra Petroleum*, the Fifth Circuit stated that a make-whole payment was the economic equivalent of unmatured interest and therefore could be disallowed under § 502(b) of the Bankruptcy Code. The court reasoned that the make-whole amount claimed by the creditors was merely interest that had not yet accrued as of the petition date. Although the note agreement at issue in *Ultra Petroleum* included an acceleration provision, such provision acted as an unenforceable *ipso facto* clause. In fact, the court stated, "whether interest is considered to be matured or unmatured for the purposes of § 502(b)(2) is to be determined without reference to any *ipso facto* bankruptcy clause in the agreement creating the claims". However, the Fifth Circuit noted that the pre-Bankruptcy Code solvent-debtor exception could operate as a carve-out from § 502(b)(2)'s general bar on unmatured interest. Therefore, it remanded to the bankruptcy court on the limited issue of whether the pre-Code solvent-debtor exception survived the enactment of § 502(b)(2).

Make-whole premiums are enforceable

The Third Circuit has taken a different tack, explicitly departing from the *Momentive* lower courts' decisions. As in *Momentive*, the *EFH* bankruptcy court focused its attention on the acceleration provision in the indenture. Because the acceleration took effect when EFH entered bankruptcy, the bankruptcy court concluded that no make-whole payment was due, and the district court concurred. On appeal, the Third Circuit reversed and held that payment of make-whole premiums was enforceable because it was the debtor's choice to file for bankruptcy in order to refinance its debt, effectively triggering the optional redemption clauses in the indentures. Further, the Third Circuit found a basis for including the default premium in the indenture itself, focusing on the default provision which included the words "all principal of and premium, if any" and interpreting those words to include the make-whole premium.

Perhaps the conflicting Second and Third Circuit decisions may be reduced simply to different facts. In *EFH*, the debtor was solvent and chose to file for bankruptcy for the explicit purpose of refinancing the notes. Whereas in *Momentive*, the debtor was insolvent. This may be a significant distinction because the *EFH* court relied on the debtor's pre-bankruptcy SEC [Securities and Exchange Commission] filings to show that the debtor voluntarily filed for bankruptcy under chapter 11 at least in part in order to avoid an optional redemption under the language of the indentures, when in fact a reason for the filing was to redeem the notes. But given the Third Circuit's clear repudiation of the *Momentive* decision, such conclusion is far from clear.

Implications

The Fifth and Second Circuit Courts appear aligned that make-whole premiums triggered by a bankruptcy petition are not enforceable, but come to that conclusion using different analyses – whereas the Third Circuit held the opposite.

However, questions remain. Had the debtor in *EFH* been insolvent and no facts supported an early redemption, would the Third Circuit have come out against enforcement of the make-whole premiums? Or would the applicable "all principal of and premium, if any" language have been sufficient for the court to enforce the make-whole? Now consider the question with inverse facts: would the Second Circuit have enforced a make-whole premium as against a solvent debtor? Probably not, as it focused solely on the interpretation of the indenture language. Nonetheless, the circuit split exists. At least in the Third Circuit, we can conclude that it is important to include in a default provision of a debt instrument the language, "all principal of and premium, if any". This theory is supported by Judge Bernstein in a recent decision (*In re 1141 Realty Owner)* holding that parties are free to contract around the general rule. In any event, the U.S. Supreme Court has denied a *writ of certiorari* of the Second Circuit's *Momentive* decision. So perhaps this is an area best addressed by US Congress, or at the very least, by tighter draftsmanship.

Do make-wholes turn corporate bonds into Priips?

The EU/UK has taken a recent position that Priips, which comprise financial products offered to consumers as an alternative to savings accounts, require additional disclosure in the form of a key information document (KID) and the satisfaction of other regulatory hurdles. Over the past several months, regulators and market participants have debated whether the inclusion of a make-whole in a debt instrument qualifies it as a Priip, thus adding a degree of burdensome considerations to a debt issuance.

On January 1 2018, the EU regulation on key information documents for Priips (EU 1286/2014) came into effect. In broad terms, the Priips regulation applies to investments where, regardless of their legal form, the amount repayable to the retail investor is subject to fluctuations because of exposure to (a) reference values or (b) to the performance of one or more assets which are not directly purchased by the retail investor.

Effect of the Priips legislation

In practice, this means that, while structured products (whatever the underlying legal form), insurance-based investments (including unit-linked and with profit products), and investment funds are properly caught, other securities might also be caught by the Priips regulation because of a 'structured' element that they possess. One example is a fixed rate bond featuring a make-whole provision (such as seen in most international debt securities, including high yield bonds), since the payment reflecting future expected cash flows from such a bond is generally subject to fluctuation due to exposure to a reference rate.

Industry uncertainty on whether these make-whole provisions turn bonds into Priips, coupled with an understandable fear of the high level of potential fines and penalties for a Priip manufacturer which does not comply with the requirement to produce a KID before the Priip can be made available to retail investors, has led to issuers and their advisers taking the more cautious, risk-minimising approach of designating bonds featuring make-whole clauses as 'not intended for retail'.

In March 2018, The Association for Financial Markets in Europe (Afme) wrote to the European Commission to highlight the substantial reduction in the availability of non-structured bonds to retail investors in the EEA that has resulted from the uncertainty caused by the Priips regulation. In response, in June 2018, Financial Conduct Authority chief executive Andrew Bailey committed to take action to address this unintended consequence of the Priips regulation, namely the resulting significant reduction in the availability of corporate bonds to retail, admitting the "rules are not perfect".

Alternative interpretations

In the interim, the alternate position that has developed in the international bond markets is that a fixed rate bond with a make-whole, but no other Priips regulation trigger, is not intended to be, and thus therefore is not, subject to the Priips regulation. Market participants have advanced interpretations of the legislation to promote this argument, including:

- by focusing on the word 'repayable' in the legislation, noting that the use of the word 'repayable' rather than 'payable' is interpreted as referring to the investment's principal amount rather than to any interest accruing and 'payable' thereon. This interpretation is consistent with the exemptions in the Prospectus Directive and with the Capital Markets Union objectives to strengthen access to public markets. It would also mean that all bonds where the capital amount (that is, the repayable amount) is not subject to fluctuation are outside the scope of the legislation, including fixed rate bonds with make-whole clauses, irrespective of fluctuating returns;
- offered a further alternative reason, as advanced by the European supervisory authorities and endorsed by Afme and the International Capital Market Association, that "where the mechanism to calculate the discount rate is known in advance to the retail investor, this could be considered as a separate case, which does

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not satisfy the criteria in Article 4(1)".

In addition, particularly in transactions were the securities are only marketed, even outside the US to professional clients (e.g., institutional accredited investors, qualified institutional buyers), market participants have gotten comfortable that any risk is mitigated by the inclusion in the offering document of proper disclaimers.

However, in his June 2018 speech, Bailey noted that the introduction of the Priips regulation was a major change for the industry, and that it is "appropriate after a period of major change to allow the market to evolve and adjust, and then see what the problems are". So while the expectations are that future legislation will clarify this question, to date the legislation has not been amended or restated to provide complete clarity. Still, based on the market position adopted in many international bond offerings that have been completed since the introduction of the legislation in 2018, clearly the market is expecting the result to be relief.

While at first glance the above topics may seem unrelated, one interesting conclusion from our analysis is the fact that a market provision that has attracted little controversy in the past recently keeps finding itself in the headlines. In this case, for what was considered a settled topic, uncertainty remains for all the topics discussed above:

- What constitutes a "voluntary" action for purposes of a *Cash America* analysis as to whether the make-whole is payable?
- In what circumstances is a make-whole enforceable (or unenforceable) in a US bankruptcy proceeding?
- Would the regulator come after a high yield bond that does not follow the Priips rules solely because of the inclusion of a make-whole provision?

Perhaps the final takeaway from this discussion is the reminder that every provision in a bond indenture, credit facility or similar finance document is subject to interpretation, or new rules and regulations that could modify prior application, so we are all well advised to keeping close track of the ever-evolving legal landscape.

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