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District Court Overturns 2006 *Adelphia* Bankruptcy Court Decision that Denied Lenders the Right to Recover Corrected and Increased "Grid Interest" After Borrower's Original Certified Financial Information Was Discovered to be False

The amount of interest to which lenders are entitled under "grid interest" formulas in loan and credit agreements should be based on the borrower's actual and accurate financial information rather than financial information reported by borrower on compliance certificates and the like. So decided the U.S. District Court for the Southern District of New York in an appeal from a 2006 decision of the Bankruptcy Court in the *Adelphia Communications* bankruptcy case. *The Bank of Nova Scotia and Citibank, N.A. v. Adelphia Communications Corporation and The Official Committee of Unsecured Creditors* (06-Civ. 4983 JGK), 2008 WL 3919198 (S.D.N.Y. Aug 22, 2008) *(In re Adelphia Communications Corp. 02-B-41729 (REG)*. Although the District Court decision may seem like an obvious application of common sense, the U.S. District Court had to reverse a respected Bankruptcy Court Judge in the Southern District of New York who decided to the contrary.

The District Court decision on appeal makes it easier for lenders to recover the higher amount of interest once such an error is discovered. However, it does not eliminate all arguments by the borrower. The District Court remanded part of the case back to the Bankruptcy Judge for further consideration of some of borrower's arguments – for example, that the lenders had waived their rights to such interest or were estopped from claiming it based on positions they took in the bankruptcy case for example, their entering into debtor-in-possession financing, filing their proof of claim, and arguing several matters to the Bankruptcy Court.

The Adelphia loan documentation provided for "grid interest" – so named because the loan agreements contained interest rate spreads which varied depending on Adelphia's reported financial performance (i.e., its leverage ratio) as specified in a grid contained in the loan agreements. Adelphia's information turned out to be false, but the Bankruptcy Judge denied the lenders' claims for higher rates that would have resulted from the true financial data that was only discovered later. Bankruptcy Judge Gerber's decision in May of 2006 limited interest to that which would result from the borrower's reported information rather than accurate information. On appeal, U.S. District Judge Koeltl reversed the decision and remanded to the Bankruptcy Judge for further findings.

Bankruptcy Judge Gerber's original decision, that has now been reversed, had denied the claims of secured lenders seeking at least $187 million of "grid interest" that would otherwise have been owing had accurate prepetition financial information been reported by Adelphia. This original decision had been closely watched because it cast significant doubt on the effectiveness of grid interest provisions in loan agreements. Judge Koeltl's decision, on appeal, mitigates this doubt and provides greater certainty for market participants. Nonetheless, the controversy highlights the need for careful drafting of loan and credit agreements to explicitly provide for such adjustments, and to insulate against some of the arguments that were made in Adelphia (and that remain to be made now that the case has been remanded back to the Bankruptcy Judge for further findings). The borrower's arguments that initially succeeded in the Bankruptcy Court are likely to be raised in other cases. The arguments also included attempts to downgrade the claims for increased interest under the secured loans to unsecured status.

The Original Arguments

The secured lenders, whose allowed claims were to be paid in full under Adelphia's proposed plan, asserted that their claims also should include a retroactive increase for grid interest dating back to the pre-petition period in an amount ranging from $187 million to $300 million. The additional interest was claimed because Adelphia's leverage ratio, as reported on pre-petition quarterly compliance certificates, was inaccurate as a result of massive accounting fraud. When restated, the correct figures would have entitled the lenders to additional grid interest.

The Debtors and the official committee of unsecured creditors (the "Committee") objected to the secured lenders' claims asserting, among other things, (a) that the lenders were not entitled to additional grid interest under either contract or tort theories, and (b) that the lenders were estopped from asserting, or had waived, any entitlement to additional grid interest by failing to include such amounts in their original proofs of claim.

The Court's Original Decision

In the original decision, Bankruptcy Judge Gerber accepted the arguments of the Debtors and the Committee. With respect to the contract claim, Judge Gerber ruled that, based on the terms of the loan agreements, the lenders were not entitled to a retroactive interest rate adjustment merely because the information reported by Adelphia later proved to be false. The Bankruptcy Judge focused on certain specific language of the loan agreements which he believed unambiguously provided that the interest rate was calculated not on what the leverage ratio actually turned out to be, but merely based on what was reported by Adelphia in its compliance certificates. The loan agreements did provide for automatic readjustment of the interest rate in the event that Adelphia failed to provide compliance certificates at all. However, significantly for Judge Gerber, the agreements did not, by their terms, provide for any adjustment if Adelphia's compliance certificates proved to be inaccurate. Thus, the court held that there was no contractual remedy providing for the retroactive adjustment of interest sought by the lenders.

Actions of the lenders in arranging debtor-in-possession financing gave the Debtor (and the Judge) an additional rationale for denying the additional interest, and demonstrate another potential pitfall for lenders who roll their prepetition financing into debtor-in-possession financing. When the lenders provided debtor-in-possession financing to Adelphia, they agreed to waive any claim for default interest arising from prepetition defaults. Absent this waiver, the amount of default interest, if allowed, would have far exceeded the lenders' claims for additional grid interest.

In the decision below, Bankruptcy Judge Gerber also rejected tort claims of fraud or misrepresentation as a basis for the lenders' claims for additional grid interest. The Judge agreed that such claims, if proven, would have given rise to liability of Adelphia. However, the Judge found that such tort claims did not give rise to secured claims under section 506(b) of the Bankruptcy Code, which permits over-secured creditors to recover post-petition interest and reasonable fees, costs and charges if provided for in the loan agreements. In addition, the Bankruptcy Judge held that the tort claims did not give rise to damages for the lenders' expectancy with respect to the additional grid interest, but rather gave rise only to compensatory damages for the lenders' actual out-of-pocket loss, which the Judge equated to the outstanding principal amount of the lenders' claims. Since the lenders' claims are to be paid in full under Adelphia's plan, the Bankruptcy Judge found that the lenders will suffer no compensable damages.

Finally, because Judge Gerber determined that the lenders were not otherwise entitled to additional grid interest, he did not address the argument raised by the Debtors and the Committee that the lenders had waived any entitlement to such interest by failing to include such amounts in their proofs of claim.

The Court's Decision on Appeal

U.S. District Judge Koeltl overturned the original judgment of Judge Gerber based on a *de novo* review of the conclusions of law. Specifically, Judge Koeltl considered two main issues: (1) whether the lenders were entitled to grid interest based on the borrower's actual financial condition as opposed to the financial condition reported on the false compliance certificates; and (2) whether under the terms of the applicable loan documentation the parties agreed that the lenders would be limited to the remedy of default interest only in the event that false compliance certificates were presented to the administrative agent.

Turning to the first issue, Judge Koeltl held on appeal that the proper construction of the loan agreements entitled the lenders to grid interest calculated on the actual leverage ratio of the loan parties and not the materially false document delivered to the administrative agent (i.e., the compliance certificates). Judge Koeltl adopted this interpretation of the credit documents in order to give "full effect" to a variety of terms and other provisions in the credit documents, specifically:

(A) one of the disputed credit agreements provided that the compliance certificate must be "duly completed," while the other imposed a requirement that the certificate "demonstrate[e]" the leverage ratio of the borrower as calculated based on accurate financial statements prepared in accordance with GAAP and that the applicable margin would be adjusted accordingly; and

(B) other customary warranties and covenants in the credit documents provided, among other things, that the loan parties maintain financial records in compliance with GAAP (i.e., both credit agreements contained affirmative covenants that the applicable financial information furnished be prepared in accordance with GAAP; one agreement further provided that such information "present fairly the consolidated information of the Persons covered thereby," while the other required that such information "fairly present the financial condition and results of operation" of the borrower) and, further, that the loan parties provide the lenders and the agents with accurate financial information (e.g., one credit agreement provided that all written information so furnished …"will be true, complete and accurate in every material respect," while the other credit agreement provided that no factual information so furnished "...will contain any untrue statement of a material fact").

Judge Koeltl emphasized the incongruity of deciding otherwise: "[t]he fact that the [Adelphia] proposed interpretation of the Agreements results in less interest being owed in the event of alleged fraud than in the event of non-payment lends additional support to the Court's interpretation." It is fair to say that the lending community would applaud this common sense and purposive interpretation and the certainty that it brings.

Turning to the second main issue, Judge Koeltl rejected a weaker argument by Adelphia that default interest was the sole remedy of lenders for borrower's delivery of inaccurate compliance certificates. Unsurprisingly, the credit documentation did not indicate any intent that default interest was to be the exclusive remedy; to the contrary, it contained language that emphasized that default interest was not intended to be the exclusive remedy (e.g., so-called "no-waiver" of remedies clauses, which are widespread and customary in the loan market). On that basis, Judge Koeltl found that the lenders are entitled to recover standard expectancy damages due to the borrowers' breaches of their contractual obligation to report accurate leverage ratios in the compliance certificates delivered to the administrative agents, and such claims for additional grid interest constituted allowable secured claims under Section 502(b) of the Bankruptcy Code.

Judge Koeltl remanded the case to determine the equitable and judicial estoppel arguments of Adelphia (i.e., that the conduct of the lenders has precluded them from claiming the grid interest or have otherwise resulted in a waiver of their rights thereto). Thus, the litigation relating to these estoppel arguments will continue.

Lessons Learned

Lenders should pay additional attention to drafting loan agreement, proofs of claim, adequate protection agreements, and DIP loan facilities to expressly provide for appropriate remedies when borrower's information or compliance certificates are inaccurate, false or fraudulent. Lenders must continue to be careful to ensure that important contractual remedies remain available to them, that these provisions in loan documents are not ambiguous or merely implicit, and are not subject to misinterpretation or a finding that they have been waived. Fortunately, Judge Koeltl's interpretation of the loan documentation provides greater comfort for lenders that deception by loan parties will not, as a general matter, be rewarded. However, the decision does not foreclose these or similar arguments in other courts in the absence of protective drafting and prudent management of the credit.

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