

# Client Alert

A report  
for clients  
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of the firm      May 2006

## Attack On Grid Interest: *Adelphia* Bankruptcy Court Denies Lenders' Claims

In a recent decision by the United States Bankruptcy Court for the Southern District of New York in the Chapter 11 cases of Adelphia Communications Corp., *et al.* ("Adelphia" or the "Debtors"), Case No. 02-41729 (REG) (May 15, 2006), Bankruptcy Judge Gerber denied the claims of secured lenders seeking at least \$187 million of so-called "grid interest" which would otherwise have been owing had accurate pre-petition financial information been reported by Adelphia, and held that Adelphia was not required to establish a reserve for such claims under its proposed plan of reorganization.

### The Arguments

In *Adelphia*, the lenders' loan agreements contained interest rates 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 (hence, the term "grid interest").

The secured lenders, whose allowed claims will be paid in full under Adelphia's proposed plan, asserted that their claims 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 and, when restated, the correct figures would have entitled the lenders to additional 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 Decision

In the decision, 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 court focused on the specific language of the loan agreements which 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. Although the loan agreements did provide for automatic readjustment of the interest rate in the event that Adelphia failed to provide compliance certificates at all, significantly, 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.

The court's holding was of particular significance because the lenders, in connection with providing debtor-in-possession financing to Adelphia, agreed to waive any claim for default interest arising from pre-petition defaults. Absent this waiver, the amount of default interest, if allowed, would have far exceeded the lenders' claims for additional grid interest.

Judge Gerber also dismissed the lenders' claims for additional grid interest based on tort theories of fraud or misrepresentation. In so doing, the court agreed that such claims, if proven, would have given rise to liability for Adelphia. However, the court found that

such tort claims did not give rise to claims under section 506(b) of the Bankruptcy Code which permits oversecured creditors to recover post-petition interest on their claims and any reasonable fees, costs or charges provided for under the loan agreements. The court also held that the tort claims here 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 court equated to the outstanding principal amount of the lenders' claims. However, since the lenders' claims are to be paid in full under Adelpia's plan, the court 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.

### Lessons Learned

Lenders should take extreme care when drafting loan agreements and proofs of claim, and when negotiating adequate protection/DIP loan facilities, to ensure that important contractual remedies remain available to them (and are not inadvertently waived) when borrowers/debtors deliver false or inaccurate financial reporting. If you would like more information about the Adelpia decision or the steps you can take to protect against a similar result, please contact one of the attorneys in our Bankruptcy and Reorganization or Finance Practice Groups.

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