Hearing Date: November 8, 2004 at 10:30 a.m. (EDT)
Reply Deadline: November 5, 2004 (EDT)[1]
PORTLAND

UNITED STATES BANKRUPTCY COURT
DISTRICT OF MAINE

In re:	)	Chapter 11
	)	
PEGASUS SATELLITE TELEVISION, INC., et al.,	)	Case No. 04-20878 (JBH)
	)	(Jointly Administered)
Debtors.	)	

REPLY OF WILMINGTON TRUST COMPANY TO THE OBJECTION OF THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS TO MOTION BY WILMINGTON TRUST COMPANY FOR AN ORDER DIRECTING IMMEDIATE PAYMENT OF PREPAYMENT PREMIUM, ACCRUED DEFAULT INTEREST, AND INTEREST THEREON UNDER THE PEGASUS JUNIOR TERM LOAN CREDIT AGREEMENT

Wilmington Trust, by and through its attorneys, hereby files this reply (the "Reply") to the objection (the "Objection") of the Committee to the Premium Motion (the "Motion").[2] In support of this Reply, Wilmington Trust respectfully states:

PRELIMINARY STATEMENT

The Objection (i) fails to respond to critical elements raised in support of the relief sought in the Motion, (ii) employs a version of the "facts" that never occurred and (iii) contorts, and in some respects misrepresents, relevant authority to fabricate a challenge to the Motion. As a

[1] By agreement of the parties, the reply deadline was extended from November 3, 2004 at 4:00 p.m. to November 5, 2004 at midnight.

[2] Terms not otherwise defined herein shall have the meanings ascribed to such terms in the Motion.

result, with respect to the Prepayment Premium, there is no dispute that it is due and the only remaining questions are whether the Prepayment Premium is reasonable under section 506(b) of the Bankruptcy Code and what test the Court should employ to make the reasonableness determination. Similarly, with respect to Default Interest, the only issue remaining after discarding the Committee's ridiculous assertion that no risk of loss to the Junior Lenders ever existed is whether, considering all relevant facts, it would be equitable to the junior creditors to reduce their recovery by denying payment of the *de minimis* Default Interest.

As demonstrated in the Motion, the Prepayment Premium is due because the sale of the Debtors' satellite assets constituted a "Change of Control" under the Credit Agreement and the Committee did not contest this basis for relief. As further demonstrated in the Motion, the Debtors' payment of the Junior Lenders' Allowed Claim was a voluntary act done with the support of the Committee to curtail the accrual of interest on the Junior Term Loan. The Committee also failed to respond to this point in the Objection, relying instead on the absurd notion that the sale of the Debtors' satellite assets was somehow forced upon the Debtors and the Committee by the secured lenders and that case law supports a denial of prepayment premiums in such circumstances. The Committee's argument is without any legal support, is factually contradicted by the Committee's own claim in the Objection that they negotiated the sale (as well as the Committee's statement that the sale was a foregone conclusion from the outset of the case), and the pleadings and statements submitted by the Committee and the Debtors to the Court in connection with the Sale Motion and otherwise.

The issue raised by the Committee is also a complete red herring in the sense that major creditors in a bankruptcy proceeding always negotiate behind the scenes to try to maximize their recoveries – something that the Committee started to do with the secured lenders before taking

control of the sale negotiations. Accordingly, the issue of whether the Prepayment Premium is due is clearly not in dispute and the Court need only analyze whether the 2% Prepayment Premium is reasonable.

Given the overwhelming weight of authority and the misrepresented cases relied upon by the Committee, the question of what test to use to determine the reasonableness of the Prepayment Premium is an easy one to answer. As discussed at length in the Motion and as noted further below, the applicable standard that is supported by most courts is one derived from state liquidated damages law in which a court considers whether actual damages are difficult to estimate and whether the prepayment amount is not plainly disproportionate to the possible loss. In grasping at straws, the Committee ignores the myriad cases approving this liquidated damages analysis and attempts to characterize as black letter law the holdings of In re A.J. Lane and a few other dissimilar cases as creating a uniform standard of exclusively federal law that investigates actual damages and the mitigation thereof. As discussed in detail below, while the A.J. Lane court held that the analysis was one of federal law, it employed a standard from the Restatement of Contracts that is similar to the state liquidated damages test and simply looked to the question of actual damages in connection with its broader inquiry. Also as discussed below, applying an actual damages test is not realistically possible given the fungible nature of cash: such an analysis flies in the face of the common practice of the long established commercial lending market. When the 2% Prepayment Premium is subjected to the real analysis used by the majority of courts, it is eminently reasonable.

With respect to Wilmington Trust's claim for Default Interest, the Committee similarly resorts to mischaracterization of fact and tortured interpretation of relevant authority to conclude that a 2.5% increase in the base rate of interest is generally inequitable. The Committee claims

that the Default Interest is inequitable because it diminishes the recovery to junior creditors and doesn't satisfy the commonly used Sheppley factors because there never was a risk of loss to the Junior Lenders. As the Court is well aware from its multiple decisions denying the Debtors' repeated efforts to pursue the "cornerstone" litigation, there was a real risk of loss to all creditors in the case until the Court approved the sale of the satellite assets on August 26, 2004. The Committee's attempt to argue that such a risk did not exist is contradicted by many of its own statements throughout the case as well as its laughable assertion in the Objection that the secured lenders forced the Asset Sale.

In similar contradictory fashion, the Committee argues on the one hand that the payment of Default Interest involves a fact intensive analysis while on the other hand limiting the issues to be examined in such an inquiry to whether junior creditors will receive less if the Default Interest is paid to Wilmington Trust. Were the Committee correct, there would be a *per se* rule that default interest could not be paid in any situation where the estate was insolvent. No such rule exists. In a fact intensive analysis, all facts must be examined. Here, additional critical facts are that the senior bondholders (the only remaining unsecured creditors who will receive any recovery whatsoever) will receive significant recoveries in excess of sixty-five cents on the dollar, that the purchase price paid by many of the current senior bondholders was far below such recovery (another contention not challenged by the Committee), that the payment of the Default Interest will reduce recoveries to the senior bondholders by only 0.2%, and that all creditors junior to the senior bondholders, whether by contractual or structural subordination, will recover nothing regardless of whether the Default Interest is paid.

Another factor supported by relevant authority, including this Court when sitting in Rhode Island in Kalian, is that significant deference (indeed, a rebuttable presumption) is given

to the default interest rate contained in a contract, so long as it is reasonable. Even the Committee, despite digging up two easily distinguishable cases, cannot dispute that a 2.5% increase in the base rate is reasonable on its face. Accordingly, when all facts are considered, the equities weigh in favor of honoring the contractual arrangement between the Debtors and Wilmington Trust and paying the Default Interest.

Finally, in the event that the Court awards payment of the Prepayment Premium and/or Default Interest to Wilmington Trust, such amounts must include interest since the Payment Date at the Default Rate since, like the Change of Control trigger for the Prepayment Premium, the Committee chose not to interpose an objection to Wilmington Trust's request therefor.

REPLY

I. THE JUNIOR LENDERS MUST BE PAID THE PREPAYMENT PREMIUM

1. Regardless of whether the Debtors' payment of the principal and accrued interest on the Junior Term Loan was voluntary — and it is unquestionable that it was — the Asset Sale constituted a Change of Control as defined in the Credit Agreement and triggered the Debtors' mandatory obligation to prepay the principal, accrued interest, and the Prepayment Premium. Accordingly, the only questions currently before the Court with respect to the Prepayment Premium are whether it is reasonable and how to make that determination. Nevertheless, because the Committee goes to great lengths to perpetuate the myth that the secured lenders' behind the scenes conduct forced the Asset Sale upon all other parties in the case, Wilmington Trust is compelled to address the issue.[3]

[3] Given the pleadings and oral arguments submitted by the Debtors, DIRECTV, the secured lenders, and, notably, the Committee in support of the Asset Sale, it is obvious that the Asset Sale was a consensual transaction negotiated almost exclusively by the Debtors, DIRECTV, and the Committee. Accordingly, Wilmington Trust believes that the entire issue is irrelevant to the determination of whether the Prepayment Premium should be paid. However, given that the Committee claims in the Objection that the Asset Sale was coerced by the secured lenders, while at the same

A. **<u>The Debtors' Prepayment of the Loans was a Voluntary Act</u>**

2. The Debtors' actions in prepaying the Junior Term Loan were patently voluntary. They admitted as much when they stated "[i]t is unquestionably in the best interests of the Debtors and the Debtors' estates to pay the Prepetition Obligations as soon as possible. The Debtors calculate that interest is accruing on the Prepetition Obligations in the amount of approximately $1 million per week." <u>See</u> Prepayment Motion at 21. Of course, such a concern is precisely why prepayment premiums are negotiated into lending agreements at their execution—to compensate lenders for the loss of their bargained-for interest over the life of the loan and the expense in dollars and opportunity costs in locating alternative investments.

3. To frame the issue in the right context, it is imperative to recognize that the Asset Sale is separate and distinct from the Debtors' decision to prepay the funds. Once the Asset Sale closed, the Debtors were under no obligation to prepay the funds and they could have addressed the payment of the Junior Term Loan or its reinstatement as an obligation of a liquidating trust in connection with whatever plan they ultimately proposed in these cases. However, the Debtors — undoubtedly pressured by the Committee who recognized the economic benefit of paying the Junior Term Loan prematurely — took the affirmative step of filing an *emergency* motion and seeking the *permission* of this Court to make the prepayment. Contrary to what the Committee wants this Court to believe, the Debtors did not prepay the funds under protest. In fact, they did not even file a response to the Motion.

4. Yet, despite this clearly deliberate choice made by the Debtors, the Committee resorts to baseless allegations and blatant misinterpretation of case law to attempt to convince the

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time congratulating itself for negotiating the transaction, and asserting that the sale was a foregone conclusion at the outset of the case, confusion is understandable. Purely to clarify the record and correct the half-truths offered by the Committee, Wilmington Trust provides a detailed chronology of the "behind the scenes" events to which it was privy that preceded the Asset Sale in an Annex (the "<u>Annex</u>") appearing at the end of this Reply.

Court that the Junior Lenders' "behind-the-scenes" contribution to the successful conclusion of these cases should render an otherwise voluntary action involuntary. The Committee cites not one shred of case law or commentary to support the proposition that events outside of the courtroom and actions "behind-the-scenes" could have any bearing whatsoever on whether a debtor's actions are voluntary nor do they cite any support for their sleight-of-hand approach in attempting to equate the Asset Sale with the prepayment.

5. To prop up its weak case, the Committee does cite to cases such as In re Planvest Equity Income Ptrs., IV, 94 B.R. 644 (Bankr. D. Ariz. 1988), In re Duralite, 153 B.R. 708 (Bankr. D. Md. 1993), In re LHD Realty Corp., 726 F.2d 327 (7th Cir. 1984), and In re Pub. Serv. Co. of N.H., 114 B.R. 813 (Bankr. D.N.H. 1990) for the proposition that prepayment premiums may be disallowed as involuntary based on the actions of the lenders. However, there is no comparison between what Wilmington Trust did in this case and what the lenders did in the above cases. In both Planvest and LHD Realty Corp., the lenders affirmatively accelerated the underlying obligation. In Duralite, the lender lifted the automatic stay and liquidated its collateral to trigger the premium at issue there and in Pub. Serv. the lender filed various pleadings and sent multiple letters to the examiner stating its unequivocal opposition to any plan that did not pay off its claims immediately. Here, Wilmington Trust did no more than what every party in this case did, other than the Debtors (until finally persuaded by its litigation losses); namely, recognize that the only chance for recouping value was a sale of the Debtors' assets and negotiate to that end (albeit in a limited fashion by Wilmington Trust).

6. Furthermore, any attempt to characterize the actions of the Junior Lenders during the negotiations leading to the Debtors' Asset Sale as coercive is contradicted even within the Committee's own brief. While the Committee congratulates itself for "[t]he Committee's hard

work in achieving the Global Settlement," it simultaneously insists that Wilmington Trust "steer[ed] these cases to a forced sale." See Objection, ¶6 and ¶62. The contradiction is obvious. The settlement negotiations were entirely the work of the Committee and the Debtors, with only token involvement by Wilmington Trust. See Settlement Motion, ¶6 (stating that, "the Debtors and the Committee have negotiated a comprehensive Settlement") and Annex.

7. As noted in the Annex, Wilmington Trust, far from being the "behind-the-scenes" orchestrator of the Global Settlement, was intentionally prohibited from attending crucial meetings and ultimately was reduced to pleading with Committee counsel to share information regarding the progress of the negotiations. If anything, the constant setbacks in the Debtors' litigation strategy in this Court forced the Debtors to rethink their strategy and pursue a sale, which every other constituent in this case supported. Likewise, Wilmington Trust assumes — since it was locked out of the sale negotiations — that the Committee was also exerting pressure to move before the Court to sell the Debtors' assets without their approval because they too feared being completely wiped out.

8. The Committee also points to Wilmington Trust's undocketed draft motion as somehow compelling the Debtors to take action they would not otherwise have taken. First, the draft motion is written to include the Committee, the secured lenders and DIRECTV as co-movants. Second, the draft motion was prepared with the full knowledge and support of the Committee and was given to the Committee by Wilmington Trust not as a threat to sell, but in furtherance of the Committee and secured lenders' joint strategy of being prepared in the event that the Debtors refused to join the settlement negotiations. See Annex. This point is evidenced by the attached email communication sent on July 7, 2004, attached hereto as Exhibit A, from

Kristopher M. Hansen, Esq. to Richard Krasnow, Esq. and copying David Botter, Esq. Mr. Hansen writes in response to Mr. Krasnow's request to see the draft motion:

> "Unfortunately, we understand that material open issues remain on the settlement and subscriber sale between DTV and the Committee and that discussions between the two of you are continuing on that front as well as with respect to the inclusion of the Debtors in the deal. As a result, we are not in a position at this time to circulate a document [the draft motion] that could have an impact on those discussions."

This is clearly not the action of a party intent on forcing others to comply with its wishes.

9. In addition, the Debtors themselves repeatedly described the Asset Sale as "in the best interests of the Debtors' estates." See, e.g., Settlement Motion, ¶26. The Junior Lenders have been unable to find any case law which supports the proposition that unfiled pleadings can cause a sophisticated debtor represented by experienced counsel to commit a wholly involuntary act, and the Committee has apparently recognized this, as they cite none. In reality, the assertion by the Committee that the Asset Sale was the secured lenders' doing is a complete farce.

10. To conclude this meaningless issue, the Committee describes in detail the choice before the Debtors when they ultimately decided to prepay the Junior Term Loan. As the Committee states, "the Debtors were faced with the dilemma of either (i) … paying substantial interest to the Secured Lenders … or (ii) paying the Loans with the proceeds of the sale." See Objection, ¶ 69. The fact that choices were available to the Debtors unequivocally refutes any argument that payment was involuntary. In In re Imperial Coronado Ptrs., Ltd., 96 B.R. 997 (B.A.P. 9th Cir. 1989), the Ninth Circuit describes a similar situation in which a debtor was faced with either reinstating a loan it could not afford or selling property that would create a prepayment obligation. The court was not swayed by the fact that the debtor did not want to reinstate the loan and held that a "conscious decision" in the face of alternatives renders any

decision voluntary. Id. at 1000. The instant case presents a similar situation. The Debtors had other options, even though less attractive, and made an affirmative choice based on sound business judgment to prepay their bank debt obligations. Indeed, in yet another inconsistency, the Committee opines that the Debtors would have breached their fiduciary duty to their unsecured creditors if they had not prepaid the Junior Term Loans. See Objection, ¶ 69. The Committee now wishes to escape from the contractual consequences of that decision and resorts to chicanery in place of sound legal argument.

B. State, not Federal, Law Governs the Reasonableness of the Prepayment Premium and it is Reasonable Under a New York Liquidated Damages Analysis.

11. The Committee argues that section 506(b) of the Bankruptcy Code requires this Court to disregard the question of whether the Prepayment Premium is enforceable under a state law liquidated damages analysis and consider only whether the Prepayment Premium is enforceable under a federal law "actual damages" approach. However, the Committee ignores the fact that the overwhelming majority of courts apply both state liquidated damages law and federal bankruptcy law and that only a distinct minority of cases interpret the federal law component of that test as different than the state law test. See, e.g., In re Vanderveer, 283 B.R. at 122 (Bankr. E.D.N.Y. 2002) (applying both state and federal law); In re Fin. Ctr. Assocs. of E. Meadow, L.P., 140 B.R. 829, 839 (Bankr. E.D.N.Y. 1992) (applying both New York state law and § 506(b)). Section 506(b) of the Bankruptcy Code does not compel a complete disregard for state law concepts of reasonableness. Instead section 506(b) of the Bankruptcy Code has been characterized as a "safety valve" that must be used "cautiously and sparingly." In re Fin Ctr., 140 B.R. at 839.

12. Any sound legal analysis of a prepayment premium must first apply state liquidated damages law. The Credit Agreement contains a choice of law provision applying

New York state law, under which "actual damages" have been held to be irrelevant to the determination of reasonableness. See United Merchs. 674 F.2d at 142. Therefore, despite the Committee's insistence upon the "actual damages" approach, the Prepayment Premium must be examined as a liquidated damages provision under New York state law. In Heller, the Second Circuit held that: "Under New York law . . . the actual damages suffered by the party for whose benefit the clause is inserted in the contract have little relevance to the validity of a liquidated damages clause." Walter E. Heller & Co. v. American Flyers Airline Corp., 459 F.2d 896, 898-99 (2d Cir. 1972). Accord, United Merchs., 674 F.2d at 142-43.

13. The Committee relies principally upon In re Duralite, In re Morse Tool, Inc., 87 B.R. 745 (Bankr. D. Mass. 1988) and In re A.J. Lane & Co., Inc., 113 B.R. 821 (Bankr. D. Mass. 1990) for the establishment of an exclusively federal law test, under which actual damages must be established in an amount equivalent to the prepayment premium or the premium will be held unreasonable. In making its case, the Committee ignores the fact that there is no controlling authority that binds this Court to apply an actual damages analysis. The Committee also ignores the myriad cases supporting the application of a state law liquidated damages analysis to make the section 506(b) reasonableness determination and fails to take the Court through a detailed analysis of Duralite, Morse and A.J. Lane. Such an analysis shows that the actual damages test is wholly inapplicable to complex commercial loan situations and demonstrates that the decisions reached in each case to reject the prepayment premiums at issue were based on more than the failure of the premium to approximate actual damages.[4] Indeed, in the final outcome, the "actual

[4] It is also questionable whether the "actual damages" found by these Courts can even realistically approximate the real actual damages faced by a lender, which could only be determined by having a lender return to court with evidence after having reinvested the payment and after sufficient time to have such investment yield a return. Clearly, the "actual damages" test is not a true test of real damages and is no more reliable than any other theoretically based examination.

damages" test may have limited applicability to simple, small-scale lending arrangements in which loan agreements are rarely the product of negotiation between lender and borrower. However, the state law liquidated damages analysis is the only realistic way in which to assess the reasonableness of premiums in commercial, complex situations involving large sums of money and significant negotiation by sophisticated parties.

14. For example, in Duralite, a chapter 7 case, the premium at issue was triggered upon early payment, breach or default of a $2.5 million loan and was calculated by determining the prior six months of charges under the agreement from the trigger date, multiplying such sum by the remaining life of the loan, and dividing such number in half. After Duralite Truck and Body & Container Corp. and its affiliate filed for chapter 7 protection, the lender, Fidelcor, moved to lift the automatic stay and liquidate its collateral. The court granted Fidelcor's motion, and the collateral was liquidated. The liquidation paid Fidelcor in full and Fidelcor sought its prepayment premium as a result of paying itself from the liquidation proceeds. Using the contractual formula, the premium amounted to 34% of the total amount paid to Fidelcor. After analyzing state law liquidated damages cases and determining that the premium was reasonable thereunder, the Duralite court determined that the legislative history to section 506(b) of the Bankruptcy Code imposed a federal standard on attorney's fees, but gave no reference for what law should apply to contractual charges like prepayment premiums. See Duralite, 153 B.R. at 713. The Duralite court then decided that it was compelled to apply only federal law in analyzing charges under section 506(b) of the Bankruptcy Code, and concluded that the federal law test should compare the market rate of interest at the time of the prepayment to the contract rate of interest and multiply the difference by the time left on the loan and then discount the figure to present value. Id. at 714. The Duralite court then subjected the premium at issue in the

case to its new formula and found that the result was lower than the 34% contract premium and found it to be unreasonable. Id. In reaching its holding, however, the court stated:

> Fidelcor has not claimed actual damages. Indeed the nature of Fidelcor's contractual interest rate, a floating rate based on the prime rate, rather than a fixed rate, would suggest it is unlikely Fidelcor could show actual damages. Additionally, there is no suggestion Fidelcor could not have reloaned the monies it collected to other customers at a similar floating rate based on the prime rate at the time of early payment. Finally, it was Fidelcor that prompted the prepayment by its collection efforts. Fidelcor initiated its efforts in these cases by filing motions for relief from stay. Where the lender has exercised its option to accelerate upon default, the economic justification for a prepayment premium as alternative performance of the bargained loan is negated.

Duralite, 153 B.R. at 715.

15. To say that Duralite is different from the instant case is an understatement. Clearly, critical components of the Duralite court's decision to deny the premium do not exist in this case, such as Fidelcor's liquidation of the collateral that actually triggered the payment, the ridiculously high 34% premium amount and the floating rate of interest on Fidelcor's loan. Concerned about these elements, the court clearly went to great lengths to void the premium. In addition, due to the simplicity of the loan, lender and relevant market, the calculation of actual damages in Duralite under the court's formula was relatively simple and likely inaccurate. See Footnote 3 above.

16. However, the current situation, involving the prepayment of a $100 million term loan with interest split between payment in kind and cash pay that was made by a sophisticated group of investors to a complex nationwide satellite television provider with an otherwise enormous and complex capital structure just isn't the same as the basic "Mom & Pop" situation confronted in Duralite and the other cases relied upon by the Committee. Indeed, as other cases have noted, the application of the Duralite actual damages test to a sophisticated situation isn't

likely to yield a consistent or accurate result. See Fin Ctr., 140 B.R. at 836-37 ("It is obvious that this language does not set forth a mechanical formula such that everyone applying it will arrive at precisely the same result . . . . There is no one right formula."). For example, determining an appropriate discount rate is not an easy task, nor is the establishment of the prevailing market rate, as it involves finding companies in similar industries involving similarly structured loans for similar amounts with similar durations. In sum, the actual damages test may be a workable solution for some small situations, but it simply doesn't work for large complex ones. That is why the cases addressing commercial lending situations apply a state law liquidated damages analysis that relies upon the soundness of the premium clause existing at the time that the loan agreement is entered into. See Walter E. Heller & Co. v. American Flyers Airline Corp., 459 F.2d 896 (2d Cir. 1972); United Merchs. and Manfrs, 674 F.2d 134 (2d Cir. 1982); In re Financial Center Assocs., 140 B.R. 829 (Bankr. E.D.N.Y. 1992).

17. In re Morse Tool, like Duralite, is simply inapplicable to the case at hand. In Morse, the court applied both state liquidated damages law and an "actual damages" federal bankruptcy law test to determine the reasonableness of a $173,096.13 prepayment premium on a loan of $3.8 million dollars. In re Morse Tool, 87 B.R. at 749-50 (Bank. D. Mass. 1988) ("§506(b) does not supplant state law, rather it supplements state law"). Further, the Morse Tool chapter 7 debtor company was a considerably smaller organization than the Debtors' exceedingly complex structure, and its loans were likewise simple by comparison. While the actual damages approach may have been practicable in such a situation, the large commercial loans which the Debtors have prepaid are simply beyond the scale of such a rote, mechanistic formula.

18. But the Committee relies most heavily on In re A.J. Lane & Co., Inc., 113 B.R. 821 (Bankr. D. Mass. 1990), which represents an outlying and minority viewpoint, and is a decision that many courts have criticized as overly simplistic and lacking an analysis of many factors other than contract rate and market rate that can affect the determination of damages. See Carlyle Apts. Joint Venture v. AIG Life Ins. Co., 635 A.2d 366, 371 (Md. 1994) (describing A.J. Lane's test as "greatly oversimplified"); In re Fin. Ctr., 140 B.R. at 837 (Bankr. E.D.N.Y. 1992) (illuminating problems with A.J. Lane's approach and pointing out the many considerations it omits); In re Vanderveer, 283 B.R. at 133 (Bankr. E.D.N.Y. 2002) (distinguishing A.J. Lane and applying state liquidated damages analysis); see also In re United Merchs., 674 F.2d 134 at 142 (2d Cir. 1982). The A.J. Lane actual damages analysis is simply insufficiently nuanced to be appropriate for usage in the Debtors' complex chapter 11 cases and is more likely to be useful in the handling of less complicated bankruptcies such as Kroh Bros. (single-asset estate composed of one piece of real property), or Imperial Coronado (original loan of $825,000).

19. In A.J. Lane, the court chose to measure actual damages based on the application of federal law **only**, a distinct minority position. The application of federal law without prior consideration of state law causes this decision to remain an outlier among courts that have decided the reasonableness of prepayment premiums. As demonstrated above, the vast majority of courts first apply state law. See, e.g., In re Lappin Elec. Co. Inc., 245 B.R. 326 (Bankr. E.D. Wis. 2000) (applying two-prong test using both state and federal law); In re Skyler Ridge, 80 B.R. 500 (Bankr. C.D. Cal. 1987) (applying both state and federal law); and other cases cited in the Motion.

20. However, even if this Court decides to follow the A.J. Lane approach, the Prepayment Premium should nonetheless be upheld. The A.J. Lane court adopted an "actual

damages" test, which included a two-pronged approach based on section 356(1) of the Restatement of Contracts (the "Restatement Test"). The Restatement Test examines whether the amount of damages: (i) is reasonable in light of either the anticipated or actual loss caused by the breach, and (ii) adequately accounts for the difficulties of proof of loss. The A.J. Lane court focused intensely on the actual damages portion of the first prong of their Restatement Test, holding that a showing of reasonableness was dependent on meeting this particular standard. See A.J. Lane, 113 B.R. at 829. Notably, however, the "anticipated loss" alternative provided for in the Restatement Test itself is markedly similar to many state liquidated damages tests, which the majority of courts would apply in this case. Under the New York liquidated damages test, prepayment provisions are enforceable as liquidated damages where: (i) actual damages may be difficult to determine; and (ii) the sum stipulated is not plainly disproportionate to the possible loss. United Merchs., 647 F.2d at 142. As set forth in the Motion, the Prepayment Premium is eminently reasonable under this test.

21. In any event, like every other material case relied on by the Committee, A.J. Lane is factually inapposite to the case at hand. In A.J. Lane, the premium at issue was contained in two separate mortgage notes: a refinance note for $1.3 million and a construction note for $1.1 million. It is simply unreasonable for the Committee to ask the Court to compare a complex $100 million multi-lender loan with the relatively straightforward refinancing and construction notes at issue in A.J. Lane. In addition, upon the prepayment event, the lender's base rate in A.J. Lane was 10.5%, having risen from 7.5% the date the refinance note was executed and from 8.5% the date the construction note was executed. Such increases are a critically important fact, that likely enabled the A.J. Lane court to argue that the lender did not suffer any actual damages by the prepayment. Here, the market interest rate for second lien loans of comparable size and

duration to companies with credit ratings equivalent to the Debtors' has actually decreased since the Junior Term Loan was made. See Affidavit of Mr. Skip Victor (the "Second Victor Affidavit"), attached hereto as Exhibit B. If the Junior Lenders attempted to reloan the prepaid principal today, they would be unable to achieve the same rate of return in an investment at the same level of risk, even assuming such an investment were available (let alone be able to find a fixed rate loan like the Junior Term Loan). And as discussed herein, the approach used in A.J. Lane would fail to consider the myriad of other factors the Junior Lenders would have to consider when reloaning funds, such as: the cost and expense of procuring a new loan, the applicable rate of return, the collateral value, and various other attendant risks and uncertainties. Regardless, as the A.J. Lane court stated, "[i]f the loan is at a fixed interest rate, and market interest rates are lower at the time of prepayment, the lender does suffer a loss from prepayment." Id. at 826. Thus, by the standards expressed in A.J. Lane, the Junior Lenders will nevertheless incur actual damages since the Junior Term Loan was a fixed rate loan.

22. Furthermore, by choosing to prepay the Junior Term Loan, the Debtors themselves proved "actual damages." If the Debtors could have reinvested the sale proceeds at a rate higher than the interest rate on the Junior Term Loan, they surely would have done so and retained the spread as profit. Rather, they (or more likely the Committee) recognized that the economics were better — and correspondingly worse for the Junior Lenders — to prepay the funds at that time, well in advance of plan formulation, let alone confirmation. Much like the Junior Lenders, in today's market the Debtors will be unable to find a non-speculative investment with a yield over 12%.

23. The Committee seeks to invalidate the Prepayment Premium because they believe, in hindsight, that the Debtors made a bad business decision. If this Court were to

validate such a position, it would not only negate basic notions of the freedom of sophisticated parties to enter into binding contracts, it would provide an incentive to borrowers to gamble with a lender's money: should interest rates rise, a debtor would honor the terms it negotiated. If, however, interest rates declined, a debtor would move to invalidate the prepayment premium.

C. **The Junior Lenders Are Under No Obligation to Mitigate and Any Such Analysis is Irrelevant**

24. The final point raised by the Committee, regarding the lack of "mitigation" on the part of the Junior Lenders, is absurd. There is no case law demonstrating that lenders who have been prepaid must mitigate their damages before a prepayment premium can be calculated, and the Committee has cited none on point. Indeed, A.J. Lane recognized the possibility of a "time lag" before an appropriate reinvestment vehicle could even be found and acknowledged the loss of profits that could be caused by substitute investment vehicles with lower rates of return. A.J. Lane, 113 B.R. at 829.

25. Additionally, there will be considerable difficulty in proving the exact amount of the loss to each of the Junior Lenders. Were the Court to adopt the Committee's standard, the ultimate amount of loss would be virtually impossible to determine. Sophisticated investors place funds into different investment vehicles, all with different risk profiles and timelines for producing a return. Aside from the practical difficulty of attempting to track prepayment proceeds through multiple investments, it is unclear what risk-adjusted rate of return or time frame would be employed to calculate whether an investment provided a return that would reduce the actual damages suffered by being paid early on the Junior Term Loan. If a lender uses loan proceeds to buy equity in a long term investment, does the lender then have to wait years for the equity investment to reap a profit before it can find out whether it will be entitled to a prepayment premium? Surely, this cannot be the test.

26. Should the Court follow the Committee's logic and adopt a standard requiring the demonstration of actual damages and mitigation thereof in the same amount as a pre-negotiated prepayment premium as a prerequisite to payment thereof, it would not only ignore clear contractual provisions and make new law, but it would reverse years of established lending practice to the detriment of corporate borrowers. Prepayment premiums are negotiated when the loan is originated to provide for circumstances that may occur in the future but are true uncertainties at the time the loan is made. If such a high evidentiary threshold were created, lenders would no longer include prepayment provisions in loan agreements and would instead simply charge higher interest rates to minimize the risk of not receiving payments for the life of the loan.

II. ACCRUED DEFAULT INTEREST UNDER THE CREDIT AGREEMENT MUST BE PAID

27. As a starting point, the Committee ignores the importance of the interest rate contained in the Credit Agreement. As many courts have noted, there is "a presumption in favor of the contract rate subject to rebuttal based upon equitable considerations." See In re Kalian 178 B.R. 308 at 314 (Bankr. D.R.I. 1995) and cases cited therein. The Committee and Wilmington Trust agree, however, that the appropriate standard by which to test this rebuttable presumption in favor of the contract rate is a balancing of the equities through intensive examination of all relevant facts. While paying lip service to the evaluation of all facts, the Committee actually relies only upon the application of two of the five factors from In re W.S. Sheppley & Co., 62 B.R. 217 (Bankr. N.D. Iowa 1986) – risk of loss to the lender and harm to unsecured creditors – and flatly misrepresents the facts of this case to shoehorn its argument into compliance therewith. Clearly, however, as many courts, including this one, have noted the "Sheppley factors are neither exclusive nor exhaustive." Kalian, 178 B.R. at 317, n. 19;

Objection at ¶ 39 (citation to Southland Corp.). Based purely on the Sheppley factors, payment of the Default Interest is reasonable, but when all facts are considered payment of the Default Interest is practically mandated.

28. With respect to the "risk of loss," it is unquestionable that the Junior Lenders faced a real and imminent risk of nonpayment all the way up to the Court's August 26th approval of the Asset Sale, and no one is more familiar with this reality than this Court, which entertained the Debtors' onslaught of litigation against DIRECTV. The Committee's arguments to the contrary are inaccurate and disingenuous. As the August 31 deadline approached, the Junior Lenders were provided with little comfort by the Debtors (or anyone else, including the Committee, whose reports from closed doors meetings were sparse) that they would accept and close a deal with DIRECTV (or any other buyer) prior to that deadline.[5] In fact, within the first week of this case, counsel for the Debtors unequivocally rejected the prepetition offer from DIRECTV and stated in court that "they [DIRECTV] made us an offer which ***we flatly reject***." See Transcript of June 4, 2004 Hearing, p. 66 of 70 (emphasis added).

[5] The Committee's argument that the Junior Lenders' recoveries were not at risk, since they knew that the Committee was negotiating with the Debtors and DIRECTV in July and thus a deal would get done that would have paid the Junior Lenders in full, also cannot be supported. First, those negotiations did not start until late June/ early July, after the default, bankruptcy filing and commencement of the Debtors' slash and burn litigation strategy. At no time was counsel to Wilmington Trust permitted to participate in the (Committee, Debtors and DIRECTV) settlement discussions. Indeed, the Committee (not DIRECTV or the Debtors) actually insisted on excluding the Junior Lenders from such discussions and the Junior Lenders were only given intermittent progress reports after repeated requests for information. Indeed, in an email attached hereto as Exhibit C, sent on July 12, 2004 from Mr. Krasnow, counsel to DIRECTV, to Mr. Hansen, *et al*., Mr. Krasnow states:

> "Tomorrow's meeting has been moved to Sidley's offices. Pegasus will be meeting with the committee at 9:30 and the DIRECTV meeting will start at 11. We understand that, at the committee's request, the lenders will not be participating. While we believe that, if this is to be a broad ranging meeting, all constituencies should be present, this isn't our call."

See Exhibit C. Second, by being left in the dark as the August 31 deadline approached, Wilmington Trust had little comfort that a deal would get done.

29. While the docket history is compelling evidence of the risk that no deal with DIRECTV would be done, the numerous and repeated statements by the Committee in its motion in support of the Global Settlement (the "Committee Support Motion") and on the record before this Court, demonstrate clearly that the Committee felt the same risk. The following are excerpts from the Committee Support Motion and the Hearing Transcript from August 25, 2004:

- "[A]lmost **as soon as it was formed**, the Committee was greatly concerned that the Debtors' litigation strategy combined with the August 31 deadline would mean that the unsecured creditors of these cases would be left with a litigation claim that did not have a great deal of value." David Botter, Esq., Committee Counsel, August 25, 2004 Hearing Transcript at 53 (emphasis added).

- "[T]he Debtors now seek to maximize the value of their estates through the implementation of an integrated global settlement … which ensures **guaranteed** value is obtained for … the Debtors' Satellite Assets – assets that could be rendered **valueless** as soon as August 31, 2004." Committee Support Motion, ¶2 (emphasis added).

- "[The Debtors] are facing the potential for **termination of their business** one week from today." David Botter, Esq., Committee Counsel, August 25, 2004 Hearing Transcript at 54 (emphasis added).

- "Pegasus' primary business – the distribution of DIRECTV DBS Services – faces an **uncertain future** on August 31, 2004. On such date, Pegasus' ability to continue to distribute DIRECTV DBS Services to its approximately 1.1 million subscribers may cease. . . . " Committee Support Motion, ¶3 (emphasis added).

- "Failure to pursue this settlement would have been a **complete and total abrogation of our fiduciary duties**. . . . [The settlement] is the best, only and last opportunity for these estates to maximize value." David Botter, Esq., Committee Counsel, August 25, 2004 Hearing Transcript at 55 (emphasis added).

- "Concerned about the **desperate** situation facing the Debtors and these estates as a result of recurring litigation defeats, increasing customer defections and the looming August 31 termination date . . . the Committee . . . commenced negotiations . . . ." Committee Support Motion, ¶4 (emphasis added).[6]

- "Given … (iii) the **dissipating** value of these estates, the Debtors and the Committee … agreed to the Global Settlement." Committee Support Motion, ¶24 (emphasis added).[7]

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[6] This statement also demonstrates that the Junior Lenders didn't "force" any settlement on the Committee and the Debtors.

[7] See Footnote 5 above.

- “By effectuating the Global Settlement, the Debtors and the Committee are … (iii) enabling substantial value for the benefit of creditors to be obtained for the Debtors’ primary assets which, for all practical purposes, may be substantially **worthless** less than two weeks from today [August 20, 2004].” Committee Support Motion, ¶28 (emphasis added).

- “This case involves Debtors whose assets are the quintessential melting ice cube.” Committee Support Motion, ¶45.

- “[e]xponentially more ominous, is the fact that Pegasus may lose its ability to distribute DIRECTV programming as of August 31, 2004. This will result in a **precipitous drop** in the value of the Debtors’ estate.” Committee Support Motion, ¶57. (emphasis added).

As these statements show, the Committee also feared a risk of loss. The collapse it was concerned about would have meant a loss of value for all parties, not just the senior bondholders but also the Junior Lenders who were structurally and contractually subordinated to over $400 million of senior secured debt. The Committee cannot have it both ways.

30. Any impact of payment of Default Interest on the junior creditors will be minimal. With respect to the return to the junior creditors, the Committee again misrepresents the situation and ignores many critical facts for the fact intensive analysis. The Committee failed to mention (and failed to challenge) that (i) the senior bondholders will receive a recovery of over sixty-five cents on the dollar and many senior bondholders bought at prices far below such recovery (ii) paying Default Interest will reduce the recoveries paid to the senior bondholders by approximately 0.2% and (iii) all creditors below the senior bondholders in priority will recover nothing <u>regardless</u> of whether the Default Interest is paid. Moreover, the Committee’s own actions undermine the integrity of their argument. The balancing of the equities does not involve the question of whether senior bondholders will be paid the original face amount of their claims. Rather, the inquiry entails the question, in a fact intensive analysis, of whether such creditors will receive a windfall or be truly harmed by payment of Default Interest to the Junior Lenders.

Indeed, the balancing is now between enforcing the terms of the Credit Agreement and section 506(b) of the Bankruptcy Code and providing distressed investors with an opportunity to further their already significant upside.

31. The Committee also unwittingly argues in support of payment of the Default Interest in its discussion of the only other Sheppley factor that it chooses to include in its analysis by stating that it will show that significantly higher rates of interest than those cited in the Victor Affidavit (referring to the First Victor Affidavit submitted in support of the Senior Lenders' Motion) are currently available for companies comparable to the Debtors. Since the Committee failed to supply support for this statement, Wilmington Trust assumes that the Committee will show that a lender could currently obtain a higher rate of interest than the non-default rate of interest contained in the Credit Agreement on a loan made to a borrower *in extremis*. If so, then Sheppley and its progeny actually support the payment of the higher contract default rate. It is only where the prevailing market rate is lower than the contract default rate that Sheppley would support a denial of the payment of a higher default rate of interest in favor of the lower non-default rate. In addition, the key to the proper application of this Sheppley factor is the determination of the rate of interest being offered to companies in a similar position to the Debtors at the time of default. Here, at the time of default, which was a day before the bankruptcy filing, the contracts that permitted the Debtors to operate their business were terminated, the Debtors were given a three month lifeline, and had days left to post a bond in order to appeal a $60 million jury verdict recently entered against them. Under these circumstances, it is hard to imagine that any lender would make a loan to such a borrower, let alone one that was subordinate to over $400 million of structurally and contractually senior bank

debt and secured by a second lien on the stock of an intermediate holding company.[8] The Committee needs to grasp reality instead of straws.

32. To conclude the discussion of Sheppley, given the obvious risk of loss witnessed by the Court, it is clear that the third factor – whether the justification proffered for an increased post-default rate (increased risk of loss) was borne out by the facts of the case – is easily satisfied. In addition to the many other facts previously discussed which support the very real risk of loss, the outcome of these cases was so unclear that prices for the Debtors' senior bonds dipped all the way to 36 cents on the dollar. When the Asset Sale was finally negotiated by the Debtors and Committee, the notes soared to their present value in the mid-to-high 60 cents on the dollar and trading in the senior bonds has slowed substantially, since the savvy investors know full well that value will no longer decline. The money is literally in the bank.

33. Finally, given the expeditious bankruptcy proceedings and Wilmington Trust's complete non-interference therewith, the final Sheppley factor (which isn't even noted by the Committee) – whether the lender caused a delay by engaging in unnecessarily obstructive tactics – is also easily satisfied. Accordingly, under a pure Sheppley analysis, the payment of Default Interest is equitable and there is absolutely no basis to rebut the presumption in favor of the contract rate.

34. Like its analysis of the Sheppley factors, the Committee's "analysis" of allegedly relevant authority is less than compelling. To support its assessment that a 2.5% increase from the base rate to the default rate is unreasonable, the Committee relies heavily on Kalian, and unearths In the Matter of Timberline, 136 B.R. 382 (Bankr. D.N.J. 1992) and In re Cummins Util., L.P., 279 B.R. 195 (Bankr. N.D. Tex. 2002) to rebut the myriad cases cited in the Motion

[8] This position is factually supported by the Second Victor Affidavit.

approving significantly higher default rate increases. While the legal theories espoused in these cases are generic and support the legal standards discussed in the Motion and Objection, they are so factually dissimilar to the instant situation that they are of limited value in weighing the facts of this case and making the reasonableness determination.

35. First, the Committee's rampant cherry-picking of quotes from Your Honor's decision in Kalian is a blatant attempt to make the facts of that case applicable to this one. However, as Your Honor is well aware, the facts in Kalian are completely inapposite to the situation here. There is simply no way to compare a lender with a $40,000 note and an 18% default rate with a sophisticated bank group with a $100 million loan and a 2.5% default rate. In addition, the lender's collateral in Kalian was well protected, the lender was never at a serious risk of nonpayment, and the junior creditors would not have received a meaningful recovery if the default interest had been awarded. Here, approval of the 2.5% Default Interest would barely make a dent in the $450 million of expected recoveries to the senior bondholders. In addition, as set forth in greater detail herein, contrary to the Committee's ridiculous assertion, the Junior Lenders' collateral was anything but well protected, especially as the Debtors' purported "prized asset" — its customer base — was eroding at an alarming rate.

36. The Committee has also failed to show that the Default Interest sought by the Junior Lenders is unreasonable. The Committee only cites to *two* cases in which a default rate in the range of 2.5% was not awarded and both of those cases are easily distinguishable from the current situation. By contrast, the Junior Lenders have cited to numerous cases that hold that default interest in the range of 2.5% is eminently reasonable.

37. Despite what the Committee wishes to be true, the court in In the Matter of Timberline *did not* hold that the 3% default rate was inequitable. Timberline, 136 B.R. at 386.

In fact, this decision backfires on the Committee and actually supports the Junior Lenders' position that a 2.5% default rate is reasonable. In Timberline, payment of default interest was denied because the lender testified that the very purpose of the default interest clause was to "coerce prompt payment" by the debtor. Id. In Timberline, the lender's note was for $840,000 and accrued interest at 12% and the court acknowledged that had the intent of the lender not been to coerce payment from the lender, it would have likely awarded the default interest since the 3% rate was reasonable. Id. The Committee's reliance on this case is simply wrong.

38. In re Cummins Util., L.P., 279 B.R. 195 (Bankr. N.D. Tex. 2002) is also factually inapposite to the current situation. Much like in Kalian, default interest was denied in Cummins because the recovery to unsecured creditors was less than 10 cents on the dollar and the lenders had failed to put other parties on notice of their intent to seek default interest. Cummins, 279 B.R. at 203. In that case, the court went through an equities analysis and was swayed by the fact that despite many opportunities to do so, the lenders waited over a year to charge default interest and never put the debtors on notice of their intention to do so. Cummins, 279 B.R. at 202. Here, Wilmington Trust made it very clear from the outset that it intended to seek Default Interest and the Stipulation reflects such understanding. Furthermore, the senior bondholders' very meaningful recovery of approximately 65-70 cents on the dollar here stands in stark contrast to the limited recovery available to creditors in Cummins.

39. In addition to the abundant case law that establishes the reasonableness of the Credit Agreement's default rate, the Second Victor Affidavit demonstrates that the Default Interest rate approximates the market rate for similar loans with borrowers in similar circumstances. Thus, it bears a reasonable relationship to the actual or projected loss as a result of nonpayment.

CONCLUSION

For the foregoing reasons, Wilmington Trust on behalf of the Junior Lenders respectfully requests that the Court overrule the Objection and enter an Order, directing immediate payment of the Prepayment Premium and Default Interest, and interest thereon at the Default Rate, and such other and further relief as this Court deems appropriate and just.

Dated: November 5, 2004

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