Electronic Arts Indentures Raise Questions About Default Interest, Efficient Breach

April 16, 2026

Why do parties rarely pursue an efficient breach of contract, even when the economic incentives appear in favor of doing so? We found ourselves asking this question while reading Octus's recent coverage of the defeasance provisions in Electronic Arts' indentures. Octus's analysis contemplates whether Electronic Arts could avoid paying a change in control premium of approximately $25 million to its existing bondholders in connection with its pending $55 billion all-cash leveraged buyout.

Without stating a position on who would have the better of the arguments on whether the premium would be due, the scenario underscores a broader strategic question: where litigation would likely proceed in New York courts and could take years to resolve, why do issuers so infrequently test the bounds of their contractual obligations? This question leads to a less commonly examined aspect of New York civil procedure that could have meaningful implications for bond issuers when contemplating a potentially efficient breach.

The Intersection of New York Prejudgment Interest and Contractual Default Interest

An efficient breach is one in which a contract counterparty determines that it is more cost-effective to intentionally breach and pay damages than to perform. Rights to specific performance aside (which are generally unavailable where money damages are an adequate remedy), New York law discourages this conduct by providing the nonbreaching party with statutory prejudgment interest—a rough approximation of the time value of money withheld as a result of the breach.

Under New York Civil Practice Law and Rules ("CPLR"), a judgment for breach of contract will accrue interest at 9% per year from the date of the breach through entry of the judgment (i.e., the "statutory rate"). In the indenture context, the New York Court of Appeals explained in *NML Capital v. Republic of Argentina* that "[i]f the parties [to a contract] failed to include a provision in the contract addressing the interest rate that governs after principal is due or in the event of a breach, New York's statutory rate will be applied as the default rate." The purpose of prejudgment interest "is to compensate

the creditor for the loss of use of money the creditor was owed during a particular period of time."

Courts also recognize that parties may contract around the CPLR by specifying a different interest rate applicable upon default or breach, including in indentures and other credit agreements. As the Court of Appeals noted in *NML Capital*, "inclusion of a clause directing that interest accrues at a particular rate 'until the principal is paid' (or words to that effect) alters the general rule that interest on principal is calculated pursuant to New York's statutory interest rate after the loan matures or the debtor defaults."[1]

However, a breach as a result of overdue principal is one of many possible defaults under a credit agreement or indenture. Where an agreement cabins default interest provisions to particular breaches by the counterparties, the inquiry becomes fact-specific as to whether the contractual rate applies or whether the statutory rate instead governs. The implications can be significant, both for bondholder recoveries and for issuers evaluating litigation risk.

Case law addressing these issues generally follows a two-step framework: first, whether the agreement specifies a default rate of interest; and second, whether that rate applies to the breach in question. The first inquiry is relatively cut and dry. The second often turns on the specific language of the indenture. For example, can bondholders receive prejudgment interest on overdue interest payable on account of overdue principal? And what if the indenture specifies a default rate but provides that such only applies to breaches on account of overdue principal and interest, and the breach in question was a failed conversion of principal to stock? As the cases below illustrate, the answer depends heavily on how the relevant provisions are drafted.

NML Capital

In *NML Capital*, the United States Court of Appeals for the Second Circuit certified several questions for the review of the Court of Appeals of New York, including whether bondholders were entitled to statutory prejudgment interest on unmade bi-annual interest payments after the issuer defaulted on its principal payments. The issuer

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[1] *See also Ajdler v. Prov. of Mendoza*, 33 N.Y.3d 120, 128-29 (2019) (holding that no default interest was due because "the recoverability of postmaturity interest payments [is] tethered to a claim for principal rather than 'a debt capable of a distinct claim'," and the contractually agreed statute of limitations on plaintiff's claim on overdue principal had tolled, but citing *NML Capital* for the principle that "[f]or timely actions, the parties' negotiated rate governs 'until payment of the principal, or until the contract is merged in a judgment'") and *Chesapeake Energy Corp. v. Bank of N.Y. Mellon Tr. Co., N.A.*, 837 F.3d 146, 151 n.6 (2d Cir. 2016) (noting that the correct prejudgment interest rate was the contract rate, as specified in the indenture at issue, for damages due to breach caused by insufficient notice by issuer for an early bond redemption that resulted in overdue payments under the indentures).

conceded that prejudgment interest applied at the statutory rate to the unmade bi-annual interest payments from the date they were due through the maturity date of the bonds—i.e., for step one in our analysis, the statutory rate was the acknowledged prejudgment rate.

The issuer's argument against prejudgment interest was in step two of our analysis—that prejudgment interest did not apply to the breach in question, as the indenture did not require the bi-annual interest payments to be made post-maturity (an argument that the court rejected), and that the imposition of prejudgment interest on the missed bi-annual interest payments "would constitute impermissible 'interest on interest,' providing a windfall to the bondholders."

The court rejected this argument as well, reiterating that "the function of prejudgment interest is to compensate the creditor for the loss of use of money the creditor was owed during a particular period of time" and that "[t]he imposition of statutory interest on the unpaid interest payments compensates the bondholders for a different loss [than the bi-annual interest payments themselves were designed to compensate for]—the failure of the issuer to timely make the interest-only payments." As a result, this case establishes that missed interest payments on overdue principal—not just the overdue principal itself—may be eligible for prejudgment interest.

Aristocrat Leisure

In *Aristocrat Leisure Ltd. v. Deutsche Bank Tr. Co. Americas*, the United States District Court for the Southern District of New York reached the opposite conclusion to that of *NML Capital* based on the specific indenture language at issue. There, the indenture provided that bondholders could convert principal due under the bonds to newly issued ordinary shares of the issuer's stock, which right terminated upon any call by the issuer to redeem the bonds. With respect to default interest, the indenture provided in section 4.03 that:

> in case there shall be a default in the payment of all or any part of the principal, interest or premium (if any) of any Bonds […] the Issuer will pay […] the whole amount then due and payable […] **plus Interest on overdue principal, interest or premium (if any), at the rate of 7.5% per annum**.

Following a dispute over the effectiveness of conversion notices and the issuer's exercise of its call right, the court awarded damages but denied specific performance. In determining the applicable prejudgment interest rate, the district court held that the New York statutory rate of 9% applied to default interest on the bondholders' damages rather than the 7.5% default rate for "overdue principal, interest or premium." The court reasoned that the indenture did "not purport to set an interest rate with respect to a

failure to deliver shares," which was a specifically enumerated Event of Default under the indenture, as were defaults in payment of principal and interest. The absence of any reference to that type of breach in the default interest provision was dispositive—"the absence of any reference to the failure to deliver shares in section 4.03 is a clear indication that the default interest rate set forth in that section does not apply to damages from any breach of Aristocrat's duty to deliver shares." Accordingly, *Aristocrat Leisure* highlights the importance of scope; even where an indenture specifies a default interest rate, that rate may not apply if the breach at issue falls outside the provision's terms.

Electronic Arts 101% Put Right and Defeasance Conflicts

The Electronic Arts indenture provides a useful case study for applying this analysis. Electronic Arts is the subject of a proposed $55 billion all-cash take private transaction that raises questions regarding the treatment of its outstanding notes—$750 million of 1.85% senior notes due 2031 and $750 million of 2.95% senior notes due 2051 (collectively, the "notes"). The notes are governed by a base indenture and a second supplemental indenture. The second supplemental indenture provides for a 101% recovery put right for bondholders upon a "Change of Control Repurchase Event," defined to require the occurrence of both a standard-definition "Change of Control" and a "Ratings Event."

In connection with the tender offer and consent solicitation, however, the offeror did not offer to repurchase the notes at 101% (or redeem them at par), instead offering consideration valued at approximately 96.9% for the 2031 notes and 79.1% for the 2051 notes. In connection with the proposed transactions, Electronic Arts indicated that it may seek to defease the notes, potentially avoiding the obligation to pay a change of control premium. While Octus has focused on whether defeasance would be effective under the terms of the indentures,[2] a broader question arises: why might an issuer choose not to test its interpretation and litigate the issue if challenged?

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[2] Section 7.4 of the base indenture provides for covenant defeasance, i.e., it permits the company, subject to satisfaction of certain conditions specified therein, to "omit to comply with any term, provision or condition set forth in any covenant established with respect to such Series pursuant to Section 2.1(i)" if the company makes the required irrevocable deposit of funds in trust solely for the benefit of the bondholders as provided in section 7.4(i), among other conditions. The referenced section 2.1(i) provides for the company to establish Events of Default or covenants in supplemental indentures. However, section 2.1(f) provides for the company to establish the right or obligation to redeem or repurchase the notes in supplemental indentures, and one could argue that the change of control put right in the second supplemental indenture is a right to redeem under section 2.1(f), not a covenant established under section 2.1(i), and accordingly, the covenant defeasance

While the conventional answer is the potential cost of litigation and the 9% interest that could accrue, that assumption warrants closer scrutiny—particularly if, under *NML Capital* and *Aristocrat Leisure*, such interest may not accrue in the manner that market participants typically expect.

Contract or Statutory—Which Rate Applies?

Let's apply the two-step analysis we outlined above: (i) does the Electronic Arts indenture displace New York's prejudgment interest rate, and (ii) if so, does the contractual rate apply to the breach at issue? Section 3.1 of the Electronic Arts base indenture provides that:

> […] The Company shall pay interest on **overdue principal** at the rate borne by or provided for in such Securities; it shall pay interest on **overdue installments of interest** at the rate borne by or provided for in such Securities to the extent lawful […].

This formulation—found in many publicly available indentures, including provisions that are substantively equivalent notwithstanding variations in wording—establishes a contractual rate of interest for "overdue principal" and interest. The more difficult question is whether the amounts at issue would qualify as "overdue principal" or "overdue installments of interest" within the meaning of that provision. If they do, the contractual rates will apply. Under New York law, provisions of this type can displace the statutory rate where they clearly provide for interest to accrue at a specified rate until payment is made.

If, however, the disputed amounts are characterized differently—i.e., as arising from a failure to comply with the change of control repurchase obligation rather than a failure to pay principal, interest or premium when due—then the statutory prejudgment interest rate of 9% may apply.[3] That distinction finds support in *Aristocrat Leisure*, where

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provisions of section 7.4 would not release the company from its repurchase obligations under the change of control put right.

Section 7.3 of the base indenture provides for legal defeasance and is much broader in scope than section 7.4, but the requirement under section 7.3(iv) to provide an IRS ruling "to the effect that the Holders will not recognize income, gain or loss for federal income tax purposes as a result of the Company's exercise of its option under this Section 7.3" may be a roadblock for the company, as it may not be possible to obtain an IRS ruling to this effect if there is a defeasance of payment obligations.

[3] A further question is whether principal and interest due on account of acceleration after an Event of Default could constitute "overdue principal" and "overdue installments of interest" under section 3.1 when such breach was triggered by an Event of Default separately enumerated from Events of Default for overdue principal and interest.

the district court held that a breach relating to a conversion right did not constitute overdue principal or interest, particularly where the relevant breach was a separately enumerated Event of Default. Here, the second supplemental indenture similarly distinguishes between a failure to repurchase following a "Change of Control Repurchase Event" and a failure to pay principal or premium when due.

The difference between applying the contractual rates and the 9% statutory rate could be economically significant, depending on the magnitude of the disputed payment, and may mark a critical decision point for an issuer's assessment of whether pursuing a contested interpretation of the indenture constitutes an efficient breach or an unjustifiable litigation risk.

Takeaways

This issue bears close watching given the novelty and complexity of the legal questions involved. As liability management and other restructuring strategies continue to evolve, market participants are likely to scrutinize more closely the extent to which existing documentation may create unintended flexibility, including the economic tradeoffs associated with a potential breach.

If litigation arising from the Electronic Arts transaction were to establish that amounts payable in connection with an issuer's failure to honor a change of control put right do not constitute "overdue principal" or "overdue installments of interest," such that the 9% statutory rate applies in lieu of the potentially much lower contract rates, then the implications could be meaningful. In that scenario, issuers may face materially higher potential exposure in contested situations, and issuers may respond by revisiting how default interest provisions are structured going forward.

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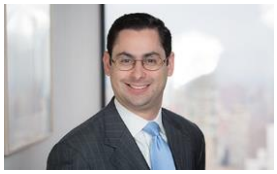

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