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More Bad News For Bondholders On Make-Whole Premiums

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For the second time in the past few months, Judge Christopher Sontchi has dashed the hopes of certain creditors in the Energy Future Holdings Chapter 11 case that they would be paid a make-whole premium worth over $400 million.


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Make-whole premiums are often used in connection with the issuance of debt in order to protect noteholders with long-term investment horizons from being repaid early. At the time of the bankruptcy filing of EFH in April 2014, certain of the EFH debtors were obligated under a series of 10 percent first-lien notes issued by EFH subsidiary Energy Future Intermediate Holding Co. (EFIH). Under the indenture governing the notes, EFIH's bankruptcy filing caused the automatic acceleration of the notes.

Shortly after the filing, EFIH sought approval of debtor-in-possession financing, in part to repay all principal and accrued interest under the notes with less expensive debt. The indenture trustee for the noteholders objected, contending that the repayment by EFIH constituted an "optional redemption" under the indenture, and that such a redemption gave rise to a secured claim under the indenture for the make-whole premium.

EFIH argued in response that no optional redemption had occurred because of the automatic acceleration under the indenture. Once the acceleration occurred, the notes were due and owing, such that the repayment of the notes could not constitute an optional redemption. Judge Sontchi overruled the trustee's objection without prejudice and permitted EFIH to make the repayment in June 2014, while reserving the trustee's right to continue to seek the make-whole premium.

In March of this year, Judge Sontchi, following the reasoning of a similar decision involving a make-whole premium in the Southern District of New York case of MPM Silicones LLC et al. (Momentive), agreed with EFH and EFIH, holding that due to the automatic acceleration, the repayment of the notes in June 2014 did not constitute an optional redemption, and that EFIH therefore had no obligation to pay a make-whole premium.

This did not fully resolve the issue, however. The trustee contended that even if the automatic acceleration could eliminate EFIH's obligation to pay the make-whole premium, under the indenture the trustee had the right to deliver, and in June 2014 in fact did deliver, a notice that rescinded the

automatic acceleration (the "rescission notice"). EFH and EFIH responded that the rescission notice was null and void by virtue of the automatic stay under Section 362 of the Bankruptcy Code. (Upon the commencement of a bankruptcy case, Section 362(a) expressly stays, among other things, "any act to collect, assess, or recover a claim against the debtor ....")

In his March opinion, Judge Sontchi noted that under Section 362(d) of the Bankruptcy Code, the automatic stay can be lifted for "cause," and he further ruled that the trustee was entitled to a separate hearing in order to seek to show that "cause" existed to lift the automatic stay retroactively. Judge Sontchi acknowledged that if "cause" existed to lift the automatic stay effective as of June 2014, it would effectively resuscitate the rescission notice and thereby trigger the right to payment of the make-whole premium.

Although Judge Sontchi left a door open for the trustee and the noteholders in March, it has now been slammed shut. After holding an evidentiary hearing in April, Judge Sontchi, again following a similar ruling in Momentive, has now ruled that the trustee failed to make its showing. In an opinion issued last week, Judge Sontchi rejected the trustee's arguments for lifting the automatic stay.

Under applicable Third Circuit precedents, the factors for assessing whether "cause" exists to lift the automatic stay in any particular case are: (1) whether any great prejudice would result to the debtor; (2) whether the hardship to the creditor seeking relief from the automatic stay "considerably outweighs" the hardship to the debtor; and (3) the probability of the creditor prevailing on the merits.

Judge Sontchi first rejected the trustee's argument that "cause" existed because EFIH was presumed for purposes of these proceedings to be solvent, and therefore no prejudice would result to the debtor or its bankruptcy estate. In what will probably be the most commented-on portion of the opinion, he held that in determining harm to a debtor's estate from lifting the automatic stay, the interests of equity holders must be considered. "While equity lies at the bottom of the waterfall of priorities under the Bankruptcy Code, its interests cannot and should not be ignored. Equity may be structurally subordinate to the creditors but it is not a second class citizen in a debtor's capital structure." Judge Sontchi noted that the impact of the make-whole premium would be $431 million, and found "great prejudice" to EFIH "[r]egardless of those amounts are going to creditors, equity or creditors of equity[.]"

He then examined whether the harm to the noteholders from maintaining the automatic stay would "considerably outweigh" the harm to the debtors from lifting the stay. Observing that the harm that would result to either side was effectively the same — the estimated $431 million make-whole premium, he held that "the harms ... are, in the best case for the Trustee, in equipoise[.]" Because in this instance the harm to both sides would be equal (i.e., the harm to either side would be either the payment or nonpayment of the amount of the make-whole premium), Judge Sontchi held that the trustee could not meet its burden of showing that the harm of maintaining the automatic stay would "considerably outweigh" the harm to EFIH.

Judge Sontchi did find that the final prong favored the trustee, as the lifting of the stay to permit the delivery of the rescission notice would mean that the payment by EFIH constituted an optional redemption and give rise to the noteholders' right to receive the make-whole premium. That was not enough, however, based on his analysis of the other two factors for weighing the existence of "cause," to warrant the lifting of the automatic stay.

Disputes over the payment of make-whole premiums have loomed large in major Chapter 11 cases the past few years, as debtors have looked to take advantage of the current low interest rate environment

to reduce or eliminate more expensive debt. Judge Sontchi's decisions in March and last week, together with the rulings in Momentive, make clear that only clear and express language in the applicable debt documents will serve to support a claim for such payments, and that the automatic acceleration of debt due to bankruptcy cannot be undone for purposes of imposing make-whole premium liability on debtors.

—By Benjamin D. Feder, Kelley Drye & Warren LLP

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DISCLOSURE: Kelley Drye & Warren LLP represents certain creditors in the Energy Future Holdings cases.