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Delaware Court in Energy Future Holdings Case Follows SDNY in Denying Make-Whole Premium after Acceleration Based on Plain Language of Loan Documents

By Nicholas F. Kajon*

The author of this article discusses the acrimonious Chapter 11 case of Energy Future Holdings Corp.

As a result of historically low interest rates and abundant global liquidity, borrowers have ample opportunities to refinance high-yield debt issued years earlier. While borrowers will save money on interest expense, lenders will lose their expected rate of return. Lenders often use make-whole premiums, no-call provisions and other yield-maintenance protections to ensure their bargained-for return for the life of the loan, or to assure compensation for lost interest in the event of early repayment. A make-whole premium is a formula-based payment to provide the lender with the net present value of future interest payments that will not be made due to early repayment.

These yield-maintenance protections are generally upheld outside of bankruptcy. If, however, the borrower files Chapter 11, then courts sometimes invalidate these protections under various theories (especially for insolvent debtors where a court might apply equitable principles to avoid prejudice to junior creditors) including that make-whole premiums constitute unmatured interest, which is subject to disallowance under Section 502(b)(2) of the Bankruptcy Code, or an improper penalty. Yet, in the *School Specialty* case, the Delaware Bankruptcy Court rejected these equitable arguments as applied to an insolvent debtor and upheld a make-whole premium after acceleration which was equal to 37 percent of the principal indebtedness.[1]

Another approach to make-whole premiums was taken in a number of high-profile cases emanating from the Bankruptcy Court for the Southern District of New York ("SDNY"), including *AMR*, *Calpine*, *Momentive,* and *Solutia*, where courts denied the right to payment of make-whole premiums after acceleration based on the plain language of the loan documents. Now, the acrimonious Chapter 11 case of Energy Future Holdings Corp. ("EFH") has given Judge Christopher S. Sontchi an opportunity to align Delaware with those SDNY decisions. On March 26, 2015, Judge Sontchi issued a long-awaited opinion construing the language in a trust indenture (the "Indenture") to preclude a $431 million make-whole premium after acceleration of the indebtedness, and rejecting the indenture trustee's argument that the Debtors had engineered the Chapter 11 filing to evade the make-whole

[*] Nicholas F. Kajon is a shareholder of Stevens & Lee, P.C., and the co-chair of the Bankruptcy and Corporate Restructuring Group practicing in the New York office. He may be contacted at nfk@stevenslee.com.

[1] *In re Sch. Specialty Inc.*, No. 13-10125 (KJC) (Bankr. D. Del. April 22, 2013).

premium.[2]

BACKGROUND

Prior to filing Chapter 11, EFH subsidiaries Energy Future Intermediate Holding Company LLC and EFIH Finance Inc. (together "EFIH") issued $3.482 billion principal amount of 10 percent First Lien Notes (the "10% Notes") with original maturity of 2020, pursuant to an Indenture dated August 17, 2010. EFIH also issued $503 million principal amount of 6.875 percent Senior Secured Notes Due 2017, pursuant to a separate but substantially identical indenture. On April 29, 2014 (the "Petition Date"), EFH and certain affiliates including EFIH filed petitions for relief under Chapter 11 of the Bankruptcy Code, and sought approval of $5.4 billion in debtor-in-possession financing to be used in part to repay all of the outstanding notes and settle certain noteholders' claims (the "DIP Motion").

On May 13, 2014, the indenture trustee, Delaware Trust Company (the "Trustee"), objected to the DIP Motion, arguing that the noteholders were entitled to a secured claim for an amount described in the Indenture as the "Applicable Premium" because: (i) an Optional Redemption would occur when the 10% Notes were repaid; (ii) the EFIH Debtors intentionally defaulted by filing bankruptcy to avoid paying the Applicable Premium; and (iii) the repayment would be a breach of the noteholders' right to rescind the notes' acceleration.[3] On May 15, 2014, the Trustee commenced an adversary proceeding by filing a complaint containing the secured claims from the May 13 objection, plus some unsecured claim.[4] The Trustee also simultaneously filed a motion seeking a declaration that it could decelerate the 10% Notes without violating the automatic stay, or alternatively the automatic stay should be modified to permit the Trustee to rescind the acceleration.

On June 6, 2014, the court approved the DIP financing and the use of a portion of the proceeds thereof to fund a settlement with certain noteholders who had agreed to settle their claims concerning the Applicable Premium. The Trustee prosecuted the adversary proceeding on behalf of those holders of 10% Notes who had chosen not to accept the settlement. These noteholders were paid their full principal and accrued interest from the DIP financing in June 2014, but continued to seek the entire make-whole premium amounting to $431 million, or 19 percent of the principal held by non-settling holders of the 10% Notes.

In September 2014, Judge Sontchi bifurcated the adversary proceeding, so his March 26 decision only dealt with Phase One of the litigation in which the court agreed to determine (1) whether EFIH is "liable under applicable non-bankruptcy law for . . . a Redemption Claim," including the "make-whole" or other "damages . . . under any 'no-call' covenant, 'right to de-accelerate,' " or applicable law, and (2)

[2] *Delaware Trust Company v. Energy Future Intermediate Holding Company LLC (In re Energy Future Holdings Corp.)*, No. 14-50363, slip op. (Bankr. D. Del. March 26, 2015).

[3] Slip Op. at 2.

[4] Slip Op. at 2. The other claims, which the court dealt with summarily and which are not analyzed herein, were: (a) an unsecured claim for breach of a purported "no-call" covenant in the Indenture; and (b) three unsecured claims, one for each of the three counts raised in the Trustee's May 13 objection.

"whether the Debtors intentionally defaulted in order to avoid paying an alleged make-whole premium or other damages."[5] The bifurcation order further provided that: "Except with respect to the Trustee's claim that EFIH intentionally defaulted to evade payment of the make-whole, 'the Court will assume solely for the purposes of Phase One that the EFIH Debtors are solvent and able to pay all allowed claims of their creditors in full.'"[6]

RELEVANT PROVISIONS OF THE INDENTURE

After conducting full discovery on the Phase One issues, the parties filed cross-motions for summary judgment. To determine whether the non-settling noteholders were entitled to the Applicable Premium, the court had to interpret the meaning of the Indenture, including Section 3.07 ("Optional Redemption"), Section 6.01 ("Events of Default"), Section 6.02 ("Acceleration") and the definition of "Applicable Premium" in Section 1.01 ("Definitions"). Section 3.07 provided that: At any time prior to December 1, 2015, the Issuer may redeem all or a part of the Notes at a redemption price equal to 100% of the principal amount of the Notes redeemed plus the Applicable Premium as of, and accrued and unpaid interest to, the date of redemption (the "Redemption Date"). Section 101 provided: "Applicable Premium" means, with respect to any Note on any Redemption Date, the greater of: (1) 1.0% of the principal amount of such Note; and (2) the excess, if any, of (a) the present value at such Redemption Date of (i) the redemption price of such Note at December 1, 2015 (such redemption price as set forth in the table appearing under Section 3.07(d) hereof), plus (ii) all required interest payments due on such Note through December 1, 2015 (excluding accrued but unpaid interest to the Redemption Date), computed using a discount rate equal to the Treasury Rate as of such Redemption Date plus 50 basis points; over (b) the principal amount of such Note.

Among Events of Default were certain bankruptcy-related defaults, including if EFIH "commences proceedings to be adjudicated bankrupt or insolvent." The Indenture provided for the automatic acceleration of the Notes in the event of a bankruptcy-related default: "[I]n the case of an Event of Default arising under clause (6) or (7) of Section 6.01(a) hereof [including EFIH's bankruptcy filing], all outstanding Notes shall be due and payable immediately without further action or notice."[7] In contrast, for non-bankruptcy defaults, the Indenture provided an option to accelerate the Notes—the Trustee or holders of at least 30 percent of the Notes "may declare the principal, premium, if any, interest and any other monetary obligations on all the then outstanding Notes to be due and payable immediately." However, if the Holders of at least a majority in aggregate principal amount of the

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[5] Slip Op. at 3.

[6] In its bifurcation order, the court also determined that if it finds EFIH liable for a Redemption Claim, and if EFIH contests that it is, in fact, solvent, Phase Two will determine "(a) whether the EFIH Debtors are insolvent, and, if so, whether that insolvency gives rise to any defenses arising under the Bankruptcy Code in favor of the EFIH Debtors that bar or limit the amount of the Redemption Claim, and (b) the dollar amount of . . . any Redemption Claim." Slip Op. at 3.

[7] Slip Op. at 18.

Notes gave written notice to the Trustee, then the Trustee had the right to waive any existing Default and its consequences under the Indenture (except a continuing Default in the payment of interest on, premium, if any, or the principal of any Note held by a non-consenting Holder) and rescind any acceleration with respect to the Notes and its consequences (so long as such rescission would not conflict with any judgment of a court of competent jurisdiction).

THE PLAIN LANGUAGE OF THE INDENTURE BARRED RECOVERY

The *EFH* court began its analysis by construing the Event of Default provision (Section 6.02), observing that the 10% Notes were automatically accelerated on the Petition Date and became due and payable immediately without further action or notice of the Trustee or any noteholder. Section 6.02 did not contain any reference to the payment of the "Applicable Premium" upon an automatic acceleration. In fact, the concept of an Applicable Premium was included in only one instance—an optional redemption under Section 3.07. The Indenture was governed by New York law, which provides that an indenture must contain express language requiring payment of a prepayment premium upon acceleration.[8] The court noted that the parties could have bargained for such a provision, and many other courts had upheld clauses specifically requiring post-acceleration payment of a make-whole, prepayment premium or certain costs.[9]

Judge Sontchi also compared the relevant language in the Indenture to acceleration provisions with substantially similar language from other cases, including *Calpine*, *Momentive,* and *Solutia*, to bolster his conclusion that the plain language of the Indenture did not provide for a make-whole premium following a bankruptcy acceleration.[10]

The *EFH* court determined that the Trustee's argument that Section 3.07, the "Optional Redemption" provision, is a wholesale bar to any repayment before December 1, 2015 was strained because the Indenture expressly distinguished between redemption and acceleration. Under New York law, a borrower's repayment

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[8] Slip Op. at 18, *citing Northwestern Mut. Life Ins. Co. v. Uniondale Realty Assocs.*, 816 N.Y.S.2d 831, 836 (N.Y. Sup. Ct. 2006) ("A prepayment premium will not be enforced under default circumstances in the absence of a clause which so states."); *In re South Side House, LLC*, 451 B.R. 248, 268 (Bankr. E.D.N.Y. 2011) ("[A] lender is not entitled to prepayment consideration after a default unless the parties' agreement expressly requires it."), *aff'd U.S. Bank Nat'l Ass'n v. South Side House, LLC*, No. 11-4135 (E.D.N.Y. Jan. 30, 2012); *In re Premier Entm't Biloxi LLC*, 445 B.R. 582, 626; Hr'g Tr. 36:9-14, *In MPM Silicones, LLC*, et al., No. 14-22503 (Bankr. S.D.N.Y. Sept. 9, 2014) ("*Momentive*").

[9] Slip Op. at 18–19, *citing See, e.g.*, *United Merchs. & Mfgrs., Inc. v. Equitable Life Assurance Soc'y of the United States (In re United Merchs. & Mfrs., Inc.)*, 674 F.2d 134, 141–43 (2d Cir. 1982); *Parker Plaza W. Partners v. Unum Pension & Ins. Co.*, 941 F.2d 349, 355–56 (5th Cir. 1991); *Teachers Ins. & Annuity Ass'n of Am. v. Butler*, 626 F. Supp. 1229, 1230 (S.D.N.Y. 1986); *In re AE Hotel Venture*, 321 B.R. 209, 217-20 (Bankr. N.D. Ill. 2005); *In re Vanderveer Estates Holdings, Inc.*, 283 B.R. 122, 126–27 (Bankr. E.D.N.Y. 2002); *In re Fin. Ctr. Assocs. of E. Meadow L.P.*, 140 B.R. 829, 834–35 (Bankr. E.D.N.Y. 1992); *In re Schaumburg Hotel Owner*, 97 B.R. 943, 952–54 (Bankr. N.D. Ill. 1989).

[10] Slip Op. at 20, *citing HSBC Bank USA, N.A. v. Calpine Corp.*, (S.D.N.Y. 2010); *In re Premier Entm't Biloxi LLC*, 445 B.R. at 626–632 (Bankr. S.D. Miss. 2010); *In re MPM Silicones, LLC*, (Bankr. S.D.N.Y. 2014); *In re Solutia Inc.*, 379 B.R. at 488(Bankr. S.D.N.Y. 2007).

after acceleration is not considered voluntary because "[a]cceleration moves the maturity date from the original maturity date to the acceleration date and that date becomes the new maturity date."[11] "Prepayment can only occur prior to the maturity date."[12] "Once the maturity date is accelerated to the present, it is no longer possible to prepay the debt before maturity."[13]

THE BANKRUPTCY FILING WAS NOT AN INTENTIONAL DEFAULT

Judge Sontchi then considered and rejected the Trustee's assertion that the bankruptcy filing was an intentional default under the Indenture. The court first noted that some indentures contain provisions that a premium will be owed if the issuer intentionally causes an event of default to avoid paying the make-whole premium, but the EFIH Indenture did not contain such a provision. Moreover, the Trustee did not meet its burden of supplying sufficient evidence for a reasonable fact-finder to conclude that the EFIH Debtors intentionally defaulted.

In fact, there was overwhelming evidence that the Debtors filed bankruptcy because they were facing a severe liquidity crisis. The Debtors had also expended significant time and resources on Project Olympus, an ultimately failed attempt to put Texas Competitive Electric Holdings Company LLC ("TCEH") into bankruptcy and convert its first-lien debt into EFH equity, but to keep EFH and EFIH out of bankruptcy. TCEH is the holding company for EFH's competitive businesses, including Luminant and TXU Energy, whereas EFIH is the holding company for EFH's regulated business, Oncor Electric Delivery Company ("Oncor"). Judge Sontchi opined that the Trustee's suggestion that the Debtors refused to market and sell Oncor, which may be worth $18 billion, to avoid having to pay a $400 million make-whole premium stretches the bounds of credulity. Thus, the court concluded that the "EFIH Debtors are no different than any other debtor that is forced into bankruptcy because of financial reasons but decides to use the tools provided by that bankruptcy . . . for business reasons."[14]

THE AUTOMATIC STAY PROHIBITED RESCISSION OF THE ACCELERATION OF THE INDEBTEDNESS

Next, the Trustee argued that it had the absolute right to rescind the automatic acceleration of the indebtedness, and that the automatic stay imposed under Section 362(a) of the Bankruptcy Code did not apply or alternatively should be modified *nunc pro tunc* to a date on or before the repayment of the 10% Notes on June 19, 2014 to permit rescission. Relying on *Momentive*, *AMR*, and *Solutia*, the *EFH* court determined that the automatic stay imposed upon EFIH's bankruptcy filing barred the rescission notice that the Trustee had sent on June 4, 2014 because it was an act

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[11] Slip Op. at 22–23 *quoting Solutia*, 379 B.R. at 484.

[12] Slip Op. at 23, *quoting In re LHD Realty Corp.*, 726 F.2d 327, 330–31 (7th Cir. 1984).

[13] Slip Op. at 23, *quoting Northwestern Mutual*, 816 N.Y.S.2d at 834 (*quoting Rodgers v. Rainier Nat'l Bank*, 757 P.2d 976 (Wash. 1988)); *see also Solutia*, 379 B.R. at 488 ("Because the 2009 Notes were automatically accelerated, any payment at this time would not be a prepayment.").

[14] Slip Op. at 24.

to "collect, assess or recover" on a claim.[15] Judge Sontchi further noted that if he were to lift the automatic stay, *nunc pro tunc* to a date on or before the repayment of the 10% Notes to allow the Trustee to waive the default and decelerate the 10% Notes, then EFIH's refinancing would be an Optional Redemption under Section 3.07 of the Indenture and the Applicable Premium would be due and owing to the non-settling noteholders.

However, the *EFH* court concluded that there was a genuine issue of material fact precluding summary judgment as to whether cause exists to modify the automatic stay. In doing so, Judge Sontchi rejected the Trustee's arguments that (1) a debtor's solvency is, as a matter of law, cause to lift the automatic stay, and (2) lifting the automatic stay would not prejudice either the bankruptcy estate or the debtor because doing so would simply hold the EFIH Debtors to their bargain. He also rejected the EFIH's argument that cause does not exist as a matter of law.

CONCLUSION

While the Trustee still has an opportunity at an evidentiary hearing to try to convince Judge Sontchi that cause exists to modify the automatic stay to allow the Trustee to waive the default and decelerate the 10% Notes, the Trustee clearly faces an uphill battle. Automatic acceleration and default provisions like the ones at issue in EHF and the SDNY decisions it relied on will likely continue to be construed to prohibit make-whole premiums after acceleration in bankruptcy. Now that courts in the two most popular venues for Chapter 11 filings have held that standard loan document language precludes allowance of a make-whole premium after acceleration, parties should anticipate even more litigation over these issues.

Lenders should consider drafting loan documents to expressly provide that the bargained-for make-whole premium will be due if the principal is paid after acceleration. Loan documents should also contain language that the premium will be owed if the issuer intentionally causes an event of default. Parties looking to invest in an existing issue should closely scrutinize the loan documents, especially the default and acceleration provisions, to determine the likelihood that the make-whole premium will be payable after acceleration if the borrower files for bankruptcy protection. Junior creditors will want to carefully analyze senior lenders' loan documents to ascertain whether they contain the deficiencies noted herein.

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[15] Slip Op. at 26–27, *citing* 11 U.S.C. § 362(a); *see also Momentive,* No. 14-22503 ("[T]he automatic stay does, in fact, apply to the sending of a rescission notice."); *AMR Corp.*, 485 B.R. at 294 ("Any deceleration of these notes, however, is barred by the automatic stay imposed by the filing of this bankruptcy."), *aff'd* 730 F.3d 88 (2d Cir. 2013); *Solutia*, 379 B.R. at 485 ("[W]here the indenture provides for an automatic acceleration any attempt at deceleration would violate the automatic stay.").