# Bankruptcy Finding for Utility Threatens Entire Financial System

*Anthony Michael Sabino and Michael A. Sabino*

Regrettably, in troubled times even members of such stalwart industries as natural gas and electricity can succumb to financial difficulties, and thus be compelled to seek refuge in the nation's bankruptcy courts. Creditors of energy companies know this all too well. Accordingly, they are vigorous in protecting their rights to repayment.

Members of such stalwart industries as natural gas and electricity can succumb to financial difficulties, and thus be compelled to seek refuge in the nation's bankruptcy courts.

Normally, be these rights simple or complicated, they are generally recognized in the bankruptcy forum, even if they must be modified or renegotiated in order to secure an orderly distribution of the debtor's assets to creditors. However, a recent Delaware bankruptcy court decision seems to chip away at that norm. As such, it is worthy of discussion. Indeed, we find some aspects of this court ruling to be rather troubling, insofar as they seriously denigrate contractual rights and expectations that the creditors in that case presumed would be upheld, to say nothing of lenders in similar situations who now must question the viability of their own legal positions.

The case is *Delaware Trust Co. v. Energy Future Intermediate Holding Co. LLC (In re Energy Future Holdings Corp.)*.[1] First, let us list a "who's who."

The eponymous Energy Future Holdings Corporation (EFH), from which the main case derives its name, is found at the center of a complicated web of corporate affiliates, including Energy Future Intermediate Holding Company LLC (EFI). From here on, we shall generally refer to EFI as the debtor and note that it was also the defendant in the relevant controversy. The debtor was the issuer of high-yield notes (i.e., "junk bonds") paying 10 percent annual interest, with all principal coming due in 2020.

Like all fixed debt, notes such as these bear "interest rate risk" (i.e., if interest rates go down, the debtor can refinance with cheaper money). The debtor "calls" the notes, and the creditor is repaid in full, but with the unhappy consequence that, in this new, lower-interest-rate environment, the creditors' options for redeploying its capital are less attractive.

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To counteract this, present-day creditors demand a "make whole" clause. In basic terms,

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the creditor calculates the amount of money it would lose in the event of a "call," and requires the payment of an additional sum of money that would literally make it whole in the event of an early redemption. The debtor's notes indeed had such a "make whole" proviso.

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The debtor, its parent, and their affiliates subsequently filed for reorganization in the Delaware bankruptcy court. The opinion states that the debtor group had put forth a Chapter 11 plan calling for a 100 percent payout to all creditors on the face amount of their debt, but the "make whole" obligations were ignored.

## CASE CENTERS AROUND "MAKE WHOLE" PROVISIONS

Blue Mountain and Halcyon, two hedge funds that were the owners of significant amounts of the notes, contested this failure of the debtors' plan to recognize and pay the "make whole" obligations. Via the named plaintiff, Delaware Trust Company, as the trustee for the notes, these creditors engaged in a somewhat convoluted set of maneuvers in the bankruptcy court, designed to bring the debtor into compliance.

Their foremost move was a motion to lift the Bankruptcy Code's automatic stay. To be sure, the creditors' efforts were made a bit more complicated for reason of a set of rather Byzantine acceleration/deceleration clauses set out in the documentation for the debt. As it were, that was the situation set before Bankruptcy Judge Christopher Sontchi.

The most significant aspect of the controversy was the automatic stay of the Bankruptcy Code. The automatic stay is truly that: an injunction automatically imposed the moment a person or entity files for bankruptcy, the effect of which is to immediately halt all efforts to collect money or property from the debtor.[2]

The objective of the automatic stay is threefold. First, it prevents the piecemeal dismemberment of the company by creditors. Second, it centralizes all creditor claims in the bankruptcy forum. Third, the automatic stay gives the debtor "breathing room," a respite intended to permit the debtor to evaluate its resources and the validity of creditor claims, and move on from there.

But the automatic stay is not inviolate. It can be "lifted" (i.e., put to the side so creditors may proceed to enforce their claims, often in state court). The fundamental requirement is that the stay be lifted "for cause." And that is the issue the bankruptcy court grappled with here.[3]

Bankruptcy Judge Sontchi commenced from the traditional starting point, noting that the automatic stay is designed to protect the debtor and its creditors alike, essentially by preserving value for an orderly liquidation or reorganization, as the case may be. Yet creditors can move to lift the stay, if they can make the requisite showing.

Things get a bit complicated from here out, the court indicated. The "for cause" standard is not well-defined in the Bankruptcy Code, as Congress left it for the courts to devise the appropriate benchmarks. This flexibility can have severe consequences for the party caught on the wrong side of the equation.

Nonetheless, in the view of this bankruptcy jurist, "cause" would pivot upon the fundamental notions of the hardship to the debtor if the motion was granted, the hardship to the creditor if its lift stay motion was denied, and the overall hardships, if any, to the totality of the creditor body. And here is where the Delaware court made short shrift of the hedge funds' motion to lift the stay.

## RE-RANKING ORDER OF CREDITORS IN PAYMENT

The court's first conclusion was that the totality of the creditor body would endure a hardship if the stay was lifted. By necessity, the finding of this hardship negated any showing of cause in favor of the creditors.

In making this portion of its ruling, the court demonstrated an inordinate concern for the equity holders of the debtor. To be sure, in the system of absolutely prioritizing the claims of creditors and other interested parties in bankruptcy cases, stockholders come dead last, far, far behind secured creditors, behind note holders (such as Blue Mountain and Halcyon here), and even behind the beleaguered unsecured creditors.

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Intriguingly, Bankruptcy Judge Sontchi fully concurred with the above axioms, even to the extent

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of employing a colorful metaphor. "[E]quity lies at the bottom of the waterfall of priorities under the Bankruptcy Code," he stated. Yet while placing them at the absolute bottom of the list, the court extended its newfound solicitude for the body of equity holders by declaring "its interests cannot and should not be ignored." While stockholders "may be structurally subordinate to the creditors," such an interested party "is not a second class citizen in a debtor's capital structure."

The court was quite vigorous in these declarations, something quite puzzling given that equity holders indisputably occupy the lowest rungs of the ladder in bankruptcy cases. The court's view is even more inexplicable, when one considers that, by all appearances, the debtor had but one shareholder—its corporate parent and affiliated debtor, EFH.

Thus, for these reasons the bankruptcy court slammed the door on these note holders, unhesitatingly ruling that the harm to the generalized body of interested parties forbade him from lifting the stay. But the court was not done just yet.

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Next up was the note holders' argument that the debtors were in fact solvent, had proposed a 100 percent repayment plan, and that this debtor in particular apparently could make good on the "make whole" payments. The bankruptcy judge was unmoved. Among other things, he opined that even a solvent debtor's estate could be harmed if the automatic stay was lifted without just cause.

Once more, the bankruptcy judge saw great harm should he permit the note holders to vindicate their rights. He opined that the "make whole" payments would remove some $431 million from the debtor's coffers. This, in turn, would diminish the recovery of the creditor body. Notably, the court made no analysis of how much the recovery of the overall creditor body would be diminished, a quantification that would have been interesting to see, given that the Chapter 11 plan on the table apparently called for a repayment in full of all the debtor's obligations, insofar as to its indebtedness.

And yet again, much concern was displayed by the bankruptcy court for shareholders, such as they were (one!). Chiding the lift stay motion as "caus[ing] nearly half a billion dollars to leave the estate," the bench seemingly found it of no importance whether those dollars would eventually go to either creditors or stockholders.

Notwithstanding that generic hesitation, the court made a particular point of stating that the equity holders would suffer. And therefore, citing the "great . . . prejudice" this flight of capital would foment, the court rejected any recognition of the validity of the "make whole" payments.

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The court next endeavored to measure the relative hardships to the note holders and the debtor upon resolution of this controversy, as part of its calculus in determining the appropriate decision to be made here. The court embarked upon a most intriguing determination in this regard.

Judge Sontchi found that the degree of potential harm to either side was counterbalanced. If the stay is maintained, the creditor loses its rights to the "make whole" payments in the amount of $431 million. Conversely, if the stay was lifted, the debtor would have to pay that same $431 million to the note holders. Without further analysis, Judge Sontchi declared a draw, which, of course, was insufficient to make a finding of "cause" sufficient to justify lifting the automatic stay.

Yet more intriguing, if not disturbing, was the additional analysis provided by the court, an exposition even the judge declared was "unnecessary to reach this conclusion" of no great hardship to the note holders in denying the motion. With regard to the foregoing contemplation of the relative hardships between the debtor and these creditors, the bankruptcy judge expressed concern that other debt holders would then bring their own motions to lift the stay if Blue Mountain and Halcyon prevailed on this motion.

In turn, more of these lift stay motions by similarly situated note holders would have a "major" (but yet unelaborated) effect upon the debtor's Chapter 11 plan. Such maneuvers by like-minded creditors could only benefit a few select note holders, at the expense of unspecified "stakeholders," ostensibly equity holders (or realistically in the instant case, the one stakeholder, the debtor's parent, EFH). It is worthy to note the court's seeming preoccupation with the debtor's affiliates and subsidiaries, and how lifting the stay here might impact their plans for a jointly administered reorganization.

And yet in the strangest twist of all, this judge took great pains to set forth in detail what he perceived these note holders had to gain if he granted the lift stay motion. If the "make whole" payments were made, Blue Mountain would gain an amount equal to approximately half a percentage point of its assets under management, while Halcyon's gain from granting the motion would equal a mere quarter of 1 percent of its managed assets. To be sure, this methodology is unique for deciding the existence or absence of cause.

Be that as it may, this final observation cemented the court's contention that the note holders failed to show a sufficient degree of hardship necessary to justify lifting the automatic stay. And so the *Energy Future* decision ended.

## A NUMBER OF QUESTIONABLE AREAS

In critiquing the *Energy Future* opinion, we regret that we find a great deal to criticize.

To be fair, some of this difficulty may be attributable to a complex set of circumstances. The debtor and its creditors appear to be victims of an overly convoluted capitalization scheme. There seem to be more layers of discrete note holders than one can shake a stick at, each one holding on to its own rung on the financial ladder by virtue of distinguishable legal claims to repayment. The intricate interaction among these disparate interests undoubtedly contributed to the difficulty of sorting out who is entitled to what.

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The second arduous circumstance arises from the apparent machinations of the debtor's own business affairs. This debtor was apparently enmeshed in a complex corporate structure of subsidiaries and affiliates, while at the same time it was owned by yet another entity, itself a companion debtor. With all of them in this jointly filed Chapter 11, emerging from bankruptcy had to be quite an intricate dance.

That said, don't waste your pity upon either debtors or creditors here. The opinion makes clear that these were sophisticated parties who knew what they were getting into. By entering into a set of complicated and opaque financing transactions, they planted the seeds of unwanted consequences when it came time to unravel their dealings in court.

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Yet it would be grossly unfair to leave it at that, with some notion that the parties got what they deserved. Recent years have proven that even unnecessarily complex capital structures can still be reorganized without discarding important bargained-for legal rights. And this failure to analyze is where the bankruptcy court did not adequately do its job for the parties, in our estimation.

First, lenders and borrowers bargain for the use of capital and the repayment thereof. Of crucial import, the debtor borrows, and knows when and how much must be repaid. The creditor has its expectations, backed up by documentation, not to mention legal precedent. The certainty of all these arrangements is only increased by an order of magnitude when dealing with parties as sophisticated as we find here in the instant case.

It is a simple enough proposition. In this case and others like it, the note holders bargained for certain rights, including, most especially, the right to the "make whole" payments. Indeed, in a high-yield borrowing scenario such as this, that right was no doubt an essential element of the deal struck. And the debtor knew this going into the transaction.

Finally, "make whole" conditions are neither so new nor so peculiar that a court of law should have difficulty according them the same viability as a court would bestow upon any other condition of borrowing. As such, the bankruptcy court did an injustice to the note holders by refusing them the opportunity to vindicate their rights.

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A longstanding part of bankruptcy cases is resolving the tension between lawfully adjusting


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the debtor-creditor relationship, yet, at the same time, according proper recognition and deference to property rights created under nonbankruptcy law.[4] It is axiomatic that the rights and obligations agreed to by parties in transactions bargained for before one side succumbs to insolvency generally remain enforceable in the bankruptcy court, subject to the aforementioned adjustment as made necessary by the circumstances.

That principle is particularly so with regard to the preordained and supposedly unchanging order of absolute priority for payment among creditors, long the cornerstone of our bankruptcy law. This order includes, most especially, the higher priority given to secured creditors and note holders, and the undeniably bottom position occupied by the debtor and its equity holders. Yet the instant ruling seems to modify those priorities in a way that cannot be reconciled with the controlling law.

Our final criticism is the one most keenly felt. It is deeply disturbing that the court placed such great emphasis upon the size of the "make whole" payments relative to the two note holders' respective asset holdings. That never has and never shall be a valid measuring stick for the grant or denial of stay relief. The proof of the foregoing is simply this—if such were the case, no creditor of appreciable size could ever prevail on a lift stay motion, because such reasoning would emplace the creditor's nominally greater resources as an insurmountable obstacle to relief from the stay.

It is highly improper to ask how much a creditor gains by enforcing a bargained-for right in comparison to the creditor's overall net worth. The sole and appropriate inquiry is whether the creditor holds a legal right to do so, a state-law right that should be enforceable in a bankruptcy court or any court of law, for that matter.

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Nearing our end here, it is with the utmost respect that we find the instant bankruptcy court decision indecipherable in a number of respects, and troublesome in others. Why such overt concern for an equity holder that apparently was an affiliated debtor in the same proceeding? Why indeed be so protective of any stockholder, given that for the entire history of American insolvency law, the interests of shareholders always come last? Why elevate their status to previously unknown and impermissible heights?

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In what was purported to be a 100 percent repayment plan, why the reluctance to permit the vindication of a creditor's bargained-for rights? Since when does the amount claimed by a creditor in a bankruptcy case depend for its validity upon its relation to the creditor's overall worth? Are bankruptcy judges now able to ask how much money does a creditor have before granting a lift stay motion? One must appreciate the danger of such inquiries, and how the Code contemplates nothing of the sort.

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Finally, what becomes of rights and obligations bargained for at arm's length between lenders and borrowers? How does this change the dynamic between them? Do loan clauses, note covenants, and the like become hollow promises, subject to capricious revision by Article I bankruptcy judges? It is not an overstatement to classify that as a horror to be avoided.

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We certainly hope that the *Energy Future* holding proves to be an anomaly. If it is not, the consequences are too dire. Let us hope for the best.

## NOTES

1. ___ B.R. ____ (Bankr. D. Del. July 8, 2015) (Sontchi, J.) ("*Energy Future*").
2. 11 U.S.C. § 362(a).
3. 11 U.S.C. § 362(d)(1).
4. *See Butner v. U.S.,* 440 U.S. 48 (1979).