By Andrew Scurria

Law360, New York (March 30, 2015, 3:56 PM ET) -- Deep within a judge's recent refusal to award Energy Future Holdings Corp. bondholders the lost interest payments from a $4 billion refinancing lies a stark lesson on why lenders' inattention can neuter their ability to collect make-whole premiums in bankruptcy.

While declining to grant a bond trustee's demand for sizable damages from a debt refinancing transaction, U.S. Bankruptcy Judge Christopher Sontchi honed in on loan documents issued in 2010 to decide if creditors that had already recovered 100 percent of their principal debts should receive additional make-whole payments.

Creditors could collect under the relevant bond indenture only if EFH was "adjudicated bankrupt or insolvent," language that seems to harken back to before 1978, when the current Bankruptcy Code was enacted and companies no longer needed to be "adjudicated" insolvent to receive court protection.

"To me, those are magic words that mean a bankruptcy lawyer didn't look at it," said Mark Joachim of Arent Fox LLP. "So it's not going to work."

Years of courtroom battles over early debt redemptions have taught bankruptcy lawyers that nothing short of ironclad indenture language will entitle bondholders to the future interest payments they lose out on when debtors refinance under bankruptcy protection. Judge Sontchi's decision follows in their wake, and while it didn't completely eliminate the trustee's ability to collect premiums that could top two-thirds of a billion dollars, it marks a clear victory for EFH.

Make-wholes, which came about to protect investors that don't want bonds redeemed before their stated maturity, depend on what happens following an event of acceleration, when a borrower's debts become immediately due and payable. Many indentures are less than explicit about whether make-whole provisions are tripped in the event of a Chapter 11, which automatically accelerates a company's debts.

While such disputes have long simmered in the restructuring community, make-whole fights have been popping up with increasing frequency as low interest rates encourage distressed borrowers to swap out existing bonds for cheaper replacement debt. A string of companies including Momentive Performance Materials Inc. and AMR Corp. have eased their way out of Chapter 11 by taking on bondholders to avoid paying refinancing premiums.

Investors have taken notice, but many have still failed to secure the firmer contract language that bankruptcy judges have required, according to Seth Lieberman of Pryor Cashman LLP, who said that such strict interpretations were becoming "if not the law of the land, then at least the norm."

With the lending market saturated and investors chasing yield, they can't always afford to demand the ironclad protections necessary to claim make-wholes following an automatic acceleration. Fuzzy indenture language can get passed down from year to year, and often the original debt buyer has sold off its holdings by the time the issue lands in court.

“Outside of the context of rescues, where people are thinking about it and more likely to run it by a restructuring lawyer, you see this language over and over and over again,” Joachim said. “You’d think it would change, but in practice it just doesn’t.”

Judge Sontchi's decision comes at a critical moment for EFH, which is moving toward a new restructuring plan after the collapse of a prearranged Chapter 11 exit strategy. Top creditors to Texas Competitive Electric Holdings Co. LLC, the debtor’s largest division, are advocating to split up the Texas-based company, while junior creditors of EFH are calling the proposal a red herring when an intercompany divorce could set off billions in tax liabilities.

The prearranged restructuring plan fell apart once bidders expressed more interest than anticipated in a prized stake in nondebtor affiliate Oncor Electric Delivery Co. LLC, forcing EFH to confront make-whole fights with multiple creditor groups.

First-lien trustee Delaware Trust Co. may not have succeeded, but Judge Sontchi’s decision holds the potential to realign allegiances by laying out his thinking for competing second-lien and unsecured noteholders, all of which hold their own specific loan protections.

“One of the things to look at with this decision is, does it bring parties to the table?” Lieberman said. “Maybe there is such advantageous language in the respective indentures, and this decision says to the debtors, ‘I better get with the unsecured and the seconds because while I was successful against the firsts, it’s clear that this [decision] in that context would be disadvantageous.’”

Judge Sontchi has not shut the door on Delaware Trust, which can still obtain bondholder premiums by showing "cause" to lift the automatic stay that protects bankrupt entities from creditor actions. When EFH entered Chapter 11, the trustee asked for permission to waive a bond default and rescind the automatic debt acceleration.

Normally, the automatic stay would bar such an action, but Judge Sontchi gave the trustee a shot to show that the "deceleration" should be treated as exempt.

“That would be a function of the trustee waiving default and decelerating the notes, and then the refinancing would be deemed an optional redemption,” Joel Perrell of Miles & Stockbridge PC said. “The court seemed to provide a bit of a roadmap on exactly how this kind of make-whole provision would apply if that were the outcome of the stay litigation.”

Creditors to Momentive and AMR took the same tack and failed.

--Editing by John Quinn and Philip Shea.