Recent Trends In Enforcement Of Intercreditor Agreements

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Law360, New York (May 2, 2017, 12:10 PM EDT) -- Over the last several decades, the enforcement of intercreditor agreements (ICAs) that purport to affect voting rights and the rights to receive payments of cash or other property in respect of secured claims have played an increasingly prominent role in bankruptcy cases. Although the Bankruptcy Code provides that "subordination agreement[s]" are enforceable in bankruptcy to the same extent such agreements are enforceable under applicable nonbankruptcy law, the handling of creditor disputes regarding such agreements has been inconsistent.[1]

Both ICAs and agreements among lenders (AALs) purport to alter the rights of junior-lien creditors or subordinated creditors in a bankruptcy of their common debtors. For example, such agreements often include waivers of the right to object to bankruptcy sales, voting restrictions on plans of reorganization, and waivers of rights to object to debtor-in-possession financing and use of cash collateral. ICAs in secured transactions are generally among creditor groups that hold different tranches or classes of debt, each secured by separate but identical liens and acknowledged and agreed to by the applicable borrowers or issuers. AALs, by contrast, are typically agreements solely among the lenders under a single secured credit facility and their agent. The borrower is not party to the AAL and grants a single lien to the agent for the lenders to secure all of its obligations under the credit facility. The borrower discharges its obligations by paying required payments to the agent under the credit facility. The AAL then determines how those payments are divided among the lenders.

Bankruptcy courts have treated ICAs and AALs inconsistently. Some courts have enforced these agreements in accordance with their terms, others have invalidated provisions in these agreements,[2] and still others have enforced agreements only to the extent that it provides the best outcome for the debtor's estate. A recent trend in the case law has been to enforce ICA and AAL provisions altering creditors' rights in bankruptcy only to the extent there is clear and unambiguous language in the agreement altering such rights. In this article, we examine three recent leading cases: Energy Future Holdings (EFH), Momentive and RadioShack. These cases addressed whether the bankruptcy court was the proper forum for intercreditor disputes (including threshold jurisdictional issues for AALs), the ability of junior creditors to object to a sale supported by senior creditors, and whether an agreement providing only for lien subordination restricts a junior creditor's ability to

receive distributions under a plan of reorganization.

Proper Forum for Intercreditor Disputes

A threshold issue in cases involving ICAs or AALs is whether bankruptcy-related intercreditor disputes (including rights to approve or object to sales, cash collateral and financing motions, vote on plans of reorganization, and receive and retain proceeds distributed by the debtor) should be decided by the bankruptcy court or another federal or state court. In both EFH and Momentive, intercreditor disputes originated in state court but were transferred to the respective bankruptcy courts administering the debtors' cases. In both cases, the bankruptcy courts held that the intercreditor disputes were "core proceedings" relating to the administration of the debtors' estates and were therefore within the scope of the bankruptcy court's jurisdiction.

Energy Future Holdings is an electric utility company with its business operations divided into two silos: a regulated electrical utility (the so-called "E side") and a nonregulated electricity generating and commodity risk management and trading entity ("TCEH," or the so called "T side"). The intercreditor dispute arose on the "T side" and was among T-side first-lien creditors regarding whether certain payments and distributions were subject to an application-of-payments provision governing sales or other dispositions of their collateral. TCEH's first-lien debt included $1.8 billion in 11.5 percent senior secured notes (the holders of such notes, the "noteholders"), approximately $22.6 billion of bank debt, and outstanding debt under certain swap and hedge agreements (the holders of bank, hedge and swap debt together, the "non-noteholders").[3]

In EFH, the noteholders initially filed suit to resolve a dispute over the allocation of certain adequate protection payments and eventual plan distributions in New York state court. The non-noteholders removed the case to the U.S. District Court for the Southern District of New York and moved to transfer the case to the Delaware bankruptcy court.[4] The noteholders sought to have the matter remanded back to state court. The Southern District of New York granted the motion to transfer to the bankruptcy court, reasoning that the dispute would not exist but for the bankruptcy proceeding and cash collateral order providing for adequate protection payments and that the dispute will affect the allocation of estate funds, which is a core bankruptcy function.

Momentive is a silicone and quartz manufacturer. At the time of its bankruptcy, its capital structure had first-, 1.5-, and second-lien secured debt, as well as additional unsecured debt.[5] The lenders negotiated an ICA that provided lien subordination of the second-lien noteholders' liens in the common collateral (as defined in the ICA). After Momentive declared bankruptcy, the second-lien creditors entered into a plan support agreement (PSA) with the debtors that provided the basis for the debtors' proposed plan. Under the PSA, the first- and 1.5-lien noteholders would receive face value of their debt but would not receive a make-whole premium, while approximately $1.3 billion in second-lien debt would be equitized.[6] In the event that the first- and 1.5-lien noteholders voted to reject the plan of reorganization, they would receive new notes at below-market interest rates on account of their secured claims[7] while the second-lien noteholders would receive new equity in the reorganized debtor.

Similar to the result in EFH, the first-lien and 1.5-lien noteholders filed suit in New York state court and the second-lien noteholders removed the matter to the U.S. District Court for the Southern District of New York, which automatically referred the case to the bankruptcy court. The bankruptcy court denied the senior creditors' motion to remand back to state court.

As demonstrated by these two cases, while dissenting creditors may prefer to initiate litigation in an alternate forum, these disputes are more likely than not to end up in bankruptcy courts if the disputes are viewed as core proceedings inextricably tied to the

administration of the debtors' cases.[8]

Interpreting Sale-Related AAL Provisions

RadioShack, by contrast, yielded more mixed results when it came to the bankruptcy court's willingness to resolve AAL-related disputes. Nevertheless, this was the first case we are aware of where a bankruptcy court addressed, at least implicitly, the enforceability of AALs in bankruptcy.[9] While an AAL would likely be considered a subordination agreement for the purposes of Section 510(a) of the Bankruptcy Code, debtors are not parties to AALs, which led to arguments that the AAL should be considered outside the scope of the property of the debtor's estate as "an agreement that does not impact the debtors and [has] nothing to do with the debtors' estates"[10] and therefore beyond the bankruptcy court's jurisdiction.

RadioShack, a chain of electronics stores, had a complex capital structure at the time it filed for bankruptcy. RadioShack had two main groups of secured lenders, an asset-based or "ABL" lender group under a revolving credit facility and a term loan lender group. The ABL and term loan had crossing liens and a split collateral structure, with lien subordination between the ABL and term loan governed by an ICA.[11] The ABL and term loan were further divided into multiple tranches, with subordination between each of these tranches of debt governed by separate AALs. The ABL lender group was divided into a first-out group, which was comprised of a number of hedge funds, and a last-out lender, Standard General. For the term loan lender group, Cerberus was the first-out lender and Salus was the last-out lender.

Standard General, acting as the stalking-horse bidder, had offered to buy approximately half of RadioShack's stores through a credit bid. Cerberus, the first-out term loan lender, initially objected to the sale but then withdrew its objection. Salus wanted to put in a competing credit bid and objected to the sale, an action Cerberus alleged was in violation of § 14(c) of the term loan AAL,[12] which prevented last-out lenders from objecting to a sale on any grounds that could only be asserted by a secured creditor if the first-out lenders consented to the sale. Certain ABL lenders also objected to the sale for other reasons.

Judge Brendan Shannon of the Delaware bankruptcy court interpreted the provisions of the AAL in the RadioShack dispute, reasoning that the AAL pertained to the "treatment of a secured creditor" and, in doing so, implicitly recognized the enforceability of AALs in bankruptcy. Accordingly, the bankruptcy court allowed Cerberus to enforce the AAL to block Salus' objections to the sale. This should provide some comfort to lenders party to AALs that their negotiated rights will be respected by bankruptcy courts to the same extent they would be under an ICA.

Plan Distributions and Lien Subordination Agreements

As mentioned above, ICAs and AALs can provide for either lien subordination or claim subordination. Under a lien subordination agreement, to the extent that there is value derived from agreed-upon collateral, the senior lender is paid first, up to the extent of its secured claim.

If there are insufficient proceeds from this collateral, the senior lender would be entitled to a pro rata share of any remaining assets the borrower may have, along with other undersecured and unsecured creditors. Payment subordination, by contrast, is a more fundamental form of subordination where the senior lender's right to payment is agreed to be superior to the junior creditor's right to payment.

In Momentive and EFH, the courts were presented with subordination agreements that provided for lien subordination, rather than payment subordination. In both cases, these

agreements were interpreted to not restrict plan distributions (e.g., equity of the reorganized debtor) because such distributions did not constitute common collateral or proceeds of collateral as defined in the applicable intercreditor agreement.

In Momentive, the first- and 1.5-lien noteholders alleged that the second-lien noteholders had breached § 4.2 of the intercreditor agreement, which provided the payment waterfall for the disposition of collateral or the proceeds of collateral, by retaining 100 percent of the common stock of the reorganized debtor when the more senior lien holders had not been paid in full. They argued that the stock of the reorganized debtor would be either common collateral or proceeds, as defined by § 9-102(a)(64) of the New York Uniform Commercial Code.

The bankruptcy court concluded that the new equity of the reorganized debtor did not constitute "common collateral," as defined in the intercreditor agreement, because none of the lenders had "a lien on that stock" or the parent company's current stock. In addition the stock did not qualify as "proceeds" of the collateral, as proceeds are defined by the New York UCC § 9-102(a)(64), because the new equity is not something a current secured party's existing lien would attach to — the new equity is distributed on account of the second-lien lenders' secured claims, not the proceeds of the debtors' assets. The court also noted that there had been no economic event to alter the nature of the assets, which is necessary to give rise to proceeds.

The issue in EFH was similar, namely whether adequate protection payments and plan distributions were distributions of collateral and/or proceeds of collateral such that the waterfall provisions of the intercreditor agreement governed their allocation.[13]

The proposed plan of reorganization called for first-lien creditors to receive common equity in the reorganized TCEH, cash, new TCEH debt, and certain other rights (the "plan distributions") and extinguishing the first-lien creditor's liens. The first-lien non-noteholders argued that plan distributions and adequate protection payments were not "collateral" or "proceeds" of collateral, as defined in the intercreditor agreement or security documents, and, as a result, should be allocated on a pro rata basis as of the petition date among the first-lien creditors in accordance with the size of each class of creditors' claims. In resolving this issue, the bankruptcy court built upon the reasoning set forth in Momentive.

In March 2016, Judge Christopher Sontchi of the Delaware bankruptcy court ruled in favor of the non-noteholders and held that the petition date allocation method advanced by the lower-interest-rate non-noteholders should be adopted. In his ruling, Judge Sontchi stressed that for the noteholders to succeed in their proposed post-petition interest allocation method, they must show that each element of § 4.1 of the ICA, "Application of Proceeds," is met. Otherwise, the intercreditor agreement would be inapplicable to the scenario at hand.[14]

The court held that plan distributions and adequate protection payments did not constitute collateral or proceeds of collateral, and therefore failed to meet the elements of § 4.1 of the ICA. Accordingly, because no other provision of the ICA applied to plan distributions and adequate protection payments, the court held that these payments should be allocated among the first-lien creditors on a pro rata basis based on the amounts owed as of the petition date.

The noteholders asserted that the plan distributions constituted "collateral" because under the spinoff transaction contemplated by the plan, the first-lien creditors' collateral would be "sold" to reorganized TCEH in exchange for reorganized common stock, along with other proceeds. However, the court did not find this argument persuasive and, adopting the reasoning in Momentive, held the first-lien creditor did not have a lien on the new common stock issued as part of the debt-for-equity swap in the plan, and therefore, to

consider the new stock received under the plan as proceeds of collateral would improperly add to the first-lien creditors' collateral. Specifically, in addressing whether the proposed spinoff transaction was a "sale or other disposition" of collateral, further relying on Momentive, Judge Sontchi concluded that the plan gave no indication that reorganized TCEH was "purchasing" the collateral nor that reorganized TCEH was a third-party purchaser, noting the absence of any "'economic event' that would create that sort of relationship."

Alternatively, the noteholders asserted that the plan distributions were proceeds of collateral. The court did not find this argument persuasive, noting the language of the security agreement limited proceeds to (1) any consideration received from the sale/disposition of assets, (2) value received by the debtor as a consequence of possessing the collateral, or (3) insurance proceeds, none of which apply to the plan distributions.[15] Further, the court held that adequate protection payments were not collateral as argued by the noteholders, but rather constituted a protection against diminution in value of collateral.[16]

Conclusion

Bankruptcy courts are increasingly willing to interpret ICAs and AALs and apply the plain language of these agreements to the facts of the case. Creditors should be cognizant of the fact that even if they may prefer to initiate litigation in an alternate forum, these disputes are typically viewed as core proceedings and will likely end up in bankruptcy court. This is especially notable because bankruptcy courts are courts of equity and judges often take a pragmatic approach to these disputes. Moreover, senior creditors appear to continue to bear the risk of agreements that do not limit junior creditors' rights in bankruptcy using clear and unambiguous language.

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[1] See 11 U.S.C. § 510(a).

[2] For example, some courts have found assignments of a junior creditor's right to vote on a Chapter 11 plan of reorganization to be unenforceable. See, e.g., In re 203 N. LaSalle St. P'ship, 246 B.R. 325, 331 (Bankr. N.D. Ill. 2000) ("Subordination ... affects the order of priority of payment of claims in bankruptcy, but not the transfer for voting rights."); In re SW Hotel Venture LLC, 460 B.R. 4 (Bankr. D. Mass. 2011) (finding assignment voting rights in subordination agreement to be unenforceable), aff'd in part, rev'd in part, 479 B.R. 210 (B.A.P. 1st Cir. 2012), vacated on other grounds, 748 F. 3d 393 (1st Cir. 2014).

[3] These obligations were secured by liens on substantially all of TCEH's assets and proceeds thereof and the relationship among the first-lien lenders with respect to the shared collateral was governed by an ICA.

[4] Specifically, Section 2.1 of the ICA provided that the scope and rank of the first-lien creditors' property rights in the collateral and proceeds thereof was pari passu among the noteholders and non-noteholders, "except as otherwise provided in Section 4.1." In re Energy Future Holdings Corp., 546 B.R. 566, 571 (Bankr. D. Del. 2016). Section 4.1 set forth the waterfall for dispositions of collateral or proceeds of collateral received in connection with the sale or other disposition of such collateral or proceeds, and contained a provision for payment of all amounts "then due and payable." Id. at 572. In its simplest form, the dispute was whether the waterfall applied and, if so, whether post-petition interest at the contract rate was "due and payable."

[5] In re: MPM Silicones LLC, No. 7:14-cv-07471, slip op. at 3-6 (S.D.N.Y. May 4, 2015).

[6] An additional $380 million in senior subordinated notes would be eliminated without receiving any distribution under the plan.

[7] Under the so-called "cramdown" provisions of the Bankruptcy Code, the bankruptcy court determined that the treatment of the noteholders' claims complied with the Bankruptcy Code because such holders would retain their liens and receive an interest rate sufficient to provide for "deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property." 11 U.S.C. § 1129(b)(2)(A)(i) -(ii).

[8] But see In re TCI 2 Holdings LLC, 428 B.R. 117 (Bankr. D. N.J. 2010) (confirming "cramdown" plan of reorganization proposed by second-lien creditors over objection of first-lien creditors despite allegations that plan violated proceeds of collateral and adequate protection provisions of ICA; holding that even if violation occurred, it would not impede confirmation of plan that complied with Bankruptcy Code).

[9] The parties in RadioShack consented to the bankruptcy court's jurisdiction to hear their AAL dispute.

[10] Hr'g Tr. at 64:8-9 (Mar. 26, 2015).

[11] In this structure, the ABL lenders have a first lien on working capital assets and a second lien on fixed or long-term assets. The term lenders have a first lien on fixed or long-term assets and a second lien on working capital assets.

[12] Specifically, Section 14(c) of the term loan AAL provided that no last-out lender (i.e., Salus) "shall object to or oppose any such sale ... on any grounds that only may be asserted by [a secured lender] if [Cerberus] ... has consented to such sale." See Exhibit A to Statement of Cerberus Lenders in Support of Sale to General Wireless Inc., In re RadioShack Corp., Case No. 15-10197 (BLS), Docket No. 1551-1, at 16 (Bankr. D. Del. Mar. 26, 2015).

[13] As background, among the first-lien creditors, the noteholders had the highest interest rate, and accordingly argued for the accrual of post-petition interest (the "post-petition interest allocation method"), regardless of whether such post-petition interest was allowed or allowable as part of their claim against the debtors, such that the noteholders would have received a larger share of the payments. The non-noteholder disagreed, arguing that the distributions should be allocated on a pro rata basis based on the amounts owed as of the petition date (the "petition date allocation method").

[14] The application of proceeds elements were as follows: (1) collateral or any proceeds of collateral are to be distributed to the first-lien creditors; (2) the collateral must be "received" by the collateral agent; (3) the collateral or the proceeds of collateral must have resulted from a sale or other disposition of, or collection on, such collateral; and (4) the

sale, disposition, or collection must have resulted from the exercise of remedies under the security documents. If any of these initial requirements were not met, the adequate protection payments and the plan distributions should be distributed outside of the ICA pursuant to the Bankruptcy Code, bankruptcy court orders and the plan.

[15] The security agreement's definition of "proceeds" was limited as follows:

> [as such] term defined in Article 9 of the UCC and, in any event, shall include with respect to any Grantor, any consideration received from the sale, exchange, license, lease or other disposition of any asset or property that constitutes Collateral, any value received as a consequence of the possession of any Collateral and any payment received from any insurer or other Person or entity as a result of the destruction, loss, theft, damage or other involuntary conversion of whatever nature of any asset or property that constitutes Collateral, and shall include (a) all cash and negotiable instruments received by or held on behalf of the Collateral Agent, (b) any claim of any Grantor against any third party for [claims dealing with Licenses, Trademarks, and Copyright] ... and (c) any and all other amounts from time to time paid or payable under or in connection with any of the Collateral.

See In re Energy Future Holdings Corp., 546 B.R. at 580 (quoting Security Agreement, § 1 (d)).

[16] After the court's March 2016 ruling, the noteholders filed an appeal to the decisions. The debtors subsequently filed and confirmed an amended plan of reorganization. Based on asserted distinction between the proposed plan at issue in the intercreditor dispute and the subsequently confirmed plan, the noteholders also asked the bankruptcy court to vacate portions of its prior ruling. The noteholders' motion to vacate and the appeal are currently pending in the Delaware courts.

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