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'Momentive' Provides a Reminder About Intercreditor Agreements

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As discussed before in this column, the growth in mezzanine and junior financing has spawned a rise in litigation over lien intercreditor agreements—agreements between creditors that govern their relative rights and remedies with respect to shared collateral.

These often intensely negotiated, and sometimes poorly drafted, documents have continued to confound courts, motivating such professional groups as the American Bar Association to encourage the market towards more standardized terms.[1] The migration of intercreditor arrangements from "silent seconds" heavily favoring first lienholders to a more complex balancing of rights and obligations between creditor groups has also placed greater pressure on document drafters.

Today we discuss a very recent decision by Bankruptcy Judge Robert D. Drain on intercreditor agreements in *BOKF, N.A. v. JPMorgan Chase Bank, N.A. (In re MPM Silicones)*,[2] worth reviewing for its rulings both on the interpretation of an intercreditor agreement, as well as on the meaning of the UCC term "proceeds." This decision arose in the MPM Silicones bankruptcy proceeding in the Southern District of New York (often referred to as *Momentive*),[3] and cites, and is in many ways an echo of, a decision we discussed in 2011 as part of the bankruptcy proceeding of *In re Boston Generating*.[4]

An examination of these cases provides valuable pointers to more effective drafting of intercreditor agreements.

Background

Intercreditor agreements are subordination agreements enforceable under §510(a) of the Bankruptcy Code.[5] The term "intercreditor agreement" broadly refers to an agreement between creditors that determines their competing rights and obligations in respect of a common obligor and/or its assets. The term encompasses both lien and debt subordination agreements.

Lien subordination agreements will set forth the relative priorities, rights and remedies of the creditors in respect of common collateral. Accordingly, to the extent there is any value derived from shared collateral, the first lienholder will be paid first from the collateral proceeds. However, to the extent that shared collateral is insufficient to satisfy the obligations due to the first lienholders, the first and second lienholders and all unsecured creditors of the debtor will rank pari passu in their right to satisfaction of their remaining debt from the unencumbered assets of the debtor. Debt subordination agreements, on the other hand, typically require the senior creditor to be paid in full before the junior creditor is paid, regardless of the value of shared or other collateral.

Momentive ICA

The rulings on the intercreditor agreement in *Momentive* (Momentive ICA) arose on motions by the second lienholders to dismiss claims asserted by the "so-called" first lien and 1.5 lien trustees alleging breaches of the Momentive ICA, as well as of the implied covenant of good faith and fair dealing, and requesting equitable relief against future breaches. As Drain noted, in a motion to dismiss the court must rule on the "legal feasibility" of the claims asserted based on the facts presented and not weigh relative evidence.[6]

The Momentive ICA was a lien intercreditor agreement. It contained broad language (in §3.1(c)) prohibiting the second lienholders from taking any action "that would hinder any exercise of remedies undertaken by the Intercreditor Agent or the v   Lenders with respect to the Common Collateral …" and a waiver from each second lienholder of "any and all rights it or any Second-Priority Secured Party may have as a junior lien creditor or otherwise to object to the manner in which the Intercreditor Agent or the Senior Lenders seek to enforce or collect the Senior Lenders Claims or the Liens granted in any of the Senior

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Lender Collateral … ."[7]

Notably, however, the Momentive ICA also contained a provision (§5.4), similar to the one in *Boston Generating*, that expressly preserved the right of the second lienholders to exercise rights and remedies against the debtors as unsecured creditors.[8] This right, as discussed below, became the undoing of much of the claims of the first lienholders.

Interpreting the Momentive ICA. The first lienholders asserted several breach of contract claims based on positions taken by the second lienholders before and during the bankruptcy case. In particular, the first lienholders contended that the second lienholders, in violation of the Momentive ICA, (1) opposed requests by first lienholders for adequate protection on their common collateral, (2) supported a priming lien as part of the debtors' DIP financing, (3) supported the debtors' objections to the first lienholders make-whole payment claims, (4) entered into a restructuring support agreement with the debtors prior to the bankruptcy case in favor of what became the debtors' Chapter 11 plan, and subsequently supported confirmation of such plan, and (5) agreed to receive property constituting "proceeds" of the common collateral. In a fairly complete victory for the second lienholders (with some matters needing to be re-pled), Drain dismissed all of the claims.

In regard to the opposition to adequate protection, the first lienholders pointed to a provision in the Momentive ICA which stated "No Second-Priority Party will contest or support any person contesting (a) any request by the Senior Lenders for adequate protection, or (b) any objection by the Senior Lenders to any motion based on the Senior Lenders' claiming a lack of adequate protection." The second lienors, on the other hand, contended that the provision preserving their rights as unsecured creditors meant they could *always*, in their capacity as unsecured creditors, object to adequate protection payments. Because of these possibly conflicting provisions, the court stated that the ICA required a more "nuanced" approach based on additional facts. The bankruptcy court then dismissed the claims of opposition to adequate protection on the ground of an inadequate factual record—the complaints simply did not allege actions the second lienholders had taken to oppose adequate protection.[9]

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In the case of opposition to the debtor's DIP financing priming lien, the court again dismissed the claim based on an insufficient factual record, but here noted that the Momentive ICA nowhere specifically prohibited junior lienors from supporting a priming lien; instead it prohibited objections to liens supported by senior lienholders. The court then further stated that the first lienholders in fact never objected to the DIP financing priming lien and went on to suggest that, based on the Momentive ICA, the plaintiffs would have difficulty prevailing without additional facts.

With respect to the second lienholders' objections to the make-whole claims of the first lienholders and their support for the cramdown Chapter 11 plan, the bankruptcy court noted that it was the debtors who were objecting to the make-whole claims and who were advocating the cramdown plan. The court stated that the second lienholders were merely supporting the debtors in these positions and, as such, were acting consistently with their rights under §5.4 of the Momentive ICA as unsecured creditors, that these were arguments any unsecured creditor could reasonably make, and were not positions taken with respect to the creditors' rights in the shared collateral.[10] Emphasizing that the Momentive ICA was neither a claim nor debt subordination agreement, the court held that the conduct of the second lienholders was outside the prohibitions of §3.1(c), which focused on enforcement of rights in respect of common collateral and not on the amount of lenders' claims.

While the court acknowledged that support of the cramdown plan raised a "closer question" than support of the make-whole payment, because cramdown also affects the manner in which the first lienholders are paid under a plan, it nevertheless reaffirmed that this conduct was "merely ensuring that the debtors acted properly in the interests of unsecured creditors in not overpaying the plaintiffs with a higher present value rate … ."[11]

What are "Proceeds" of Common Collateral? The Momentive ICA (in §4.2) prohibited receipt of "Common Collateral or proceeds thereof" in connection with the "sale or disposition of or collection on such Common Collateral upon the exercise of remedies" until an event of default under any first lienholder indebtedness is cured or waived or a "Discharge of Senior Lender Claims" has occurred.

The parties conceded that a Discharge of Senior Lender Claims had not occurred. The first lienholders therefore asserted that receipt by the second lienholders of certain property—a possible $30 million charge under a backstop agreement in connection with a rights offering, reimbursement of certain professional fees and, in return for the second lienholders secured and unsecured claims, all of the new common stock of the reorganized parent debtor, constituted receipt of "Common Collateral or proceeds thereof" and hence violated the Momentive ICA. However, the arguments of the first lienholders failed yet again.

The bankruptcy court first observed that, although cash may constitute Common Collateral, any payment made under

the backstop agreement would be based on the rights of the second lienholders under such agreement and in consideration of a separate unsecured obligation to backstop new exit financing for the debtors, and would therefore not be in respect of their remedies as secured creditors. The complaint with respect to receipt of professional fees was dismissed for failure to disclose the basis for such payments, and the court's inability to discern whether the payment itself was derived from the exercise of remedies with respect to Common Collateral.

Finally, the bankruptcy court examined whether the new common stock was "Common Collateral or proceeds thereof." The first lienholders argued that such asset was captured by the broad definition of "proceeds" in New York UCC §9-102(a)(64). In particular, they pointed to part (B) of such definition, which includes "whatever is collected on, or distributed on account of, collateral" and part (C) of such definition, which covers "rights arising out of collateral." However, the court flatly disagreed, holding as a matter of law that the stock did not constitute an asset to which any secured party's lien would attach, even under the expansive UCC definition of "proceeds." To the contrary, the shares of stock were to be received on account of or based on rights arising out of the second lienholders' liens and claims, and not the debtors' assets The court subscribed to the view that "proceeds" under the UCC should represent some of the collateral's "economic value or productive capacity,"[12] and that in this instance the value of the common collateral remained fully intact and unaffected by the issuance of the stock. In fact, to argue that the new stock constituted proceeds of collateral would, in the court's view, unfairly add to such common collateral. As a result, the court held that receipt of such common stock would not violate the terms of the Momentive ICA.

Conclusion

There are several important takeaways from *Momentive*.

First, intercreditor agreements tend to be strictly interpreted by courts to enforce the bargained-for rights of the parties. As noted by another Southern District court in an earlier decision, *Ion Media Networks v. Cyrus Select Opportunities Master Fund (In re Ion Media Networks)*,[13] "[a]ffirming the legal efficacy of unambiguous intercreditor agreements leads to more predictable and efficient commercial outcomes and minimizes the potential for wasteful and vexatious litigation."

In the absence of clearly crafted waivers and restrictions, intercreditor agreements do not automatically preclude second lienholders from maintaining actions in bankruptcy proceedings to the detriment of first lienholders.

In addition, courts appear reluctant to strip from second lienholders rights they may hold in their capacity as unsecured creditors. To the same extent that a clearly worded restriction on a second lienholder will be enforced in accordance with the terms of the intercreditor agreement,[14] in the absence of such unambiguous restrictions or waivers of rights, the court will not alter the contract merely to give effect to the spirit of the subordination scheme inherent in such agreements. Citing *Boston Generating*, the bankruptcy court in *Momentive* held that "unless very clearly precluded or constrained by an intercreditor agreement," the rights available to the second lienholders as unsecured creditors must not be curtailed.[15] Drain gave particular notice of the rights of the second lienholders, as unsecured creditors, to ensure that the debtors have acted properly as fiduciaries to such creditors.[16]

Finally, first lienholders need to be aware that distributions of equity interests of a debtor would not, under *Momentive* and even in the instance of a blanket lien, be captured under the broad UCC definition of "proceeds" as construed by the court.

In the absence of clearly crafted waivers and restrictions, intercreditor agreements do not automatically preclude second lienholders from maintaining actions in bankruptcy proceedings to the detriment of first lienholders. Any drafting exercise with respect to an intercreditor agreement must take these wider considerations into account in order for the agreement to effectively reflect the intent of the parties.

1. See Alan M. Christenfeld and Barbara M. Goodstein, "New ABA Model Intercreditor Agreement Offers Guidance," N.Y.L.J., Aug. 5, 2010.
2. 518 B.R. 740 (Bankr. S.D.N.Y. 2014). This decision was issued on Oct. 14, 2014. As of the date of submission of this article for publication, there is no indication that this ruling has been appealed.
3. Drain has also issued a number of interesting rulings during the *Momentive* plan confirmation process on subjects that are beyond the scope of this column, including make-whole provisions, debt subordination agreements and cramdowns. See Bankr. S. D. N. Y., Sept. 9, 2014, available at http://www.nysb.uscourts.gov/judge-drain-opinions (last visited Dec. 1, 2014).
4. 440 B.R. 302 (Bankr. S.D.N.Y. 2010). See also Alan M. Christenfeld and Barbara Goodstein, "First Lien Lenders Beware: Drafting Points to Consider," N.Y.L.J., Feb. 3, 2011.
5. 11 U.S.C, §510(a) of the Bankruptcy Code provides:

> A subordination agreement is enforceable under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law.

6. 518 B.R. at 744.
7. Id. at 750-51.
8. Section 5.4 of the Momentive ICA, as quoted by Drain in *Momentive*, provides as follows:

> *Notwithstanding anything to the contrary in this Agreement*, the Second-Priority Agents and the Second-Priority Secured Parties *may exercise rights and remedies as an unsecured creditor against the Company* or any Subsidiary that has guaranteed the Second-Priority Claims in accordance with the terms of the applicable Second-Priority Documents and applicable law.

Id. at 748 (emphases added by Drain).

9. The bankruptcy court order gave the first lienholders a period of 30 days to amend their complaints in this regard. Id. at 756-57.
10. In a previous ruling, the bankruptcy court had disallowed the first lienholders' make-whole right as a matter of New York law. To the extent that this ruling is not overturned, it would render moot the claims of the first lienholders' made with respect to the alleged breach of the Momentive ICA in this regard. As Drain noted, "the defendants cannot be liable under the ICA for objecting to invalid claims." Id. at 749.
11. Id. at 752.
12. Id. at 755, quoting R. Wilson Freyermuth in "Rethinking Proceeds: The History, Misinterpretation and Revision of U.C.C. Section 9-306," 69 Tul. L. Rev. 645 (1995).
13. 419 B.R. 585, 595 (Bankr. S.D.N.Y. 2009).
14. See *In re Erickson Retirement Communities*, 425 B.R. 309 (Bankr. N.D. Tex. 2010).
15. 518 B.R. at 750.
16. Id. at 751.

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