New York Law Journal
Corporate Update
WWW.NYLJ.COM
An ALM Publication
VOLUME 255—NO. 105
THURSDAY, JUNE 2, 2016

SECURED TRANSACTIONS

Are Intercreditor Agreements Now Going According to Plan?

By
Barbara M. Goodstein

Intercreditor agreements should add consensus and cohesion to the bankruptcy process. They provide a framework to align creditors with often directly conflicting interests, before those interests are tested under the duress of a restructuring or liquidation. And this opportunity for pre-restructuring alignment is of greater importance given today's active secondary loan market, which clears a path for the debtor's original relationship lenders to sell their interests should a restructuring loom. Distressed debt purchasers, on the other hand, may have different objectives that make them less willing to join forces with longer-term holders.

The desire to avoid the destructive nature of intercreditor disputes motivated the American Bar Association to produce a model first lien/second lien intercreditor agreement in 2010 (Model ICA).[1] Unfortunately, the road to a quick and easy resolution of intercreditor issues has not yet been realized. Notwithstanding the call of judges and bar associations for greater precision in their drafting, these agreements continue to suffer from a lack of clarity. Moreover, they often fail to take heed of the likely path of a restructuring.

BARBARA M. GOODSTEIN *is a partner at Mayer Brown.* SEAN G. KULKARNI, *an associate at Mayer Brown, assisted in the preparation of this article.*

Intercreditor agreements typically involve debt and/or lien subordination. While the Bankruptcy Code provides that "subordination" agreements are enforceable in the context of a proceeding, and while there is case law supporting a broad read of the term "subordination,"[2] views continue to differ as to whether subordination captures solely "debt subordination," "lien subordination," or both.[3] The result is, of course, fertile ground for litigation.

'Delaware Trust' and 'Marathon Asset' illustrate varying ways to interpret a supposedly standard intercreditor priority of payments scheme.

We examined certain of these issues in late 2014 through the decision of New York Bankruptcy Judge Robert D. Drain[4] in *BOKF, N.A. v. JPMorgan Chase Bank, N.A. (In re MPM Silicones)* (*Momentive*).[5] In *Momentive*, the court adjudicated a series of disputes under an intercreditor agreement between first and second lien creditors. Intercreditor issues recently again took center stage in two decisions of the Delaware Bankruptcy Court, both issued by the same judge in the same case but involving, in this instance, solely first lien creditors.

Today we revisit intercreditor agreements in light of these two latest decisions, and discuss the problems that continue to plague creditors in enforcing these agreements.

Delaware Trust and Marathon Asset

The back-to-back decisions of Judge Christopher Sontchi in the cases of *Delaware Trust Co. v. Wilmington Trust, N.A. (In re Energy Future Holdings)*, decided on March 11, 2016 (*Delaware Trust*),[6] and *Marathon Asset Management, LP v. Wilmington Trust, N.A. (In re Energy Future Holdings)*,[7] decided on April 12, 2016 (*Marathon Asset*), illustrate varying ways to interpret a supposedly standard intercreditor priority of payments scheme.

In April 2014, Texas Competitive Electric Holdings Company (TCEH or debtor), a subsidiary of Energy Future Competitive Holdings Company (EFCH), filed a voluntary Chapter 11 petition in Delaware. As of the petition date, the TCEH debtors (which term includes EFCH and TCEH's debtor subsidiaries) had approximately $25.6 billion in first lien debt, consisting of approximately $22.6 billion in outstanding revolver and term loans, $1.75 billion in outstanding senior secured notes and approximately $1.23 billion of liabilities under interest rate swap and commodity hedging agreements. The first lien debt

was secured by substantially all of TCEH debtors' assets. Each class of first lien debt ranked pari passu in right of security. Shortly after commencement of the bankruptcy case, the TCEH debtors sought approval to use cash collateral and to make adequate protection payments to first lien creditors. Subsequently, the debtors filed their plan of reorganization (Plan). The Plan contemplated a spin-off transaction in which substantially all of the first lien collateral would be transferred to a newly-created entity (Reorganized TCEH) in exchange for various assets, including 100 percent of the reorganized entity's common stock, certain cash on hand, including proceeds from the issuance of debt and preferred shares, certain debt instruments and tax receivable payments (collectively, Plan Distributions).[8] Reorganized TCEH common stock and other assets, in turn, were to be distributed to the first lien creditors. In *Delaware Trust,* certain first lien creditors advocated different approaches to the proper calculation and allocation of both adequate protection payments and Plan Distributions (collectively, Distributions). In *Marathon Asset*, a group of first lien creditors argued that they were entitled, to the exclusion of other first lien creditors, to the proceeds from a release of cash collateral securing repayment of letter of credit obligations.

In both of these cases, a subset of first lien creditors argued that an intercreditor agreement (ICA) provision governing the "application of proceeds" among competing first lien creditors should determine the method for allocating certain amounts. The ICA provision at issue in both cases (Section 4.1) provided that "[r]egardless of any Insolvency or Liquidation Proceeding which has been commenced by or against the Borrower …, Collateral or any proceeds thereof received in connection with the sale or other disposition of, or collection on, such Collateral upon the exercise of remedies under the Security Documents by the Collateral Agent shall be applied in the following order …"[9] Rulings in favor of either set of plaintiffs would have caused a material decrease in the ratable share of payments to which the defendants in each case (holders of separate classes of first lien debt) were otherwise entitled. Applying the same reasoning and interpretation in each case, the bankruptcy court held that, while the ICA did apply, its Section 4.1 distribution waterfall did not control because the Distributions or other payments did not constitute "Collateral" or "proceeds thereof," there was no "sale or other disposition of or collection on" any Collateral, no "exercise of remedies" had occurred notwithstanding the commencement of the debtor's insolvency proceeding, and, in one of the two cases, the Collateral had not been "received" by the Collateral Agent.

'Delaware Trust'

In the first of the two cases, Delaware Trust Company (DTC), the indenture trustee for the first lien noteholders, argued that ICA Section 4.1(a) required each first lien creditor's ratable share of the Distributions to be calculated on a rolling basis and to include post-petition interest (Post-Petition Interest Method). Since the interest rate on the first lien notes was higher than the corresponding rates on other first lien debt, inclusion of post-petition interest would give the first lien noteholders a larger ratable share of Distributions than other first lien creditors (in a net amount of approximately $90 million).[10]

Intervening defendants (Intervenors) Titan Investment Holdings LP, a lender under the first lien credit agreement (Titan), and J. Aron & Company and Morgan Stanley Capital Group (holders of swap debt), opposed DTC's proposed allocation method. In the Intervenors' view, Distributions should be made according to the Bankruptcy Code, orders of the bankruptcy court and the plan of reorganization itself rather than the ICA, and should therefore be based on a ratable share of first lien claims as of the petition date without accounting for accrued but unpaid post-petition interest (Petition Date Method).[11]

Judge Sontchi first confirmed that the relationship among the first lien creditors with respect to their shared collateral was to be determined by the ICA.[12] He then identified four conditions under the ICA to application of its priority of payments scheme (and to DTC's claim to post-petition interest): (1) Collateral or any proceeds of Collateral must 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 result from a sale or other disposition of, or collection on, such Collateral; and (4) the sale, disposition, or collection must result from the exercise of remedies under the Security Documents.[13]

Collateral or Proceeds Thereof. The bankruptcy court then examined whether Plan Distributions constituted "Collateral" or proceeds thereof. DTC claimed that the spin-off proposed under the Plan was akin to a direct transfer of first lien Collateral to the first lien creditors, effectively no different than if the first lien creditors had foreclosed or otherwise collected on the Collateral itself.[14] Judge Sontchi, however, compared the TCEH spin-off arrangement to the debt-for-equity swap of *Momentive*. In *Momentive*, common stock of the newly reorganized debtor was distributed to existing second lienholders. In that case, Judge Drain determined that neither the plaintiffs (first and 1.5 lienholders) nor the defendant

second lienholders could claim a lien on the newly issued stock because, in particular, their collateral did not change in any way as a result of the issuance and distribution of the new stock and to hold otherwise would unfairly add to the collateral.[15] DTC argued, on the other hand, that TCEH was transferring its interest in the first lien Collateral to and receiving stock from a newly created entity—Reorganized TCEH. A *Momentive*-type restructuring, by contrast, would have entailed simply issuing stock in existing TCEH to the first lien creditors in exchange for their cancelled debt.

The bankruptcy court rejected DTC's argument as form over substance, holding that the involvement of a newly created entity in *Delaware Trust* was insufficient to alter the fundamental outcome in *Momentive*. Judge Sontchi was similarly unmoved by DTC's foreclosure analogy, emphasizing that the first lien creditors did not take control of the assets, there was no "disposal" of assets and, unlike a foreclosure, deficiency claims against the debtors were being extinguished under the Plan.[16]

The bankruptcy court further determined that new debt issued by the reorganized debtor entity would not constitute Collateral. Such debt instruments are *obligations* of the spin-off entity and not *assets* of that entity. More broadly, the court rejected DTC's contention that even if plan distributions were not Collateral, they were "proceeds" of Collateral, again noting, among other factors, the absence of any sale or disposition of assets constituting Collateral.[17]

As for adequate protection payments, the bankruptcy court ruled flatly that such payments protect against diminution in the value of collateral, and do not therefore, by their nature, constitute a payment of collateral.[18]

Receipt by Collateral Agent; Sale or Disposition of Collateral. The bankruptcy court then dismissed DTC's claim in respect of the second condition to applicability of the ICA (i.e., the Collateral must be "received" by the Collateral Agent), since the Distributions were not being paid to the Collateral Agent. DTC was likewise unsuccessful in demonstrating that the spin-off transaction constituted a sale or other disposition of, or collection on, such Collateral (the third requirement for applicability of the ICA). According to the court, TCEH was not "purchasing" the Collateral, Reorganized TCEH was not a third-party purchaser, and there was no "economic event" taking place to indicate a bona fide "sale."[19]

Exercise of Remedies. Finally, the court held that no "exercise of remedies" had taken place, despite DTC's repeated assertions that the Collateral Agent had been exercising remedies through, among other things, its (a) consenting to the Plan and accepting Plan Distributions, (b) seeking and receiving adequate protection payments, (c) forbearing from exercising rights and (d) filing of proofs of claim. In rejecting DTC's arguments, the bankruptcy court emphasized language in the ICA requiring the direction of the Required Secured Parties prior to the Collateral Agent's enforcement of the Security Documents or exercise of remedies, which direction had not been established.[20] The "Required Secured Parties" threshold could be satisfied only through affirmative votes of the first lien lenders and hedge providers.[21] Consequently, the first lien noteholders (acting through plaintiff DTC as indenture trustee) were unable to provide the necessary instruction to the Collateral Agent.[22]

'Marathon Asset'

Marathon Asset involved a similar intra-first lien creditor dispute over the applicability of the same Section 4.1 of the ICA, and, not surprisingly, Judge Sontchi incorporated and relied upon his ruling in *Delaware Trust*.

Marathon Asset Credit Facility Structure. The senior credit facility at issue in *Marathon Asset* included two L/C tranches, one of which consisted of "Deposit L/Cs" to support certain contingent liabilities of the borrower in connection with environmental matters, the borrower's commodity hedging arrangements and other borrower activities. The Deposit L/C Facility was required to be fully cash collateralized on the closing date by cash held in a Deposit L/C Collateral Account. The cash (amounting to $1.25 billion) was funded by a subset of senior lenders (the Deposit L/C Lenders) in a separate, senior loan tranche (the Deposit L/C Loans), and not by the borrower. The borrower granted a first priority lien on the Deposit L/C Collateral Account to the Collateral Agent, for the benefit of the Deposit L/C Issuers (but not the Deposit L/C Lenders), and a second-priority lien for the benefit of all secured parties (including, but omitting any priority for, the Deposit L/C Lenders).

As with *Delaware Trust*, the principal question before the bankruptcy court was whether the ICA or the bankruptcy plan governed the distribution of amounts in the Deposit L/C Collateral Account. The Chapter 11 plan provided for pro rata distribution of such amounts in accordance with the various facility lenders' allowed credit agreement claims. In response, plaintiffs (successors in interest to the Deposit L/C Lenders) asked the bankruptcy court to establish a priority right in favor of the Deposit L/C Lenders to the extent of the "Undrawn Overage Amount" (i.e., the positive difference between the aggregate stated amount of outstanding Deposit L/Cs and the amount that the

Deposit L/C beneficiaries were entitled to draw on those Deposit L/Cs).[23] However, distributions of amounts from the Deposit L/C Collateral Account were governed by the same Section 4.1 as in *Delaware Trust*, so in order for plaintiffs to establish a priority right to receive such monies, they had to satisfy the same four elements as applied in *Delaware Trust*; namely, that the amounts in the account constituted Collateral or proceeds of Collateral; that there was a "sale, transfer or other disposition of, or collection on" Collateral and an exercise of remedies; and that the Collateral Agent was receiving the proceeds of such action. In this instance, the plaintiffs were again found to fail to satisfy the first three elements. As a result, the court determined it did not need to decide whether proceeds were being received by the Collateral Agent.[24]

Conclusion

Building upon the precedent established in *Momentive*, the *Delaware Trust* and *Marathon Asset* decisions show the continued willingness of courts to honor lien intercreditor agreements as subordination agreements under Bankruptcy Code §510(a), but also that payments to secured creditors under a plan of reorganization are not ipso facto collateral or proceeds thereof. While one may question some of the reasoning behind the court's analysis, these decisions are consistent with the tendency of courts to construe narrowly the relevant distribution provisions in an intercreditor agreement before overriding relevant provisions of a bankruptcy reorganization plan.

The adverse rulings in each of *Delaware Trust* and *Marathon Asset* have been appealed.[25] DTC's appeal not surprisingly focuses on the distinctions between the *Momentive* debt-for-equity swap and the *Delaware Trust* spin-off; in particular, whether the actual transfer of debtor's collateral assets to a Reorganized TCEH in exchange for common stock in that spin-off entity supports the finding of a "disposition" of collateral and a distribution to first lien creditors of "Collateral" or "proceeds" thereof. A reversal by a Delaware Federal District Court, or at least further clarification as to the significance (or lack thereof) of the factual distinctions between the *Momentive* and *Delaware Trust* structures, will be important in guiding loan market participants. Whether the District Court agrees with the bankruptcy court's emphasis on first lien creditors retaining a deficiency claim against the debtor following a foreclosure action will also be of interest to market observers.

> 'Delaware Trust' and 'Marathon Asset' show the continued willingness of courts to honor lien intercreditor agreements as subordination agreements under Bankruptcy Code §510(a).

The first lien creditors in *Delaware Trust* and *Marathon Asset* amended and restated their ICA in 2009, and it is not unreasonable that the parties chose not to further amend their agreement based solely on the ABA's publication in 2010 of the Model ICA. In fact, plaintiff DTC argued successfully that the Model ICA was irrelevant to the case, in part by noting, as its title suggests, that the Model ICA's focus is first lien/second lien intercreditor arrangements rather than the allocation of rights among classes of first lien creditors.

Nonetheless, there is some irony in DTC's assertion as to the irrelevance of the Model ICA to its case. With one exception discussed below, the Model ICA waterfall priority of payments applies to collateral or proceeds received in connection with an "Enforcement Action."[26] ABA commentary indicates this is intended to provide first lienholders with a "head start" relative to enforcement of their liens during the applicable standstill period agreed to by second lienholders.[27] By implication, the requirement to undertake an enforcement action would not serve a similar purpose in the context of a first lien-only ICA.

However, the term Enforcement Action is definted broadly in the Model ICA to capture "not only the foreclosure against collateral and other standard secured party remedies, but also the initial steps of a consensual disposition of collateral."[28] Far from irrelevant, incorporation of the Model ICA's broad Enforcement Action concept might have benefited DTC more than the "exercise of remedies" requirement in its own ICA, at least as construed by the *Delaware Trust* court.

It is also interesting to note that the Model ICA contains, as an exception to the prior right of first lienholders to receive collateral or proceeds, the receipt in certain circumstances of debt or equity securities pursuant to a plan, as occurred in both *Momentive* and *Delaware Trust*.[29] The *Delaware Trust* and *Marathon Asset* ICA omitted this exception entirely. With Chapter 11 cases trending more frequently to the distribution of equity in the reorganized debtor to the secured creditors, creditors would do well to follow the guidance and fuller scope of drafting recommendations included in the Model ICA, even when tailoring that model agreement to a first lien-only ICA.

Financing parties must scrutinize all account and distribution waterfall mechanics in order to reflect the

expectations of each individual creditor class as to their respective priority of repayment or distribution in a bankruptcy proceeding (both prior to and following an actual direction and exercise of remedies). Doing so will help ensure that Chapter 11 plan distributions are allocated in predictable fashion, that is, according to plan.

••••••••••••●●••••••••••••••

1. See Alan M. Christenfeld & Barbara M. Goodstein, "New ABA Model Intercreditor Agreement Offers Guidance," 244 N.Y.L.J. 25 (Aug. 5, 2010).

2. 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." Intercreditor agreements providing for lien or debt subordination are generally deemed to be subordination agreements enforceable under §510(a) (see, e.g., *Ion Media Networks v. Cyrus Select Opportunities Fund (In re Ion Media Networks)*, 419 B.R. 585, 595 (Bankr. S.D.N.Y. 2009)).

3. See The Committee on Commercial Finance, ABA Section of Business Law, Report of the Model First Lien/Second Lien Intercreditor Agreement Task Force, 65 Bus. Law. 809, 867 & n.95 (2010) (hereinafter, ABA Model ICA).

4. See Barbara M. Goodstein, "'Momentive' Provides a Reminder About Intercreditor Agreements," 252 N.Y.L.J. 107 (Dec. 4, 2014).

5. 518 B.R. 740 (Bankr. S.D.N.Y. 2014) (hereinafter, *Momentive*).

6. 546 B.R. 566 (Bankr. D. Del. 2016) (hereinafter, *Delaware Trust*).

7. 548 B.R. 79 (Bankr. D. Del. 2016) (hereinafter, *Marathon Asset*).

8. Under TCEH's Plan, first lien creditors were to receive (a) the common stock of Reorganized TCEH; (b) 100 percent of TCEH and its debtor subsidiaries' cash on-hand and Reorganized TCEH's new debt or the cash proceeds of such new debt; (c) the rights to purchase $700 million of Energy Future Holdings (EFH) common stock under a rights offering and the EFH common stock purchased pursuant to the exercise of those rights; (d) certain stock in TCEH's ultimate parent and any excess cash that remained after distributions were made to the holders of general unsecured claims against certain of TCEH and its debtor subsidiaries; and (e) the rights to receive payments pursuant to a tax receivable agreement entered into by Reorganized TCEH if any. *Delaware Trust*, 546 B.R. at 575.

9. *Delaware Trust*, 546 B.R. 572. See also *Marathon Asset*, 548 B.R. at 85.

10. *Delaware Trust*, 546 B.R. at 568.

11. DTC claimed that the Post-Petition Interest Method was applicable only to distributions in the form of common stock and new debt (or proceeds of new debt) of Reorganized TCEH, cash on-hand and the rights to payment under Reorganized TCEH's tax receivables agreement (accepting the Petition Date Method for the other Distributions). Id. at 575-76.

12. Id. at 571.

13. Id. at 578.

14. Id. at 578-79.

15. *Momentive*, 518 B.R. at 755-56.

16. *Delaware Trust*, 546 B.R.at 579.

17. Id. at 580.

18. Id. at 581.

19. Id. at 582.

20. Id. at 583-84. Note that the ICA states as follows: "unless and until the Collateral Agent shall have received such direction, the Collateral Agent may (but shall not be obligated to) take such action, or refrain from taking such action, in order to preserve or protect its Liens and/or the value of the Collateral as it shall deem advisable in the best interest of the Secured Parties." The court did not address whether this language could arguably encompass certain actions considered to fall within the exercise of remedies.

21. *Delaware Trust*, 546 B.R. at 573.

22. DTC further argued that post-petition interest was "due and payable" regardless of whether such interest was held to apply in the bankruptcy proceeding. Priority *third* of the ICA distribution waterfall allocated "on a pro rata basis … all principal and other amounts then due and payable in respect of the Secured Obligations," and the latter term included post-petition interest "whether or not allowed or allowable in an Insolvency or Liquidation Proceeding." Since the relevant Distributions were held not to constitute "Collateral," the court "explicitly" made no ruling on the "due and payable" issue. Id. at 573, 584.

23. Plaintiffs estimated the "Undrawn Overage Amount" to be "$500 to $600 million or more." *Marathon Asset*, 548 B.R. at 85.

24. Id. at 90. Notwithstanding the decision of the *Marathon Asset* court to reject the application of ICA Section 4.1 to allocations from the Deposit L/C Collateral Account, the court went on at length in dicta to analyze the textual meaning of the priority of payment provisions in regard to whether, as drafted, the term "Deposit L/C Obligations" in fact captured payments to the Deposit L/C Lenders and not just the Deposit L/C Issuers, a discussion of which is beyond the scope of this article.

25. *Delaware Trust*, appeal docketed, No. 1:16-cv-00189 (RGA) (D. Del. March 28, 2016), *Marathon Asset*, appeal docketed, No. 1:16-cv-00298 (RGA) (D. Del. April 22, 2016).

26. ABA Model ICA, 65 Bus. Law. at 846.

27. Id. at 845 & n.41.

28. See id. at 876 & n.102.

29. See id. at 864 & n.88.

Reprinted with permission from the June 2, 2016 edition of the NEW YORK LAW JOURNAL © 2016 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited. For information, contact 877-257-3382 or reprints@alm.com. # 070-06-16-05