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A Narrow Reading of Lien Rights in Plan Distributions: Enforcing Intercreditor Waterfall Provisions in Bankruptcy

By Jason Ulezalka and Jonathan W. Young*

The authors of this article discuss a recent U.S. Court of Appeals for the Third Circuit opinion regarding the enforcement of intercreditor agreements in bankruptcy. Although the opinion is not binding precedent, it provides important drafting considerations for finance and restructuring practitioners, and reflects a growing alignment of courts in the Second and Third Circuits as to the interpretation of intercreditor agreement provisions.

Circuit Judge Stephanos Bibas, of the U.S. Court of Appeals for the Third Circuit, has delivered an important opinion regarding the enforcement of intercreditor agreements in bankruptcy.[1] The ruling was not an opinion of the full court and, accordingly, is not binding precedent.

However, the opinion does provide some important drafting considerations for finance and restructuring practitioners, and reflects a growing alignment of courts in the Second and Third Circuits as to the interpretation of intercreditor agreement provisions.

BACKGROUND

This decision stems from the 2014 bankruptcy filing by Energy Future Holdings Corp. and its subsidiaries ("Energy Future"). One of the Debtor subsidiaries, Texas Competitive Electric Holdings Company (together with its subsidiaries, "Texas Competitive"), was acquired by Energy Future in a 2007 leveraged buyout. In connection with that acquisition, Texas Competitive borrowed approximately $25 billion in the form of secured bank debt and also entered into certain swap agreements (which were also secured). The bank debt

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[1] *In re: Energy Future Holdings Corp., et al. v. Morgan Stanley Capital Grp., Inc. and Wilmington Trust, N.A.*, 773 Fed. Appx. 89 (3d Cir. 2019).

and swap agreement creditors were generally referred to in the bankruptcy case as the *2007 creditors*. In 2011, Texas Competitive issued approximately $2 billion of certain 11.5 percent secured notes. Those note creditors were treated as a separate class of creditors in the bankruptcy case, known generally as the *2011 creditors*. Importantly, the interest rate on the obligations owed to the 2011 creditors was significantly higher than the interest rate on the obligations owed to the 2007 creditors.

The same collateral secured the obligations owed to both the 2007 and 2011 creditors. Such collateral consisted of substantially all of the assets of Texas Competitive. Accordingly, the 2007 and 2011 creditors entered into an intercreditor agreement to govern their rights and obligations relative to the shared collateral pool. While the 2007 and 2011 creditors extended credit at different times and pursuant to different instruments, under the terms of the intercreditor agreement both groups functionally shared a *pari passu* first lien position.

Following commencement of the bankruptcy case, Texas Competitive sought permission to use the shared cash collateral in conjunction with continued operations. In approving the requested use of cash collateral, the bankruptcy court ordered Texas Competitive to make monthly adequate protection payments to both creditor groups.

The 2007 creditors and 2011 creditors were both undersecured in the Energy Future bankruptcy proceeding, and a dispute arose as to how certain plan distributions and adequate protection payments (such distributions and payments, collectively, the "Distributions") would be allocated amongst the two competing groups of creditors. Central to this issue was the interpretation of the "waterfall" provision in the Intercreditor Agreement.

As noted above, the obligations owed to the 2011 creditors was subject to a significantly higher interest rate than the obligations owed to the 2007 creditors. Accordingly, during the course of the bankruptcy proceeding, the 2011 creditors continued to accrue post-petition interest at a higher rate than the 2007 creditors.

The 2007 and 2011 creditors disputed whether the waterfall provision applied to the Distributions. If the waterfall applied, then the secured obligations would include post-petition interest, and the 2011 creditors would be entitled to a larger share of the proceeds available for distribution. If the waterfall did not apply, the secured obligations would be allocated based on the Secured Obligations as of the bankruptcy petition date—which would disregard post-petition interest.

If the waterfall provision applied, approximately $90 million of additional

accrued interest would be allocated from the 2007 creditors to the 2011 creditors.

THE OPINION

The opinion from Judge Bibas concluded that the waterfall provision did not apply to the Distributions and, accordingly, the amount of Distributions owed to the 2007 creditors and 2011 creditors should be calculated based on what Energy Future owed each creditor group at the time of the bankruptcy filing.

The language of the intercreditor agreement made the waterfall provision applicable only to (1) distributions of collateral or (2) proceeds received in connection with a sale, collection, or disposition of collateral *upon an exercise of remedies by the collateral agent* (emphasis added).

With respect to the first prong of this analysis, Judge Bibas held that the Distributions were not collateral under the waterfall:

> [N]ot every payment from the subsidiary's assets is a payment of collateral. A payment of collateral reduces the amount of money owed on a debt. The subsidiary, however, made the adequate-protection payments in exchange for the creditors' agreement to let the subsidiary use the collateral for other purposes. The adequate-protection payments did not decrease the amount of money the subsidiary owed on the debts. So, as the bankruptcy court correctly held, the adequate-protection payments are not payments of collateral.[2]

Judge Bibas continued:

> [T]he plan distributions [were] made from assets on which the creditors had no liens. The plan specified that the creditors' liens did not extend to any assets the subsidiary had because of the plan. The plan distributions were made from those assets. And bankruptcy law confirms that assets acquired after bankruptcy generally are 'not subject to any lien resulting from' a prior agreement. 11 U.S.C. § 552(a). Thus, the plan distributions are not distributions of collateral.[3]

With respect to the second prong of this analysis, Judge Bibas held that the Distributions were not proceeds of collateral under the waterfall. The waterfall provision provided for two explicit requirements in order for payments or distributions to be proceeds: (i) the proceeds must be from a sale, collection, or disposition of collateral; and (ii) that sale, collection, or disposition must be part

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[2] *Energy Future Holdings*, 773 Fed. Appx. at 93.

[3] *Id.*

of a remedy implemented by the collateral agent.

The adequate protection payments did not meet the first requirement, according to the Third Circuit, since no sale, collection, or disposition of collateral occurred before those payments were made. Further, the bankruptcy proceeding was not a remedy implemented by the collateral agent. Accordingly, the Distributions were not proceeds under the waterfall provision.

HARMONY WITH THE BANKRUPTCY COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

Judge Bibas's analysis aligns harmoniously with Judge Robert Drain's recent decision in the *Momentive* case, pursuant to which the U.S. Bankruptcy Court for the Southern District of New York also ruled that certain plan distributions were not "collateral" to be governed by the waterfall provision applicable to that case.[4]

In *Momentive*, the bankruptcy court also focused on the meaning of "proceeds" and found that common stock in the reorganized debtors issued to a junior creditor could not comprise "proceeds" of common collateral as a matter of law. The court in that case held that, in order to be "proceeds," the common stock would have had to result from a *change* in the collateral that *diluted* the collateral's value. However, the senior creditors retained their liens on all of the common collateral and that collateral was not diminished by the distribution of new stock under the plan to the defendants. Accordingly, no "proceeds" were generated. The bankruptcy court found that a literal exchange or transformation of the object comprising the collateral is necessary for proceeds to be generated.

As Judge Drain explained in the *Momentive* case, "From the perspective of the debtors, that stock is not something that any currently secured party's existing lien would attach to, even under the expansive definition of "proceeds" in [UCC] section 9-102(a)(64), because the new common stock comprises proceeds of the [junior creditors'] liens and claims, not the proceeds of the *debtors'* assets that constitute the Common Collateral."[5]

In affirming Judge Drain's opinion, the district court further noted that "the property interest in the reorganized common stock belongs to the party who is

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[4] *BOKF, N.A. v. JPMorgan Chase Bank, N.A. (In re MPM Silicones, LLC)*, 518 B.R. 740 (Bankr. S.D.N.Y. 2014), *aff'd*, *BOKF NA v. Wilmington Sav. Fund Soc'y FSB* (*In re MPM Silicones LLC*), 596 B.R. 416 (S.D.N.Y. 2019).

[5] *Id.* at 754 (emphasis in original).

vulnerable to an encumbrance affixing to that property."[6]

In other words, a party with a lien on the junior creditor's rights against the debtors could assert that lien against the new common stock, but a secured creditor of the debtors' could not assert its lien against that stock because the debtors' assets were not distributed, or otherwise affected by, the disbursement of the stock. The property constituting the shared collateral remains unaffected by the disbursement of the new stock. The new stock is not proceeds of the shared collateral.[7]

PRACTICAL CONSIDERATIONS

Two influential courts have therefore come to the same conclusion—new property rights awarded in a confirmed Chapter 11 plan do not amount to "proceeds" of pre-petition, pre-confirmation collateral. Based on that analysis, each court strictly construed the intercreditor agreement at issue, and declined to subject plan consideration to the terms of the intercreditor agreement. While Judge Bibas's decision is non-binding, it will certainly be cited as persuasive authority in future cases—particularly given the extent to which it harmonizes and supports Judge Drain's decision in *Momentive*.

From a drafting perspective, practitioners will want to revisit the terms of their intercreditor agreements, and specifically include adequate protection payments, plan distributions, stock, warrants and other equity rights in the reorganized debtors. While the *Energy Future Holdings* and *Momentive* decisions held that the intercreditor agreements were inapplicable by their terms, a different result may well have been reached if the agreements specifically provided for this form of consideration. If the parties to an intercreditor agreement intend to prohibit all distributions to junior creditors (whether such distributions are made from collateral proceeds, an exercise of remedies or otherwise) until such time that the senior creditors have been paid in full, then the intercreditor agreement should reflect that arrangement explicitly.

In addition, practitioners should consider the practical implications of the gap period between confirmation and Effective Date in light of these two decisions. If pre-confirmation lien rights do not reach the reorganized equity or other plan consideration, it will be essential to preserve the full range of lien rights until the plan has become effective—particularly if the plan has a delayed effective date.

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[6] *BOKF NA v. Wilmington Sav. Fund Soc'y FSB* (*In re MPM Silicones LLC*), 596 B.R. at 436.

[7] *BOKF, N.A. v. JPMorgan Chase Bank, N.A. (In re MPM Silicones, LLC)*, 518 B.R. at 754–55.

It is also worth considering the implications of these decisions for intercreditor agreements restricted to lien subordination, as opposed to payment subordination. Under a lien subordination agreement, the senior lien creditor has priority in the collateral proceeds, while the junior lien creditor collects from the collateral proceeds only to the extent there is value remaining after the senior lien creditor has been paid in full in cash. The senior lien creditor has no priority of payment, however, with respect to proceeds of assets that are not collateral. Under a payment subordination agreement, junior lien creditors cannot receive payments from any source before the senior lien creditors have been paid in full in cash.

In both the *Energy Future Holdings* and *Momentive* cases, the aggrieved group of creditors would have substantially benefited from a payment subordination arrangement.[8] That is not to say that junior creditors are voluntarily going to agree to payment subordination without a meaningful increase in their rate of return.

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[8] As noted above, the *Energy Future Holdings* creditors shared a *pari passu* first lien position, such that lien subordination was not applicable. However, the point remains that the 2011 creditors would have benefited from a waterfall provision that applied to all payments (not just payments made from collateral proceeds).