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Third Circuit Rules Intercreditor Agreement Doesn't Apply to Plan Distributions

On June 19, 2019, the U.S. Court of Appeals for the Third Circuit (the "Court") issued a decision concerning the distribution of collateral under an intercreditor agreement—finding that adequate protection payments and plan distributions that were not generated from sales of collateral were not collateral or proceeds thereof and, therefore, were not subject to the intercreditor agreement's waterfall provision.[1] The Third Circuit's decision in this case is consistent with a recent opinion from the Southern District of New York.[2]

BACKGROUND AND BANKRUPTCY COURT DECISION

Texas Competitive Electric Holdings Company LLC (the "Debtor"), a subsidiary of Energy Future Holdings, owed money to two groups of noteholders who shared equal priority and whose debt was secured by the same collateral. Nevertheless, different interest rates applied to the groups—the first group's notes had a lower interest rate (the "2007 Group") than the second noteholder group (the "2011 Group" and collectively with the 2007 Group, the "Noteholders"). An intercreditor agreement (the "Agreement") governed the relationship between the two noteholder groups, and the Agreement contained a waterfall provision that governed distributions of collateral or proceeds from the sale, disposition, or collection on the collateral. After the Debtor's 2014 bankruptcy filing, the Noteholders received adequate protection payments from the Debtor for the use of the collateral. In 2016, the bankruptcy court approved the Debtor's plan of reorganization which required that the Noteholders give up any claims to the collateral in exchange for plan distributions. The Noteholders disagreed about how the adequate protection payments and the plan distributions should be split between them.

The 2011 Group filed a lawsuit arguing that under the waterfall, the split should be based upon what would be owing to the Noteholders when the payments and distributions were actually made by the Debtor. This allocation would include post-petition interest and therefore favored the noteholder group with the higher interest rate because two years elapsed

between the filing and the plan distributions. The 2007 Group argued that each noteholder group's share of the payments and distribution should be based upon the amounts they were owed when the bankruptcy case was filed because, as under-secured creditors, the noteholder groups were not entitled to post-petition interest. The bankruptcy court agreed with the 2007 Group—finding that the waterfall provision in the Agreement was inapplicable and therefore the allocation of proceeds should be based upon the relative claim amounts as of the commencement of the bankruptcy case. The district court affirmed.

DECISION ON APPEAL

On appeal, the Third Circuit affirmed the district court and held that because the waterfall provision did not apply, the allocation should be made based upon the claim amounts as of the bankruptcy filing. This conclusion rests on the Court's view that the payments and distributions under the plan did not constitute collateral or proceeds and therefore the Agreement's waterfall provision was not implicated.

The Court stated that "a payment of collateral reduces the amount of money owed on a debt."[3] Here, the adequate protection payments were made in exchange for the Debtor's use of the collateral rather than to reduce the debt. Additionally, the distributions were made from assets that were not subject to the Noteholders' liens. Thus, neither the payments nor the distributions constituted collateral. Further, the restructuring that resulted in the payments and distributions "was not part of a remedy implemented by the collateral agent" and therefore, based on the language in the Agreement, there was an additional basis not to apply the waterfall provision at issue.[4]

CONCLUSION

Notwithstanding the favorable result for the 2007 Group, an intercreditor agreement could be more precisely drafted to achieve the opposite result by expressly stating that the waterfall provision applies to distributions made by a chapter 11 debtor. It should also be noted that the Court's decision is nonprecedential and as such, is not binding on later Third Circuit panels. Nevertheless, the opinion is an important reminder about the need to draft intercreditor agreements carefully.

[1] *Delaware Trust Co. v. Morgan Stanley Capital Group* (In re Energy Future Holdings Corp.), No. 18-1957, 2019 WL 2535700 (3d Cir. June 19, 2019).
[2] *In re MPM Silicones, LLC*, 518 B.R. 740 (Bankr. S.D.N.Y. 2014), *aff'd sub nom. In re MPM Silicones, LLC*, 596 B.R. 416 (S.D.N.Y. 2019).
[3] *In re Energy Future Holdings Corp.*, 2019 WL 2535700 at *3.
[4] *Id.* The language in the Agreement's waterfall provision required that: (1) the proceeds must be from a sale, disposition, or collection of collateral; and (2) the sale, distribution, or collection must be part of a remedy implemented by the collateral agent.