Clients&FriendsMemo

Delaware Bankruptcy Court Rules TCEH First Lien Distributions Are Governed by the Bankruptcy Code, Not by Intercreditor Agreement Waterfall

March 21, 2016

On March 11, 2016, Judge Christopher Sontchi of the U.S. Bankruptcy Court for the District of Delaware issued an opinion in the *Energy Future Holdings* bankruptcy that resolved an intercreditor dispute over $90 million in proceeds to be distributed under the plan of reorganization. The Court determined that distributions under a plan of reorganization and monthly adequate protection payments made pursuant to a cash collateral order were governed solely by the plan and order, and were not required to be distributed in accordance with a waterfall provision in an intercreditor agreement.

Background

In April 2014, Texas Competitive Electric Holdings LLC and its affiliates ("TCEH") commenced chapter 11 proceedings in the Bankruptcy Court for the District of Delaware. TCEH's bankruptcy case is one of the largest bankruptcy cases in United States history, in part because TCEH has one of the largest capital structures of any chapter 11 debtor.

As of the petition date, TCEH's capital structure consisted of approximately $25 billion of first lien debt, including (i) $22.6 billion of debt outstanding under a credit agreement (the "Bank Debt"), (ii) $1.75 billion of debt outstanding under a first lien indenture (the "First Lien Notes"); and (iii) $1.255 billion of debt outstanding under first lien interest rate swap and commodity hedge agreements (collectively, the "First Lien Obligations"). Each of the First Lien Obligations by their terms rank pari passu, and the holders of the First Lien Obligations have a lien on substantially all of TCEH's assets. In connection with the issuance of the First Lien Obligations, TCEH and holders of the First Lien Obligations entered into a Collateral Agency and Intercreditor Agreement (the "ICA"), which in certain circumstances, governs the rights of the holders of the First Lien Obligations with respect to their collateral and its proceeds.

Shortly after filing its bankruptcy petition, TCEH sought the Bankruptcy Court's approval to use cash collateral and to pay TCEH's first lien creditors monthly cash payments as adequate

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protection. Certain holders of the First Lien Notes argued that the waterfall provision in the ICA requires that each first lien creditor's ratable share of the adequate protection payments must be calculated on a rolling monthly basis to include post-petition interest (the "Post-Petition Interest Calculation"), and that the calculation of each creditor's pro rata share of adequate protection payments would be a precursor to distributions made under TCEH's plan. Ultimately, the parties agreed to include in the cash collateral order a holdback mechanism, wherein the difference between (A) the petition date allocation calculation and (B) the amounts that the noteholders would otherwise receive under the Post-Petition Calculation included is deducted from the swap counterparties and lenders' monthly adequate protection payments. Such amounts were to be held in escrow pending a resolution of the intercreditor dispute.

On March 13, 2015, Delaware Trust Company, as indenture trustee for the First Lien Notes ("DTC"), filed a complaint in New York state court against Wilmington Trust N.A, in its capacity as collateral agent and administrative agent, seeking (i) a declaration that under the intercreditor agreement post-petition interest had to be included in calculating each creditor's ratable share of past and future adequate protection payments and (ii) specific performance releasing the holdback amounts to the plaintiff (the "ICA Action"). Shortly thereafter, Morgan Stanley[1] and J. Aron, holders of the First Lien Swaps moved to intervene in the litigation, and the administrative agent removed the case to federal court. On July 23, 2015, the U.S. District Court for the Southern District of New York granted the motions to intervene, held that the ICA Action was a core bankruptcy dispute, and therefore transferred the ICA Action to the Delaware bankruptcy court. *See Delaware Trust Co. v. Wilmington Trust, N.A.*, 534 B.R. 500 (S.D.N.Y. 2015).[2]

In September 2015, DTC filed an amended complaint in the Bankruptcy Court, asserting that both adequate protection payments and plan distributions should be allocated pursuant to the Post-Petition Interest Calculation. The Trustee contended that the waterfall provision applied regardless of any bankruptcy proceeding, and required that monies be distributed to pay for "Secured Obligations" including post-petition interest, regardless of whether such amounts are allowed in the bankruptcy case. Based on this broad definition, DTC argued that the holders of First Lien Notes were entitled to a larger pro rata share of adequate protection payments and plan distributions because the First Lien Notes accrue at a higher rate of interest vis-à-vis the other first lien creditors. The parties subsequently filed cross-motions for judgment on the pleadings.

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[1] Cadwalader represents Morgan Stanley, a first lien swap counterparty, in TCEH's chapter 11 case and as an intervenor-defendant in the *Delaware Trust* litigation.

[2] A summary of the District Court's decision on jurisdiction and further detail regarding the procedural history of this matter is available in a prior Cadwalader memorandum: *TCEH Bankruptcy: SDNY Transfers Delaware Trust Company v. Wilmington Trust N.A. Intercreditor Dispute to Delaware Bankruptcy Court, Reaffirming Broad View of Bankruptcy Jurisdiction* (August 5, 2015), *available at* http://www.cadwalader.com/resources/clients-friends-memos/tceh-bankruptcy-sdny-transfers-delaware-trust-company-v-wilmington-trust-na-intercreditor-dispute-to-delaware-bankruptcy-court-reaffirming-broad-view-of-bankruptcy.

Court's Decision

Following oral argument on March 4, 2016, the Bankruptcy Court entered an opinion and order on March 11, 2016, ruling in favor of the Defendants and granting their motions for judgment on the pleadings. The Bankruptcy Court held that the ICA did not apply to the adequate protection payments or plan distributions because none of the conditions set forth in the ICA's waterfall were satisfied. Those elements, according to the Court, are: "(i) Collateral or any proceeds of Collateral are to be distributed to the First Lien Creditors; (ii) the Collateral must be "received" by the Collateral Agent; (iii) the Collateral or the proceeds of Collateral must have resulted from a sale or other disposition of, or collection on, such Collateral; and (iv) the sale, disposition, or collection must have resulted from the exercise of remedies under the Security Documents." The Court found that in order to for DTC to prevail, DTC would be required to demonstrate that each element has been satisfied.

First, the Court held that the plan distributions and adequate protection payments were not collateral or proceeds thereof. Relying on Judge Drain's decision in *Momentive*[3], the Court held that stock in a reorganized entity distributed pursuant to a plan in exchange for secured claims did not qualify as collateral or proceeds. To hold otherwise, according to Judge Sontchi, would contradict existing case law addressing whether "a secured creditor receives the 'indubitable equivalent' of its secured claim…if it receives stock in the reorganized enterprise as party of cramdown treatment under a chapter 11 plan." Opinion at 25-26. Further, the Court rejected DTC's contention that the transaction in the plan was akin to a foreclosure. According to the Court, the restructuring under the plan was not a foreclosure because (i) deficiency claims would be wiped out, (ii) there is no disposal of assets, and (iii) the first lien creditors would not control any of the assets. *Id.* at 26.

The Court likewise found that the proceeds of new Reorganized TCEH debt would not qualify as collateral. According to the Court, the "Debt Funds are *debt* and **not** *assets* of Reorganized TCEH. These Debt Funds will be an *obligation* of Reorganized TCEH, not an *asset* of Reorganized TCEH into which collateral was converted." Opinion at 26 (emphasis in original). The Court rejected Plaintiff's arguments that the other distributions qualified as collateral. The other distributions, according to the Court, did not exist prior to the bankruptcy case, were created under the plan, and were assets belonging to Reorganized TCEH (not TCEH). Thus, the Court held that none of the distributions qualified as collateral or proceeds thereof.

The Court similarly held that the adequate protection payments under the cash collateral order did not qualify as collateral or proceeds of collateral. According to the Court, adequate protection

[3] *BOKF, NA v. JP Morgan Chase Bank, N.A. (In re MPM Silicones LLC)*, 518 B.R. 740 (Bankr. S.D.N.Y. 2014).

payments are not a payment of collateral—"rather, adequate protection is designed to protect secured creditors against diminution in value of their collateral." Opinion at 29.

Second, the Court held that the waterfall in the ICA did not apply, because neither the plan distributions nor the adequate protection payments were paid to the Collateral Agent. With respect to the adequate protection payments, the Court expressly noted that the cash collateral order provided for direct payments to the first lien creditors, and thus the second prong was not satisfied.

Third, the Court held that the plan distributions were not the resolution of a sale or disposition of collateral. While DTC contended that the spin-off transaction contemplated under the plan is a "sale," the Court noted that nothing in the plan stated that Reorganized TCEH would "purchase" the collateral. Moreover, nothing in the plan supported the notion that Reorganized TCEH is a third party purchaser. Consequently, the Court held that the plan distributions did not result from the sale or disposition of collateral.

Finally, the Court held that the disposition of collateral or collection on collateral did not result from the exercise of remedies by the collateral agent. DTC set forth multiple reasons for why the collateral agent exercised remedies, including: (i) the collateral agent was a party to the plan support agreement, (ii) the plan would result in the release of liens and only the Collateral Agent is empowered to release liens, (iii) the collateral agent's receipt of plan distributions would qualify as an exercise of remedies, (iv) the filing of a proof of claim qualified as an exercise of remedies, and (v) the collateral agent's forbearance is an exercise of a remedy. The Court rejected each of these arguments. First, the Court noted that each of the provisions on which DTC relied explicitly required a direction from a requisite amount of creditors, which DTC never established. Second, the Court held that simply holding liens is not an exercise of remedies, and that exercise of remedies would require more. Third, the Court was not convinced by Plaintiff's argument that filing a proof of claim qualified as an exercise of remedies, because, among other things, the remedial provisions in TCEH's security documents explicitly required a direction from a requisite amount of first lien creditors, which was absent here.

Because DTC failed to establish that any of the conditions precedent for the waterfall were satisfied, the Court held that the distributions were to be allocated pursuant to the Bankruptcy Code, and would not include post-petition interest. Accordingly, the Bankruptcy Court denied DTC's motion for judgment on the pleadings, and dismissed the amended complaint with prejudice.

Conclusion

The Bankruptcy Court's decision in *Delaware Trust* makes clear that distributions to secured creditors under a plan are not, *per se*, collateral or the proceeds of collateral. They are simply payments on the debt. This is consistent with *Momentive*, the first decision to directly address this subject. We are not aware of any contrary precedent. The decision also demonstrates that intercreditor agreements may not always control relative distributions in bankruptcy, even where the agreement provides that it will apply in insolvency.

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