

# Clients & Friends Memo

## ***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**

On July 23, 2015, in an action arising from the huge TCEH chapter 11 bankruptcy, Judge Paul A. Engelmayer of the U.S. District Court for the Southern District of New York issued an opinion in *Delaware Trust Company v. Wilmington Trust N.A.*<sup>1</sup> denying plaintiff's motion to remand the case back to New York state court, and granting defendants' motion to transfer the case to the District of Delaware, from where it will be referred to the United States Bankruptcy Court for the District of Delaware.

The issue before the District Court was whether a New York court, or the Delaware Bankruptcy Court where the chapter 11 cases of Texas Competitive Electric Holdings LLC and certain of its affiliates (collectively, "TCEH") are pending, should resolve an intercreditor dispute regarding how to allocate the debtor's monthly adequate protection payments among its creditors. Resolution of this issue by Judge Engelmayer turned largely on whether the dispute over the allocation methodology for the payments is considered a "core" proceeding within the underlying TCEH chapter 11 cases (*i.e.*, one that either "arises under" or "arises in" the bankruptcy proceeding). The District Court ultimately ruled in favor of the defendants and decided that the matter is indeed core, thereby warranting that the case be properly heard by the Delaware Bankruptcy Court. If a dispute "arises under", or "arises in", the ongoing bankruptcy proceeding, it must be transferred to the Bankruptcy Court overseeing the bankruptcy case.<sup>2</sup>

The decision is important because it reaffirms the often challenged principle that contractual disputes between creditors may qualify as "core" proceedings in circumstances where, as here, the underlying dispute could only arise in the context of a bankruptcy proceeding.

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<sup>1</sup> Cadwalader represents Morgan Stanley Capital Group in TCEH's chapter 11 case, as well as in its capacity as an intervenor defendant in the *Delaware Trust* litigation.

<sup>2</sup> 28 U.S.C. §§ 1334(b), 1412.

**Background**

In April 2014, TCEH filed for chapter 11 protection in the Bankruptcy Court for the District of Delaware. TCEH's bankruptcy case is one of the largest bankruptcy cases in United States history with a capital structure consisting of over \$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 (the "First Lien Swaps" and together with the First Lien Notes and Bank Debt, the "First Lien Obligations"). Each of the First Lien Obligations rank pari passu and 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 in 2007 entered into an Intercreditor Agreement, which contained a permissive New York choice of forum clause, and in certain circumstances governs the rights and priorities of the holders of the First Lien Obligations with respect to their collateral.<sup>3</sup>

Shortly after filing its chapter 11 petition, TCEH filed a motion seeking authorization to use cash collateral. As part of that motion, TCEH requested authorization to provide adequate protection to the holders of the First Lien Obligations, as compensation for the diminution in value of their collateral during the chapter 11 case. On June 6, 2014, the Bankruptcy Court entered a cash collateral order, which provided that each of the holders of the First Lien Obligations would: "receive from the TCEH Debtors their ratable share" of the aggregate amount of monthly adequate protection payments.<sup>4</sup> Under the express terms of the order, each creditor's ratable share is calculated based on the proportion of the First Lien Obligations owing as of the petition date. Accordingly, post-petition interest is not included in the calculation of each creditor's ratable share.

At the June 2014 hearing for the cash collateral order, Aurelius Capital Management, a first lien noteholder, argued that the Intercreditor Agreement 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 Calculation"). Aurelius also contended 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.

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<sup>3</sup> Wilmington Trust N.A. is the successor collateral agent under the Intercreditor Agreement, and is also the administrative agent for the Bank Debt.

<sup>4</sup> *In re Energy Future Holdings Corp., et. al.*, Case No. 14-10979 (Dkt. 855).

On March 13, 2015, Delaware Trust Company, as indenture trustee for the First Lien Notes, 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. Shortly thereafter, Morgan Stanley 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.

The plaintiff then moved to remand the case to New York state court on the grounds that the action was a non-core contractual dispute that would not have any impact on TCEH's bankruptcy case. The plaintiff argued that a federal court would lack subject matter jurisdiction to resolve the dispute, or at a minimum, should be required to abstain from resolving the dispute. The administrative agent and intervenor defendants subsequently cross-moved to transfer the case to the Delaware Bankruptcy Court on the grounds that (i) the resolution of the dispute would require an interpretation of federal bankruptcy law (including whether post-petition interest would even be permissible under the Bankruptcy Code) and (ii) the dispute did not exist independently from the bankruptcy case. The defendants therefore argued that remand would be inappropriate, as the action was a "core" dispute that arose in TCEH's chapter 11 case.

### **The Court's Decision**

The District Court concluded that it had subject matter jurisdiction because in the context of bankruptcy proceedings, a federal court has jurisdiction over all civil proceedings arising under title 11, or arising in or related to cases under title 11. Here, the District Court held that the action arose in TCEH's chapter 11 case for several reasons.

*First*, the District Court found that the action had no practical existence but for the bankruptcy proceedings. Specifically, the intercreditor dispute over the adequate protection payments could only have arisen in the context of the ongoing bankruptcy proceedings because the concept of adequate protection derives from the Bankruptcy Code. The District Court found it telling that while the parties had been signatories to the Intercreditor Agreement since 2007, no dispute emerged *until* TCEH's bankruptcy filing. Thus, the entire dispute—which centered on the right to receive adequate protection payments—would have no existence but for the bankruptcy case, and therefore such claims could only "arise in" the bankruptcy case.

*Second*, the District Court held that the dispute was core because it would affect the allocation of the Debtors' property, and the allocation of the Debtors' property is a core bankruptcy function. Here, the District Court found that the action would affect the allocation of TCEH's property because the plaintiff's complaint explicitly sought a declaration and specific performance that all future monthly adequate protection payments be allocated using the Post-Petition Calculation.

According to the District Court, the plaintiff's request for prospective relief would unavoidably impact TCEH's property and on that basis is a core proceeding.

*Third*, the District Court rejected and labeled as misleading plaintiff's argument that an intercreditor contract dispute cannot be a core proceeding, and that what was at issue was a rather routine contract action involving a pre-bankruptcy contract. Relying on the Second Circuit's decision in *In re U.S. Lines, Inc.*<sup>5</sup> and the Southern District of New York's decision in *In re Extended Stay*,<sup>6</sup> the Court noted that a contractual dispute between creditors may be core where the dispute is not independent of the reorganization, meaning it is either (i) the type of proceeding that is unique to or uniquely affected by the bankruptcy proceedings or (ii) the type of proceeding that would directly affect a core bankruptcy function. The District Court concluded that the dispute over the adequate protection payments at play in this case was not independent of TCEH's bankruptcy case because the dispute emerged in the bankruptcy proceedings, and was intertwined with them.

In particular, the Court concluded that the dispute was "uniquely affected by" TCEH's bankruptcy because Aurelius previously admitted that disputes over allocations made under the Intercreditor Agreement would be intertwined with the plan confirmation process. According to the District Court, Aurelius' prior statements in the bankruptcy case suggested "that the resolution of this present allocation dispute will have sequellae in the bankruptcy proceedings."<sup>7</sup> Moreover, the District Court also found that the action appeared likely to affect a core bankruptcy function, including whether to confirm TCEH's plan of reorganization. Consequently, the District Court held that although the action did concern the interpretation of a contract, the dispute was core because it arose from and was intertwined with the broader bankruptcy and plan confirmation process.

*Fourth*, the Court found that the action was core because the dispute potentially would require a court to consider the interaction between the Intercreditor Agreement and bankruptcy law. By way of example, the Court noted that the Post-Petition Calculation could potentially conflict with section 506 of the Bankruptcy Code, which provides that post-petition interest is to no longer accrue unless secured creditors are oversecured. Likewise, the District Court found that whether the monthly adequate protection payments qualified as "Collateral or any proceeds thereof" (as such term is used in the Intercreditor Agreement) may hinge on an interpretation of the cash collateral order and the Bankruptcy Code.

Because the District Court determined that the action was core, it therefore found that the plaintiff's request for mandatory abstention was moot. In addition, the Court held that permissive abstention

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<sup>5</sup> 197 F.3d 631 (2d Cir. 1999).

<sup>6</sup> 435 B.R. 139 (S.D.N.Y. 2010).

<sup>7</sup> *Delaware Trust Company v. Wilmington Trust N.A.*, 15-cv-02883-PAE, 2015 WL 4503521, at \*13 (S.D.N.Y. July 23, 2015).

was inappropriate because the interests of efficiency and economy strongly favored a comprehensive “one-stop shop” resolution of the dispute in the bankruptcy proceeding. Finally, the Court granted the defendants’ motion to transfer the case to the Delaware bankruptcy court on the grounds that (i) the action could have been brought in Delaware; (ii) the interests of justice would be served by transferring the case given that the dispute was interrelated with the bankruptcy case; and (iii) a transfer would be convenient for all of the parties. The District Court thus indicated that the matter should be heard by a judge who is intimately familiar with the facts, issues, and entities of the bankruptcy generally, and with the facts of the dispute specifically.

### Conclusion

Judge Engelmayer’s decision in *Delaware Trust* reaffirms the broad scope of bankruptcy jurisdiction, even in instances where the underlying dispute is between creditors and based on the interpretation of a prepetition contract. Where, as in *Delaware Trust*, the action is intertwined with the bankruptcy case, a court may conclude that a contractual dispute between creditors is a core proceeding. This decision may also potentially impact another pending TCEH intercreditor dispute commenced in New York by Marathon Asset Management, which also seeks an interpretation of the same Intercreditor Agreement at issue in *Delaware Trust*, and where there is likewise a dispute over bankruptcy jurisdiction.<sup>8</sup> It remains to be seen whether SDNY Judge Analisa Torres, presiding over the Marathon action, will be persuaded by Judge Engelmayer’s decision and find that the dispute in that case would also most appropriately be decided in the Delaware Bankruptcy Court.

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<sup>8</sup> *Marathon Asset Mgmt., LP v. Wilmington Trust, N.A.*, Case No. 1:15-cv-04727 (AT)(AJP) (S.D.N.Y.).