Clients&FriendsMemo

District Court Holds That Receipt of Reorganized Stock Did Not Violate Turnover and Standstill Provisions in Intercreditor Agreement

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On November 30, 2018, Judge Nelson S. Román of the United States District Court for the Southern District of New York issued a decision affirming the dismissal of certain claims brought by senior secured creditors against junior secured creditors concerning the alleged breach of standstill and turnover provisions in an intercreditor agreement that governed the creditors' relationship as creditors with recourse to common collateral. *See In re MPM Silicones, LLC*, No. 15-CV-2280 (NSR), 2018 WL 6324842 (S.D.N.Y. Nov. 30, 2018) ("*Momentive*"). Notably, the District Court specifically held that the junior creditors' entry into a restructuring support agreement and their subsequent receipt of common stock in the reorganized debtors under the confirmed reorganization plan did not violate the intercreditor agreement at issue because the junior creditors did not exercise remedies in their capacities as secured creditors with respect to their shared collateral, and the reorganized stock that they received under the plan did not qualify as collateral or proceeds thereof so as to trigger the relevant intercreditor agreement provisions that the senior secured creditors were relying upon in the first instance.

Bankruptcy Code Section 510(a) provides that a subordination agreement is enforceable in a bankruptcy proceeding "to the same extent that such agreement is enforceable under applicable nonbankruptcy law." *Momentive* serves as a reminder, however, that whether conduct or bankruptcy distributions to creditors are subject to an intercreditor agreement turns on the express language of the specific agreement at issue. Indeed, in *Momentive*, the District Court noted that when the rights in question arise under the Bankruptcy Code, and thus would be rights naturally afforded to creditors in bankruptcy, courts do not seem inclined to enforce language agreed upon prepetition that arguably waives such rights unless it reflects a clear and explicit agreement of the parties. Specifically, the District Court noted that where "there is no express waiver or specific constricting language in the contract, courts are reluctant to read such constraints into broad provisions," and that the "growing consensus is that agreements that seek to limit or waive junior noteholders' voting rights must contain *express* language to that effect." *Id.* at *10 (emphasis in original).

Background

Prior to its bankruptcy, Momentive issued three tranches of debt that were secured by liens entitled to different priorities with respect to so-called "Common Collateral." To govern the relationship between these creditors vis-à-vis the Common Collateral, Momentive and certain trustees for each of the tranches of debt entered into an intercreditor agreement, which generally provided for lien subordination. To effectuate this lien subordination, the intercreditor agreement contained standard protections for the senior creditors, providing that the senior creditors' liens had complete priority over the junior creditors' liens.

The intercreditor agreement also contained two other key provisions favoring the senior creditors. First, the intercreditor agreement prohibited junior creditors from taking "any action that would hinder any exercise of remedies undertaken by the [senior creditors] with respect to the Common Collateral," and provided that the junior creditors would waive any rights that they would have with respect to the senior creditors' exercise of remedies with respect to the Common Collateral. This provision—commonly referred to as a "standstill" provision—would be enforceable against the junior creditors up until the "Discharge of Senior Lender Claims," which generally meant that all of the senior creditors' claims had been paid in full.

Second, the intercreditor agreement contained a "turnover" provision, which required junior creditors to segregate and turn over collateral or proceeds thereof to the senior creditors, to the extent that they were received in contravention of the terms of the intercreditor agreement. In that regard, the intercreditor agreement specifically provided:

> Any Common Collateral or proceeds thereof received by any [junior creditor] in connection with the exercise of any right or remedy (including setoff) relating to the Common Collateral in contravention of this Agreement shall be segregated and held in trust for the benefit of and forthwith paid over to ... the applicable Senior Lenders.

Id. at *12.

However, as is typical in lien subordination agreements, the intercreditor agreement in *Momentive* also provided that notwithstanding anything to the contrary therein (including the standstill provision), the junior creditors retained the right to "exercise remedies as an unsecured creditor" against the debtors. Thus, despite the restrictions placed on the juniors creditors' rights and remedies in respect of the Common Collateral, the intercreditor agreement also provided that such juniors would have broad—"nearly unfettered'—rights to act if they were doing so in their capacity as unsecured creditors. *Id.* at *19.

In 2014, Momentive and its debtor affiliates commenced chapter 11 cases in the Bankruptcy Court for the Southern District of New York. Shortly thereafter, the debtors entered into a restructuring support agreement with the junior creditors, pursuant to which the junior creditors agreed to support the debtors' plan of reorganization with certain elements. Under the contemplated plan, the junior creditors were to receive common stock in the reorganized debtors, in exchange for the release and discharge of their liens on the Common Collateral and their claims against the debtors. With respect to the senior creditors, the plan contained a "deathtrap provision," which provided senior creditors with the option to either (i) accept the plan immediately and receive a cash payment in full of principal and interest on their notes (without payment of any make-whole premiums) or (ii) reject the plan and receive replacement notes with a present value equal to the allowed amount of the senior creditors' secured claims. The senior creditors voted to reject the plan. Nevertheless, with the junior creditors' vote in favor of the plan, the plan was confirmed over the senior creditors' objection, resulting in the instant litigation.

On June 18, 2014, the senior creditors commenced an action in the Supreme Court of the State of New York, which was removed to United States District Court for the Southern District of New York and, ultimately, to the Bankruptcy Court, asserting claims against the junior creditors alleging, among other things, that the junior creditors breached the intercreditor agreement by both supporting a plan that did not provide for the payment of the senior creditors' make-whole premiums and, likewise, by accepting distributions under the plan, including the acceptance of common stock in the reorganized debtors. The senior creditors alleged that these actions breached the standstill and turnover provisions in the intercreditor agreement.

Ultimately, Judge Drain of the Bankruptcy Court of the Southern District of New York dismissed the adversary complaint. The Bankruptcy Court first held that the standstill provision was not breached because the intercreditor agreement expressly preserved the rights of the junior creditors to exercise remedies of an unsecured creditor. Given this provision, the Bankruptcy Court held that the junior creditors' support of the plan and objection to the senior creditors' make-whole premium claims did not qualify as an exercise of remedies with respect to the Common Collateral in violation of the standstill provision because those actions were the assertion of rights that any unsecured creditor could exercise in a bankruptcy proceeding. Further, the Bankruptcy Court held that the receipt of stock in the reorganized debtors did not qualify as collateral or proceeds thereof as such terms were used in the intercreditor agreement, and therefore did not violate the turnover provision therein. Rather, according to the Bankruptcy Court, the reorganized stock comprised the proceeds of the junior creditors' liens and claims, not the proceeds of the "Common Collateral" governed by the intercreditor agreement.

The District Court Decision

On May 27, 2015, the senior creditors appealed the Bankruptcy Court's decision to the District Court, but again did not prevail. On November 30, 2018, the District Court affirmed the Bankruptcy Court's decision, holding that the junior creditors did not breach the intercreditor agreement. The District Court first addressed the senior creditors' assertion that the junior creditors breached the standstill provision by supporting the debtors' chapter 11 plan. Like the Bankruptcy Court, the District Court rejected the senior creditors' claims on the basis that the intercreditor agreement provided junior creditors with the right to exercise remedies against the debtors as unsecured creditors. Thus, while the standstill provision prohibited the exercise of remedies with respect to the Common Collateral, the intercreditor agreement did not bar the ability of the junior creditors to support the plan, because in voting to accept the plan, the junior creditors acted in their capacity as unsecured creditors.

In so holding, the District Court cited with approval a line of cases holding that subordination agreements must be explicitly clear that a junior creditor has waived its substantive rights in a bankruptcy proceeding. *See In re Boston Generating LLC*, 440 B.R. 302, 319 (Bankr. S.D.N.Y. 2010) ("If a secured lender seeks to waive its rights to object to a 363 sale, it must be clear *beyond peradventure.*") (emphasis added); *In re Dura Automotive Systems, Inc.*, 379 B.R. 257 (Bankr. D. Del. 2007) (holding that noteholders had right to be heard at confirmation proceedings where no action clause did not explicitly prohibit their right to be heard). By contrast, the District Court noted that when standstill provisions were considered enforceable by other bankruptcy courts in other cases, the applicable agreements were explicitly clear that the junior creditor could not engage in any obstructionist behavior and could not individually exercise *any* remedies. *See Erickson Retirement Communities*, 425 B.R. 309 (Bankr. N.D. Tex. 2010) (enforcing standstill provision where agreement prohibited junior creditors from exercising "any rights or remedies").

The distinction, therefore, according to the District Court, was that standstill provisions were enforceable in bankruptcy proceedings when they explicitly prevented "obstructionist behavior by junior creditors," as opposed to "broad language directed at maintaining the hierarchy of lien priorities." *Momentive*, 2018 WL 6324842, at *11. Because the agreement in *Momentive* fell into the latter category, the District Court found that it did not contain an express waiver of the junior creditors' rights to support a plan as the senior creditors had alleged.

The District Court also affirmed the Bankruptcy Court's holding that the junior creditors did not violate the turnover provision. Like the Bankruptcy Court, the District Court held that the turnover provision did not apply because the plan distributions to the junior creditors did not qualify as "Common Collateral" or the proceeds thereof, so as to trigger the turnover provision and require the juniors to relinquish their distributions to the seniors. The District Court determined that, in order to constitute proceeds of Common Collateral, "the [c]ommon [s]tock would have had to have been the result of a *change* in the collateral that *diluted* the collateral's value." *Id.* at *13 (emphasis in original). Thus, "proceeds" could only result from "an action that exhausted, decreased, diluted, or otherwise used up the Common Collateral," and thus, the "literal exchange or transformation of the object comprising the collateral is necessary." *Id.* at *14. The common stock did not qualify as proceeds, according to the District Court, because "the Common Collateral did not change from the issuance and distribution of new stock." *Id.*

The District Court also agreed with the Bankruptcy Court that the stock received by the junior creditors under the plan's debt for equity swap comprised the proceeds of the junior creditors' liens and claims, not the proceeds of the Common Collateral. To hold otherwise, according to the District Court, would "completely disable debtors from restructuring, whilst allowing secured creditors to simultaneously maintain unencumbered liens and scavenge on all assets in bird's-eye view." *Id.* at *15. The District Court therefore concluded that "although the term 'proceeds' can arguably yield different meanings outside of the bankruptcy context…the Court finds it clear beyond a doubt that proceeds was never intended to—and as a matter of economics cannot—refer to reorganized common stock that the [junior creditors] received in lieu of giving up their liens to the Common Collateral" and restructuring their debts. *Id.* at *16.

Conclusion

Bankruptcy Code Section 510(a)'s broad protections enforcing subordination agreements in bankruptcy should not be taken to mean that senior creditors have absolute rights over junior creditors in bankruptcy proceedings. Rather, whether or not the conduct of junior creditors violates an intercreditor agreement seemingly turns on the express language and wording of the agreement itself. Indeed, this seems particularly true in the context of lien subordination agreements, which typically preserve the ability of a junior creditor to exercise remedies of an unsecured creditor, and instead prohibit only the exercise of remedies with respect to the shared collateral that is the subject of the intercreditor agreement. Senior creditors hoping to protect their rights in an intercreditor agreement should be mindful of ensuring that any rights in favor of junior creditors intended to be waived are in fact waived expressly and unambiguously (especially when such rights arise under the Bankruptcy Code), as well as in a manner that will restrain the junior creditors when acting as both secured *and unsecured* creditors. The trend appears to be that courts have not been willing to enforce the waiver of such rights merely on the basis of generally applicable language effectuating lien subordination; specificity is required.

Accordingly, parties to an intercreditor agreement should be particularly mindful of the express wording used in their turnover and standstill provisions. *Momentive* demonstrates that parties have a lot to win—or lose—based on the express language in such agreements, which dictates the applicability of certain lender protections in the bankruptcy context. Where, as in *Momentive*, a provision applies only to shared collateral or the proceeds thereof, senior creditors should be mindful that such provisions might not capture all potential creditor distributions in the bankruptcy plan context.

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