Clients&FriendsMemo

What's in a Name? Court Holds That Despite Its Title, a Security Agreement Also Subordinated Junior Creditor's Rights to Payment

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On October 29, 2021, Judge Laura Taylor Swain, the presiding judge in the Puerto Rico bankruptcy case, ruled that approximately $2 billion in intragovernmental loan claims were subordinated to bonds issued by the Puerto Rico Highway and Transportation Authority ("HTA") pursuant to an assignment and security agreement.[1] The Court's opinion provides guidance on several important issues regarding subordination agreements, including the distinction between payment and lien subordination, the importance of including certain provisions in drafting such agreements, and the operation of a tiered subordination structure.

Factual Background

In May 2017, the Commonwealth of Puerto Rico (the "Commonwealth") and HTA (together with the Commonwealth, the "Debtors") commenced restructuring proceedings pursuant to the Puerto Rico Oversight, Management, and Economic Stability Act ("PROMESA"). As of the petition date, HTA had over $4 billion of bond claims, as well as approximately $2 billion of loan claims. HTA's bonds were issued under two bond resolutions adopted in 1968 and 1998. Each bond resolution contained language requiring HTA to subordinate any future debt to the bonds. Bonds issued under the 1968 resolution had payment priority over the bonds issued under the 1998 resolution, and HTA was required to cover deficiencies on the 1968 resolution bonds before covering payment deficiencies on the 1998 resolution bonds.[2] Pursuant to the resolutions, the bonds were secured by certain excise taxes imposed by the Commonwealth and assigned to HTA.

Beginning in 2008, the Government Development Bank for Puerto Rico ("GDB") entered into a series of loan agreements with HTA, pursuant to which GDB issued over $2 billion in loans to HTA. In 2013, GDB and HTA entered into an assignment and security agreement (the "Security Agreement") pursuant to which HTA purported to assign certain excise taxes to GDB and granted a security interest in those taxes to secure GDB's loan claims. The taxes subject to the Security

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1 *AmeriNational Community Services LLC v. Ambac Assurance Corp. (In re Fin. Oversight & Mgmt. Bd. for P.R.)*, Adv. Proc. No. 21-00068-LTS, 2021 WL 5121892 (D.P.R. Oct. 29, 2021). Cadwalader represented certain of the bondholder defendants in this adversary proceeding.

2 *See id.* at **1-2.

Agreement were imposed pursuant to Puerto Rico's Acts 30 and 31 of 2013. Acts 30 and 31 provided that the taxes imposed pursuant to those laws "shall be used solely for the payment of principal of and interest on the bonds and other obligations of" HTA.[3] These loan claims were later transferred to the GDB Debt Recovery Authority ("DRA") as part of a consensual restructuring proceeding for GDB under Title VI of PROMESA.

The Security Agreement contained several provisions evidencing that GDB's loans were subordinate to HTA's bonds. First, numerous provisions in the Security Agreement provided that the security interest granted in favor of GDB "shall be junior, inferior and subordinate in all respects to the outstanding bonds of" HTA.[4] Second, the Security Agreement contained a provision that "creates a waterfall of payment priorities" for all revenues allocated pursuant to Acts 30 and 31. That waterfall provision specifically required GDB to apply the revenues that it received (or any proceeds thereof) first to the payment of HTA's bonds and only thereafter to the payment of GDB's loans.[5] Third, the loan agreements governing GDB's loans provided that the loans were subordinate to HTA's bonds.

In 2021, the Commonwealth filed a plan of adjustment that reflected the terms of a plan support agreement executed by the HTA bondholders. Under the plan, HTA bondholders would receive a contingent value instrument as consideration for the partial settlement of their claims against the Commonwealth. The plan also provided that the DRA would receive a subordinate tranche of payments under the contingent value instrument, meaning that DRA would not receive payments until after HTA's bonds were satisfied.

After the Commonwealth filed its plan of adjustment, the collateral monitor and servicer for DRA's debt (the "DRA Parties") filed an adversary complaint against certain HTA bondholders. The DRA Parties' complaint alleged four counts seeking declaratory relief, including specifically that (i) the DRA Parties had an exclusive right to payment from revenues allocated under Acts 30 and 31 and (ii) the DRA Parties' loan claims were not subordinate to the bonds. The bondholder defendants moved to dismiss.

The Court's Decision

The Court granted the HTA bondholder defendants' motion to dismiss, and dismissed all counts of the DRA Parties' complaint. Of significance, the Court held that (i) the DRA did not have an exclusive right to payment from the Acts 30 and 31 revenues and (ii) the DRA's claims were payment subordinated to HTA's bonds.

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3 *Id.* at *3.

4 *Id.* at *4.

5 *See id.*

The Bondholders' Recourse

The Court first addressed the DRA Parties' contentions that only DRA—but not HTA's bondholders—had the right to be repaid from revenues collected under Acts 30 and 31. The Court rejected this argument, finding that the plain language of Acts 30 and 31 permitted HTA to use the taxes imposed thereunder to pay "bonds and other obligations."[6] In addition, the Court noted that, consistent with the plain text of Acts 30 and 31, the Security Agreement "emphasizes and prioritizes the rights of Bondholders to be repaid from the Acts 30-31 Revenues."[7] Indeed, the Security Agreement made clear in several different provisions that the Acts 30 and 31 revenues were assigned to the payment of HTA's outstanding bonds. In particular, the Court noted that the Security Agreement's waterfall provision prioritized the payment of the bonds from Acts 30 and 31 revenues, thereby making clear that the bonds could recover from those revenues. The Court thus dismissed the counts of the complaint that alleged that only DRA had a right to be repaid from Acts 30 and 31 revenues.

Subordination

The Court next turned to the counts of the DRA Parties' complaint that sought declarations that DRA was not subordinated to the bondholders and that DRA had a senior claim on certain property of the Debtors. The Court held that the Security Agreement clearly subordinated DRA's loan claims and liens to HTA's bonds. In support of this conclusion, the Court noted that the Security Agreement provided that the interests of the DRA in Acts 30 and 31 revenues were "junior, inferior, and subordinate *in all respects* to the outstanding bonds of [HTA] issued pursuant to the Bond Resolutions" (emphasis added).[8] Further, the Court found that the Security Agreement "unambiguously prioritizes Bond payments by establishing a waterfall (or 'turnover') mechanism."[9] While the DRA Parties claimed that this turnover provision was intended to only benefit future bonds that were used to repay GDB's loans (a process referred to as "bonding out"), the Court noted that the plain text of the subordination provisions referred only to "outstanding bonds" issued under the bond resolutions, not to future bonds. The Court therefore concluded that the DRA's loan claims were unambiguously subordinated to HTA's bonds.

The DRA Parties further claimed that even if the Security Agreement provided for subordination, the agreement—which, as its title suggests, granted liens on collateral—could provide only for lien subordination, not debt subordination. The Court acknowledged that some courts "distinguish

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6 *Id.* at *7.

7 *Id.*

8 *Id.* at *9.

9 *Id.*

between lien subordination and payment subordination."[10] Under lien subordination, a creditor demotes the priority of its security interest in common collateral in favor of another property interest.[11] Lien subordinated creditors typically do not forfeit their rights to be repaid from assets that do not constitute shared or common collateral. By contrast, in debt or payment subordination, a junior creditor agrees that its rights to payment and collection from all of the borrower's assets are subordinate to the rights of another claimant.[12]

The Court held that "whatever distinctions may be evident or reasonably inferred in other contexts are precluded here by the plain language of the Security Agreement."[13] The Court found that the Security Agreement provided for payment subordination as well, not merely lien subordination. In particular, the Court noted that the granting clauses subordinated DRA's liens "in all respects" to the "outstanding bonds."[14] In other words, the plain text of the subordination provision subordinated DRA's interests to a debt obligation, not simply to another lien on the same collateral. Further, the Security Agreement's waterfall and turnover provisions made "abundantly clear that . . . the payment priority of the Bonds is higher than that of the Loans."[15]

Finally, the Court addressed the DRA Parties' contention that the Security Agreement's subordination provisions subordinated only the DRA's loans and interests to "outstanding bonds" under the "Bond Resolutions." The DRA Parties claimed that the defined term "Bond Resolutions" included only bonds issued under the 1998 resolution, but not bonds issued under the 1968 resolution.

The Court found that even if the Security Agreement's defined term for "Bond Resolutions" could be construed to reference only the 1998 resolution, the failure to include the 1968 resolution within that defined term was "inconsequential."[16] The Court noted that the contractual provisions subordinated DRA's loans and liens to the 1998 bonds "in all respects" and that under the express terms of the 1998 resolution, the bonds issued thereunder were "subordinated to payment in full of the [bonds issued under] the 1968 Resolution."[17] Consequently, the Court held that the "conclusion cannot be evaded that the Loans are effectively subordinated to the" bonds issued under the 1968 resolution "by force of being subordinated 'in all respects' to the" bonds issued

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[10] *Id.* at *10.

[11] *See In re Lantana Motel*, 124 B.R. 252, 256 (Bankr. S.D. Ohio 1990).

[12] *See id.* at 255-56.

[13] *In re Fin. Oversight & Mgmt. Bd. for P.R.*, 2021 WL 5121892 at *10.

[14] *Id.*

[15] *Id.*

[16] *Id.* at *9.

[17] *Id.*

under the 1998 resolution.[18] Having found that the contractual language unambiguously subordinated DRA's loans to all of HTA's bonds, the Court dismissed all counts of the complaint that sought declaratory relief that DRA's loans were not subordinated to the HTA bonds.

Analysis and Subordination Agreement Drafting Considerations

The decision in *AmeriNational* confirms that, as with any other contract dispute, the plain text of a subordination agreement will govern. Section 510(a) of the Bankruptcy Code provides that a "subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law."[19] Broad language, like the language addressed in *AmeriNational*, therefore may substantially reduce a junior creditor's recoveries in a bankruptcy proceeding. The case thus serves as a strong reminder that the importance of care in drafting subordination agreements and including appropriate and specific protective and operative language should not be underestimated.

Where, as in *AmeriNational*, a contract subordinates a security interest to another debt obligation and contains a waterfall provision, a court may properly conclude that the effect of the waterfall provision would bar payments to a junior creditor until the senior creditor's claims are paid in full. Parties therefore should exercise significant caution and care in drafting subordination provisions, including those in security agreements. If parties wish to limit the scope of a provision to provide only for lien subordination, then the provision must clearly specify that the junior creditor's security interest in common collateral is subordinate only to a senior creditor's security interest (if any) in that same property. Such agreements also should make clear that the junior creditor retains the rights of any other unsecured creditor to share in other assets that are not subject to the subordination provisions. Absent such specific language, a court may construe a waterfall and subordination provision to broadly provide for payment subordination (in addition to lien subordination) with respect to all of the borrower's assets.

AmeriNational also confirms the proper operation of capital structures that contain tiered subordination. When a junior subordinated creditor agrees to turn over its recoveries to senior subordinated debt and the senior subordinated debt is then contractually required to turn over its recoveries to the senior debt, a court may properly conclude that the junior subordinated creditor has in effect agreed to subordinate its claims to the senior debt—even without specifically identifying that debt within the subordination provisions governing the junior subordinated creditors' claims. This is so because the junior subordinated creditor agrees to delay its rights to payment until the senior subordinated creditor's claims are satisfied and the senior subordinated creditor's claims may not be satisfied until it is no longer contractually obligated to turn over its recoveries to the senior creditors. That is precisely what the Court found in *AmeriNational*. Parties wishing to

[18] *Id.*

[19] 11 U.S.C. § 510(a).

avoid this result should therefore consider eliminating any language that subordinates their claims "in all respects" to senior subordinated debt and removing any turnover obligation in their contracts.

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