Clients&FriendsMemo

Third Circuit Affirms Rulings That Distributions to TCEH First Lien Creditors Are Governed by the Bankruptcy Code Rather Than Intercreditor Agreement Waterfall Provision on Enforcement of Collateral Remedies

June 24, 2019

On June 19, 2019, the United States Court of Appeals for the Third Circuit (the "Third Circuit") affirmed a ruling of the United States District Court for the District of Delaware (the "District Court") dismissing challenges by certain first lien creditors of Texas Competitive Electric Holdings LLC ("TCEH") to the plan distributions and adequate protection payments made during TCEH's bankruptcy case. Specifically, the Third Circuit held that the waterfall provision set forth in an intercreditor agreement ("ICA") between three groups of *pari passu* TCEH first lien creditors (collectively, the "First Lien Creditors") did not govern the allocation of plan distributions and adequate protection payments because the plan distributions and adequate protections payments (1) were not collateral or proceeds thereof, and (2) did not result from any exercise of remedies by the collateral agent, as required by the ICA.[1] *In re: Energy Future Holdings Corp., et al. v. Morgan Stanley Capital Grp., Inc. and Wilmington Trust, N.A.*, 2019 WL 2535700 (3d Cir. June 19, 2019).

The Third Circuit's decision brings hopeful closure to years of litigation by certain of the First Lien Creditors that were attempting to claim entitlement to a larger *pro rata* portion of the distributions at issue, based on an interpretation of the ICA that the Third Circuit has affirmed did not apply.

Background and Lower Court Opinions

In April 2014, TCEH commenced Chapter 11 proceedings in the United States Bankruptcy Court for the District of Delaware (the "Bankruptcy Court"). On the petition date, TCEH had over $25 billion of first lien debt, which included first lien bank debt, notes, and interest rate swaps. Each of these obligations were secured by a lien on the same collateral, and the relationship among those creditors concerning the collateral was governed by the ICA.

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[1] Cadwalader represents Morgan Stanley Capital Group Inc., one of the appellees in the intercreditor dispute discussed herein.

During the case, the Bankruptcy Court ordered TCEH to make monthly adequate protection payments to its First Lien Creditors in exchange for the right to use such creditors' cash collateral (the "Adequate Protection Payments"). More than two years later, the Bankruptcy Court confirmed a Chapter 11 plan, which provided for the following distributions to the First Lien Creditors in exchange for their liens and claims against TCEH: (i) 100% of reorganized TCEH's common stock; (ii) certain cash (including proceeds of newly issued debt); and (iii) contract rights to receive payments from tax benefits that the government owed TCEH (the "Plan Distributions" and, together with the Adequate Protection Payments, the "Distributions").

Delaware Trust Company, the indenture trustee for TCEH's first lien notes (the "2011 Creditors"), filed suit challenging the allocation of Distributions among the First Lien Creditors. The 2011 Creditors argued that the Distributions should be allocated pursuant to the ICA's waterfall provision, which it claimed required inclusion of post-petition interest for purposes of allocation of the Distributions. Specifically, Section 4.1 of the ICA—entitled "Application of Proceeds" provided: "Regardless of any insolvency or Liquidation Proceeding which has been commenced by or against the Borrower or any other Loan Party, Collateral or proceeds thereof received in connection with the sale or other disposition of, or collection on, such Collateral upon the exercise of remedies shall be applied" in a particular order. Of relevance to the 2011 Creditors' claims was the third priority in ICA Section 4.1, which provided for distribution "on a *pro rata* basis, to the payment of….all principal and other amounts then due and payable in respect of the Secured Obligations." According to the 2011 Creditors, "Secured Obligations" was broadly defined in the ICA to include post-petition interest – *regardless* of whether such interest was actually allowed in a bankruptcy proceeding.

If the waterfall provision indeed applied as the 2011 Creditors urged, the 2011 Creditors claimed that they in turn would be entitled to a larger share of the Distributions because their notes accrued at a higher interest rate than the other First Lien Creditors (the "2007 Creditors"). And because the First Lien Creditors were only receiving distributions equal to 41% of the outstanding principal amount of the first lien debt, the 2011 Creditors' interpretation of the waterfall provision in the ICA would result in other First Lien Creditors receiving less Distributions on account of the principal amount of their claims. The parties estimated that at least $90 million was at stake in this intercreditor dispute that could have inured to the benefit of the 2011 Creditors to the detriment of the *pari passu* 2007 Creditors.

But, as the 2007 Creditors argued, and the Third Circuit has now affirmed, the waterfall provision did not govern every asset distributed to the First Lien Creditors. Rather, by its terms, the waterfall provision only applied to "[1] Collateral or [2] any proceeds thereof received in connection with the sale or other disposition of, or collection on, such Collateral upon the exercise of remedies under the Security Documents by the Collateral Agent." The Bankruptcy Court held that the ICA's waterfall provision did not control the allocation of Distributions among the First Lien Creditors

because: (i) the Adequate Protection Payments and Plan Distributions were neither collateral nor proceeds of collateral; (ii) the Distributions were never received by the collateral agent; (iii) the Distributions were not the result of any exercise of remedies by the collateral agent under the Security Documents; and (iv) the Distributions were not received upon the sale or disposition of the collateral.[2] The District Court affirmed,[3] leading the 2011 Creditors to appeal to the Third Circuit.

The Third Circuit's Decision

The Third Circuit affirmed, concluding that the Distributions were not collateral or proceeds of collateral and did not result from any exercise of remedies by the collateral agent.

In finding that the Distributions were not payments of collateral, the Third Circuit explained that a payment of collateral reduces the amount owed on a secured debt. However, the Adequate Protections Payments, which TCEH made to compensate the First Lien Creditors for TCEH's use of their cash collateral during the bankruptcy case, did not decrease the amount TCEH owed on its debts to the First Lien Creditors; therefore, they were not payments of collateral.

Additionally, because the Plan Distributions were made from assets on which the First Lien Creditors had no lien, they likewise could not constitute a payment of collateral. Indeed, the Third Circuit noted that the plan of reorganization expressly provided that the debtors' assets vested solely with the reorganized debtors, free and clear of any prepetition liens. The Third Circuit reasoned that the Plan Distributions were made from post-petition assets acquired by TCEH, and assets acquired after a debtor's bankruptcy filing generally are not subject to a prepetition lien. The Third Circuit further reasoned that its interpretation was supported by Section 552(a) of the Bankruptcy Code, which provides that assets acquired by debtors after filing for bankruptcy are not subject to any prepetition liens.

Second, in finding that the Distributions were not proceeds of collateral, the Third Circuit explained that the Adequate Protection Payments were not proceeds "received in connection with the sale or other disposition of, or collection on, such Collateral upon the exercise of remedies under the Security Documents by the Collateral Agent". Indeed, the 2011 Creditors could not identify any

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[2] *In re: Energy Future Holdings Corp.*, 546 B.R. 566 (Bankr. D. Del. 2016). A more detailed summary of the bankruptcy court's decision and the procedural history is available in prior Cadwalader memorandums: *Delaware Bankruptcy Court Rules TCEH First Lien Distributions Are Governed by the Bankruptcy Code, Not by Intercreditor Agreement Waterfall* (Mar. 21, 2016) available at https://www.cadwalader.com/resources/clients-friends-memos/delaware-bankruptcy-court-rules-tceh-first-lein-distributions-are-governed-by-bankruptcy-code-not-by-intercreditor-agreement-waterfall and *TCEH Bankruptcy: SDNY Transfers Delaware Trust Company v. Wilmington Trust N.A. Intercreditor Dispute to Delaware Bankruptcy Court, Reaffirming Broad View of Bankruptcy Jurisdiction* (Aug. 5, 2015) available at https://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.

[3] *In re: Energy Future Holdings Corp.*, 585 B.R. 341 (D. Del. 2018).

sale or disposition of collateral preceding the Adequate Protection Payments. Instead, they argued that the payments were proceeds of collateral because they were intended to offset the collateral's diminution in value. As the 2007 Creditors had asserted, the Third Circuit ultimately reasoned that there simply can be no proceeds from a sale absent such a sale. Therefore, the Adequate Protection Payments could not constitute proceeds of the First Lien Creditors' collateral, and thus, the ICA's requirements were not satisfied as to the Adequate Protection Payments.

Finally, while the Plan Distributions resulted from a restructuring of TCEH, the restructuring did not result from any exercise of contractual remedies under the relevant security documents by the collateral agent, as expressly required by the ICA's waterfall provision. Indeed, TCEH's creditors, rather than the collateral agent, voted for the restructuring, which the Bankruptcy Court approved. Thus, the Plan Distributions resulted by operation of the Bankruptcy Code and with the approval of the Bankruptcy Court. The Third Circuit noted that the Bankruptcy Court was, clearly, not the collateral agent. Moreover, the Third Circuit held that the collateral agent's participation in TCEH's bankruptcy was "a far cry from a collateral agent's typical remedy: selling the collateral at a foreclosure sale." Therefore, the Plan Distributions were not the result of any exercise of remedies by the collateral agent, and the ICA's requirements were not satisfied as to the Plan Distributions. Accordingly, the Third Circuit held that the ICA did not govern the allocation of Distributions among the First Lien Creditors—affirming the arguments by the 2007 Creditors that the ICA waterfall provision addressed very particular circumstances—when the collateral agent was directed to exercise remedies under the security documents and therefore received the collateral or the proceeds of the collateral. That did not happen in this case.

Conclusion

The Third Circuit's decision in TCEH confirms that courts will properly scrutinize the terms of an intercreditor agreement in determining whether such agreement applies to distributions and payments made to creditors in bankruptcy cases. This conforms with other relevant decisions—such as *Momentive*[4]—which similarly interpreted intercreditor provisions more narrowly. Many intercreditor agreements contain waterfall provisions, which provide for a roadmap for certain distributions. The roadmap is often set forth in the preamble to such provisions—much like it was in Section 4.1 of the ICA in this case. As the Third Circuit's decision here confirms, the scope of those provisions is ultimately determined by the language within the preamble. If the preamble provides that it applies only to distributions of collateral received upon an enforcement action by the collateral agent, then the provision might not apply to distributions made under a Chapter 11 plan if those conditions are not also triggered. As such, when negotiating and drafting intercreditor agreements, parties should pay close attention to the language used in an intercreditor agreement's waterfall provision. If the parties' intent is for the waterfall provision to govern plan distributions and

[4] *Momentive Performance Materials Inc. v. BOKF, N.A. (In re: MPM Silicones, L.L.C.)*, 874 F.3d 787 (2d Cir. 2016).

adequate protection payments in a bankruptcy case, then the parties should draft the waterfall provision to explicitly cover such distributions.

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