Settlements, Subordination and Syndicated Debt: Recent Noteworthy Bankruptcy Decisions

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The last 12 months have produced a number of important bankruptcy developments relevant to the primary and secondary loan markets. Appellate courts disagreed with bankruptcy courts – and in certain instances each other – over a number of key issues, with one case making it all the way to the Supreme Court. While all of these decisions have implications for issuers and holders of syndicated debt, rulings from the past year appear to be driven less by general equitable or policy concerns, and more by the courts' fact-specific, purportedly objective application of express statutory and contractual terms. To the extent a common thread exists, it appears to be that clarity counts – courts are enforcing valid statutory and contractual rights to the extent, and only to the extent, such rights are clearly stated in the applicable statute or contract. The notable exception to this general trend is *Jevic*, the first case discussed below and the subject of the above-referenced Supreme Court appeal, where the Third Circuit upheld the validity of a controversial form of settlement that is neither expressly permitted nor expressly prohibited by the Bankruptcy Code. Whether this exception will withstand Supreme Court scrutiny or be brought into line with the general trend remains to be seen.

Settlements

In June 2016, the Supreme Court granted certiorari in *Jevic*,[1] a Third Circuit case involving a "structured dismissal"[2] (described by the Third Circuit as "a disposition that winds up the bankruptcy with certain conditions attached instead of simply dismissing the case and restoring the status quo ante"[3]). The *Jevic* settlement provided for distributions to various settling administrative expense, priority, and general unsecured creditors, but left certain other priority creditors impaired, which would have been impermissible in the plan context under the Bankruptcy Code's "absolute priority" rule.[4]

Prior to its decision in *Jevic*, the Third Circuit had not taken a position on the issue of whether traditional confirmation requirements such as the absolute priority rule applied in the pre-plan settlement context, which was the subject of an ongoing circuit split. The Fifth Circuit adopted a per se rule in *AWECO* that the "fair and equitable" requirement, which, among other things, includes strict adherence to the Bankruptcy Code's priority scheme, applies to any distribution of estate property under a pre-plan settlement.[5] However, in *Iridium*, the Second Circuit rejected *AWECO*'s rule as "too rigid," and held that although "whether a particular settlement's distribution scheme complies with the Code's priority scheme must be the most important factor for the bankruptcy court to consider when determining whether a settlement is 'fair and equitable' under Rule 9019," a court may nevertheless approve a pre-plan settlement that distributes assets without compliance with the Bankruptcy Code's priority scheme if other factors "weigh heavily in favor of approving a settlement."[6]

With Jevic, the Third Circuit joined the Second Circuit in holding that settlements providing for distributions that do not strictly comply with Bankruptcy Code requirements for plan distributions are permissible under certain rare circumstances.

Jevic

In *Jevic*, the Third Circuit held that "the [Bankruptcy] Code permits a structured dismissal, even one that deviates from the § 507 priorities, when a bankruptcy judge makes sound findings of fact that the traditional routes out of Chapter 11 are unavailable and the settlement is the best feasible way of serving the interests of the estate and its creditors."[7]

Jevic Transportation, Inc. ("Jevic") was a trucking company that had been acquired in 2006 by a subsidiary of the private equity firm Sun Capital Partners ("Sun") in

1 *Official Comm. of Unsecured Creditors v. CIT Group/Business Credit Inc. (In re Jevic Holding Corp.)*, 787 F.3d 173 (3d Cir. 2015).

2 The three exits out of a chapter 11 provided for in the Bankruptcy Code are (i) confirmation of a plan of reorganization or liquidation; (ii) conversion to chapter 7; or (iii) dismissal, which, pursuant to 11 U.S.C. § 349, essentially restores the status quo (liens, lawsuits, etc.) existing before the debtor filed for bankruptcy. In some instances, however, parties have implemented "structured dismissals" incorporating various settlement terms as an alternative means of resolving chapter 11 cases. Typical key structured dismissal terms may include, but are not limited to: broad releases; provisions for distributions to certain creditor groups (such as, for example, "gifting" provisions granting a recovery to otherwise-out-of-the-money unsecured creditors); provisions specifying that orders entered by the bankruptcy court shall remain in full force and effect; and retention of jurisdiction by the bankruptcy court.

3 787 F.3d at 177.

4 Section 1129(b), which sets forth various confirmation requirements for cramdown of a plan on a non-accepting class of creditors, provides, among other things, that a plan is only "fair and equitable" (and, thus, confirmable) if "[w]ith respect to unsecure creditors . . . the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property[.]" 11 U.S.C. § 1129(b)(2)(B)(2). This requirement is known as the "absolute priority" rule.

5 *In re AWECO, Inc.*, 725 F.2d 293, 298 (5th Cir. 1984). The Fifth Circuit reasoned:
As soon as the debtor files a petition for relief, fair and equitable settlement of creditors' claims becomes a goal of the proceedings. The goal does not suddenly appear during the process of approving a plan or compromise. Moreover, if the standard had no application before confirmation of a reorganization plan, then bankruptcy courts would have the discretion to favor junior classes of creditors so long as the approval of the settlement came before the plan . . . *Id.*

6 *In re Iridium Operating LLC*, 478 F.3d 452, 463-64 (2d Cir. 2007).

7 787 F.3d at 185-86.

a leveraged buyout transaction financed by CIT Group ("CIT'). Jevic continued to struggle over the next two years, and by May 2008, had ceased substantially all its operations, given its employees notice of their impending terminations, and filed a voluntary chapter 11 petition. As of the petition date, Jevic owed about $53 million to CIT and Sun,[8] the first-priority senior secured creditors, and more than $20 million to its tax and general unsecured creditors.

Two groups filed lawsuits during the chapter 11 case. First, a group of Jevic's terminated truck drivers (the "Drivers") filed a class action against Jevic and Sun alleging violations of federal and state Worker Adjustment and Retraining Notification ("WARN") Acts based on Jevic's failure to provide them with 60 days' written notice before laying them off. Second, the official creditor's committee appointed in Jevic's bankruptcy case (the "Committee") brought an action alleging fraudulent and preferential transfer claims against CIT and Sun.

In 2012, the key players in the bankruptcy case – the Committee, CIT, Sun, the Drivers, and "what was left of Jevic" – convened to negotiate a settlement of the Committee's action against CIT and Sun. By that time, Jevic's only remaining assets were the Committee's action against CIT and Sun and $1.7 million in cash (which was subject to Sun's lien) because the bulk of Jevic's tangible assets had already been liquidated to pay off the lender group led by CIT. Facing the risk of administrative insolvency and with no real viable alternative, the Committee, CIT, Sun, and Jevic reached a settlement agreement pursuant to which (i) the settlement parties would release one another and the Committee's adversary proceeding against CIT and Sun would be dismissed with prejudice; (ii) CIT would pay $2 million into an account earmarked to pay Jevic's and the Committee's legal fees and other administrative expenses; (iii) Sun would assign its lien on Jevic's remaining $1.7 million in cash to a trust, which would pay tax and administrative claims, and (after payment of such priority claims) general unsecured claims on a pro rata basis; and (iv) Jevic's chapter 11 case would be dismissed.

As the Third Circuit explained, "[t]here was just one problem with the settlement: it left out the Drivers, even though they had an uncontested WARN Act claim against Jevic."[9] The Drivers' WARN Act claims were unliquidated, but were estimated by the Drivers to have been worth $12.4 million, of which $8.3 million constituted priority wage claims under 11 U.S.C. § 507(a)(4). While the record was not explicit as to precisely how the Drivers came to be excluded from the settlement, Sun was apparently unwilling to pay the Drivers as long as their WARN Act action was still pending because Sun, a co-defendant in that action, understandably did not want to fund litigation against itself. The Committee was also incentivized to exclude the Drivers "because a settlement that paid the Drivers' priority claim would have left the Committee's constituents with nothing."[10]

Both the Drivers and the United States Trustee (the "UST") objected to the settlement on the grounds that it provided for distributions of estate property in direct violation of the priority requirements of section 507 of the Bankruptcy Code. The Drivers also argued that the Committee had breached its fiduciary duty to creditors by agreeing to a settlement that froze out the Drivers, and the UST also objected on policy grounds that structured dismissals were not permitted under the Bankruptcy Code.

The bankruptcy court overruled these objections in an oral opinion approving the settlement and dismissal.[11] The bankruptcy court acknowledged the absence of any express authorization under the Bankruptcy Code for the distribution and dismissal contemplated by the proposed settlement, but found that there was "'no realistic prospect' of a meaningful distribution to anyone but the secured creditors unless the settlement were approved because the traditional routes out of chapter 11 bankruptcy were impracticable."[12] Specifically, there was "no prospect" of confirming a plan of reorganization or liquidation, and, because all estate cash was encumbered, there would have been insufficient funds for a chapter 7 trustee to effectively administer the estate upon conversion.[13] Additionally, the secured creditors had "'stated unequivocally and credibly that they would not do this deal in a Chapter 7'" and the Drivers were not positioned to receive any recovery, even if they prevailed in their objection.[14]

The bankruptcy court held that settlements, in contrast to chapter 11 plans, need not comply with the absolute priority rule. The bankruptcy court also rejected the Drivers' argument that the Committee had breached its fiduciary duty by supporting a settlement opposed by the Drivers. Specifically, the bankruptcy court dismissed the notion that the Committee's fiduciary duty to unsecured creditors gave each creditor veto power over any proposed settlement, and noted that the Drivers were never barred from participating in the settlement negotiations and were not prejudiced by the settlement because their claims against Jevic's estate were "'effectively worthless'" given the estate's lack of unencumbered funds.[15] Finally, the bankruptcy court found that approval of the settlement was warranted under the traditional multi-factor *Martin* test,[16] reasoning

8 *Id.* at 176.
9 *Id.* at 177.
10 *Id.* at 178.
11 *Id.*
12 *Id.*
13 *Id.* at 181.
14 *Id.* at 179.
15 *Id.* at 178.
16 In determining whether to approve bankruptcy settlements, the Third Circuit applies the test set forth in *Myers v. Martin* (*In re Martin*), 91 F.3d 389 (3d Cir. 1996), which balances the following factors: (1) the probability of success in litigation; (2) the likely difficulties in collection; (3) the complexity of the litigation involved, and the expense, inconvenience and delay necessarily attending it; and (4) the paramount interest of the creditors." *See In re Martin*, 91 F.3d at 393.

that the litigation in the Committee's action against CIT and Sun was complex and the likelihood of success was "'uncertain at best' given the legal hurdles to recovery, the substantial resources of CIT and Sun, and the scarcity of funds to finance further litigation."[17] Faced with what it viewed as a choice between "a meaningful return or zero," the bankruptcy court determined that "'[t]he paramount interest of the creditors mandate[d] approval of the settlement'" and nothing in the Bankruptcy Code precluded such approval.[18]

After the district court affirmed the bankruptcy court's rulings on appeal, the Drivers appealed to the Third Circuit, with amicus curiae support from the UST.[19] Because the Drivers effectively conceded that the bankruptcy court had not abused its discretion in approving the settlement and dismissing the bankruptcy case to the extent the bankruptcy court had the authority to do so, the Third Circuit focused on (i) "whether structured dismissals are ever permissible under the Bankruptcy Code," and, if so, (ii) "whether settlements in that context may ever skip a class of objecting creditors in favor of more junior creditors."[20] The Third Circuit answered both questions in the affirmative.

With respect to the general permissibility of structured dismissals, the Third Circuit reasoned that while such relief was not expressly authorized under the Bankruptcy Code, "structured dismissals are simply dismissals that are preceded by other orders of the bankruptcy court (e.g., orders approving settlements, granting releases, and so forth) that remain in effect after dismissal."[21] Noting that 11 U.S.C. § 349(b) permits a bankruptcy court to alter the effect of dismissal "for cause," the Third Circuit found that while dismissal would typically "reinstate the prepetition state of affairs," "the Code does not strictly require dismissal of a Chapter 11 case to be a hard reset."[22] In response to the Drivers' argument that permitting structured dismissals would "pav[e] the way for illegitimate sub rosa plans engineered by creditors with overwhelming bargaining power," the Third Circuit emphasized that the appeal before it did not involve a situation where either a confirmable plan or conversion to chapter 7 were potentially viable options, and, therefore, its holding that bankruptcy courts had discretion to approve structured dismissals was limited to a situation where there had been no "showing that a structured dismissal ha[d] been contrived to evade the procedural protections and safeguards of the plan confirmation or conversion processes."[23]

With respect to the permissibility of priority-skipping settlements outside of the plan context, the Third Circuit looked to the conflicting Fifth Circuit *AWECO* and Second Circuit *Iridium* decisions and adopted the *Iridium* approach. Noting that settlements are favored in bankruptcy and can involve '"dynamic'" situations (such as where a settlement is proposed before the nature and extent of claims against the debtor's estate are resolved), the Third Circuit reasoned that the "more flexible" *Iridium* approach "better account[ed] for these concerns" than *AWECO*'s *per se* rule.[24] However, the Third Circuit acknowledged that "[s]ettlements that skip objecting creditors in distributing estate assets raise justifiable concerns about collusion among debtors, creditors, and their attorneys and other professionals," and therefore held that "bankruptcy courts may approve settlements and structured dismissals that deviate from the priority scheme of § 507 of the Bankruptcy Code only if they have 'specific and credible grounds to justify [the] deviation.'"[25]

Turning to the facts before it, the Third Circuit found that the bankruptcy court had "sufficient reason" to approve the settlement and structured dismissal of Jevic's case, and therefore affirmed, but cautioned that "this result is likely to be justified only rarely."[26]

Numerous parties filed amicus curiae briefs before the Supreme Court urging reversal of the Third Circuit's decision to the extent it approved a priority-skipping settlement, including, among others, the United States, 19 states, and the Loan Syndications and Trading Association (the "LSTA"). The Supreme Court heard oral argument on December 7, 2016, and the parties (and the loan market) are currently awaiting a decision.

Takeaways

While bankruptcy practitioners tend to agree that *Jevic* (and any Supreme Court affirmance or reversal) will likely have a significant impact on bankruptcy restructurings, there is a substantial difference of opinion as to whether that impact will be positive or negative. On the one hand, critics of the Third Circuit's decision argue that it may destabilize and/or chill the credit markets, where predictability and confidence that negotiated contractual rights will be respected in bankruptcy are critical for market participants' risk analyses (the LSTA view). On the other hand, supporters of the decision argue that it will further the bankruptcy tradition of enabling creative (and oftentimes practical) solutions to complex problems, and will actually maximize the value of the estate assets being distributed by giving parties the flexibility to devise more efficient means of resolving chapter 11 cases. Certain parties, such as taxing authorities and other priority claimants, may view the decision with

17 787 F.3d at 178-79.
18 *Id.* at 179.
19 *Id.*
20 *Id.* at 179-82.
21 *Id.* at 181.
22 *Id.*
23 *Id.* at 181-82.
24 *Id.* at 183-84 (quoting *In re Iridium Operating LLC,* 478 F.3d at 464).
25 *Id.* at 184 (quoting *In re Iridium Operating LLC*, 478 F.3d at 466).
26 *Id.* at 186.

greater alarm based on concerns that they are more-likely targets for exclusion from priority-skipping settlements. In contrast, a secured creditor who suffers under a Jevic-based settlement in one bankruptcy case could easily find itself benefitting from such a settlement in another case,[27] although whether that opportunity outweighs the overall risk is an open question. Additionally, even those who oppose the type of priority-skipping settlement approved in *Jevic* may nevertheless be concerned about the possibility of a Supreme Court ruling that structured dismissals are wholly prohibited under the Bankruptcy Code – relief that even the petitioners are not seeking. For better or worse, the Supreme Court's forthcoming decision should provide greater clarity as to the scope of permissible means for resolving chapter 11 cases.

Subordination

The last several years have produced a number of decisions clarifying the extent to which intercreditor agreements will be enforced in bankruptcy, and 2016 was no different. In particular, the complex and hotly-contested bankruptcy cases of Energy Future Holdings Corp. and its affiliates (collectively, "*EFH*") have generated multiple decisions on the issue, two of which are highlighted below.

EFH I

In March 2016, the bankruptcy court in the *EFH* bankruptcy proceedings issued an opinion ("*EFH I*"),[28] resolving an intercreditor dispute among various groups of first lien creditors over the allocation of adequate protection payments and distributions under a plan of reorganization. The EFH I court strictly construed the parties' intercreditor agreement and concluded that, based on the nature and structure of the adequate protection payments and plan distributions at issue, such items were not covered by, and therefore not required to be allocated among the various first lien creditor groups according to, the waterfall provisions of the intercreditor agreement.

In April 2014, Texas Competitive Electric Holdings Co. LLC ("TCEH") and its parent, Energy Future Competitive Holdings LLC ("EFCH," and together with TCEH and its debtor subsidiaries, the "TCEH Debtors"), along with certain affiliates, filed voluntary chapter 11 petitions in the District of Delaware. As of the petition date, the TCEH Debtors had approximately $25.6 billion in principal amount of first lien debt, including (i) approximately $22.6 billion of term loan and revolving loan debt under a credit agreement (the "TCEH First Lien Bank Debt"); (ii) approximately $1.75 billion of senior secured notes under an indenture (the "TCEH First Lien Notes"); and (iii) approximately $1.23 billion of debt under certain first lien interest rate swap agreements and secured hedge and power sales agreements (the "TCEH First Lien Swaps and Hedges," and collectively with the TCEH First Lien Bank Debt and the TCEH First Lien Notes, the "TCEH First Lien Obligations"). The TCEH First Lien Obligations were secured by liens on substantially all of the TCEH Debtors' assets.

The relationship among the holders of the TCEH First Lien Obligations (the "TCEH First Lien Creditors") was governed by a Collateral Agent and Intercreditor Agreement (the "ICA"). Section 2.1 of the ICA provided that the scope and rank of the TCEH First Lien Creditors' rights in proceeds of collateral were *pari passu* "except as otherwise provided in Section 4.1."[29] Section 4.2 of the ICA similarly provided that after the commencement of any "Insolvency or Liquidation proceeding," no payments were to be made "from the ***proceeds of Collateral*** by any Loan Party to the Collateral Agent for the benefit of any Secured Party, except as provided for in Section 4.1."[30] Section 4.1 of the ICA, which governed "***Application of Proceeds***" and set forth the payment waterfall, provided that "***[r]egardless of any Insolvency or Liquidation Proceeding*** which has been commenced by or against the Borrower or any other Loan Party, ***Collateral or 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 shall be applied in the following order . . ."[31]

Section 4.1 of the ICA further provided that after payment of various amounts, the Collateral and proceeds subject to the waterfall were to be applied "on a pro rata basis, to the payment of, without duplication, (a) all principal and other amounts ***then due and payable*** in respect of the Secured Obligations (including Cash Collateralization of all outstanding Revolving Letters of Credit) and (b) the payment of Permitted Secured Hedge Amounts ***then due and payable*** to any Secured Commodity Hedge Counterparty under any Secured Commodity Hedge and Power Sales Agreement . . ."[32] "Secured Obligations" were defined as including, without limitation, "interest accruing at the then applicable rate provided in the applicable Financing Document after the maturity date of the relevant Secured Obligations and any Post-Petition Interest," "***whether or not allowed or allowable in an Insolvency or Liquidation Proceeding***."[33]

27 For example, in the context of chapter 11 cases involving sales of substantially all of a debtor's assets under section 363 of the Bankruptcy Code, structured dismissals have been used as a means of providing some degree of closure for debtors and their stakeholders where either the remaining assets are insufficient to cover the administrative expenses associated with confirming a plan and/or the costs of funding such plan.

28 Del. Tr. Co. v. Wilmington Tr., N.A. (*In re Energy Future Holdings Corp.*), 546 B.R. 566 (Bankr. D. Del. 2016).

29 *Id.* at 571.

30 *Id.* at 572 (emphasis added).

31 *Id.* at 571-72 (emphasis added).

32 *Id.*

33 *Id.* at 573 (emphasis added).

On the petition date, the TCEH Debtors sought bankruptcy court approval to use cash collateral and make monthly adequate protection payments to the TCEH First Lien Creditors (the "AP Payments"). One of the holders of the TCEH First Lien Notes objected, arguing that the waterfall provision in Section 4.1 of the ICA required that the AP Payments should be allocated among the TCEH First Lien Creditors in a manner that took into account the different rates of accrual of postpetition interest under the various tranches of first lien debt, recalculated on a monthly basis to reflect variations in claim sizes (the "Postpetition Allocation Method"). After holders of TCEH First Lien Bank Debt opposed this allocation demand, the TCEH Debtors and an ad hoc committee of TCEH First Lien Creditors eventually agreed to language in the final cash collateral order reserving all rights regarding the allocation dispute and establishing a holdback mechanism whereby a portion of the AP Payments representing the difference between (i) the AP Payments as calculated based on the aggregate amount of TCEH First Lien Obligations outstanding as of the petition date (the "Petition Date Allocation Method") and (ii) the AP Payments as calculated using the Postpetition Allocation Method would be held in escrow pending resolution of the allocation dispute.

The TCEH Debtors eventually proposed a plan of reorganization under which the TCEH Debtors would form a new entity ("Reorganized TCEH"), transfer various assets, including TCEH's interests in its subsidiaries, to Reorganized TCEH, and receive 100% of Reorganized TCEH's common stock, the cash proceeds of the Debt Offering, and the cash proceeds of the Preferred Stock Sale. The plan provided that TCEH First Lien Creditors would receive distributions in the form of: (i) common stock in Reorganized TCEH (the "Reorganized TCEH Stock"), (ii) 100% of the TCEH Debtors' cash on-hand and the net cash proceeds from (x) the issuance of new debt by Reorganized TCEH (the "Debt Offering") and (y) the sale by Reorganized TCEH of certain preferred stock to third-party investors (the "Preferred Stock Sale"); (iii) rights to purchase $700 million of EFH common stock under a rights offering and the EFH common stock purchased pursuant to the exercise of such rights; (iv) certain stock in TCEH's ultimate parent and any excess cash remaining after distributions to general unsecured creditors of certain TCEH Debtors; and (v) rights to receive payments pursuant to a tax receivable agreement entered into by Reorganized TCEH (the "TRA Rights," and collectively with items (i) through (iv), the "Plan Distributions"). The plan provided that all distributions thereunder would be made in accordance with the Prepetition Allocation Method, except that items (i), (ii), and (v) of the Plan Distributions described above would be distributed in accordance with a final order resolving the intercreditor dispute.

In March of 2015, Delaware Trust Company ("DTC"), the indenture trustee for the TCEH First Lien Notes, commenced an action in New York state court against Wilmington Trust, N.A., in its capacities as the collateral agent and the administrative agent under the ICA, and the escrow agent for the escrow established in connection with the final cash collateral order seeking a declaratory judgment that the AP Payments should be allocated using the Postpetition Allocation Method (which, because the TCEH First Lien Notes accrued interest at a higher rate than the other TCEH First Lien Obligations, would have resulted in a greater proportionate share of the recovery for the holders of the TCEH First Lien Notes) and seeking specific performance directing the escrow agent to turn over the escrowed portion of the AP Payments to the TCEH First Lien Trustee. The administrative agent for the holders of the TCEH First Lien Bank Debt and certain additional holders of TCEH First Lien Obligations other than TCEH First Lien Notes (collectively, the "Intervenors") intervened, arguing that the Petition Date Allocation Method should be used. The litigation was eventually transferred to the EFH bankruptcy court,[34] and, after the TCEH Debtors filed their proposed plan of reorganization, the TCEH First Lien Trustee amended its complaint in September 2015 to demand that the Postpetition Allocation Method be applied to the Plan Distributions in addition to the AP Payments.

In March of 2016, the bankruptcy court issued an opinion ruling in favor of the defendants in DTC's action and granting their motions for judgment on the pleadings. The bankruptcy court held that the ICA did not apply to the AP Payments or the Plan Distributions. The bankruptcy court identified the following conditions as required (collectively) to trigger Section 4.1 of the ICA: (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."[35] The bankruptcy court found that none of these requirements had been satisfied.

First, the bankruptcy court held that the AP Payments and the Plan Distributions were not "Collateral" or "proceeds of Collateral." With respect to the AP Payments, the bankruptcy court reasoned that such payments were "designed to protect secured creditors against diminution in value of their collateral," and, as such, did "not constitute payment of collateral."[36] With respect to the Plan Distributions, the bankruptcy court adopted Judge Drain's holding from a decision ("*Momentive I*")[37]

34 *See Del. Tr. Co. v. Wilmington Tr., N.A.*, 534 B.R. 500 (S.D.N.Y. 2015) (finding that intercreditor action was a "core" bankruptcy dispute and ordering transfer to the EFH bankruptcy court).

35 546 B.R. at 578.

36 *Id.* at 581.

37 *BOKF, N.A. v. JPMorgan Chase Bank, N.A. (In re MPM Silicones, LLC)*, 518 B.R. 740 (Bankr. S.D.N.Y. 2014) ("*Momentive I*").

previously issued in similar intercreditor litigation in the Momentive bankruptcy cases in the Southern District of New York. In *Momentive I*, Judge Drain concluded that common stock received by secured creditors in a debt-for-equity swap under a plan of reorganization did not constitute "proceeds of collateral", reasoning that because the secured creditors' collateral had not actually changed as a result of the issuance and distribution of the new stock, to hold that such stock constituted proceeds of collateral would "unfairly add to such collateral" and would contradict existing case law regarding "whether a secured creditor receives the 'indubitable equivalent' of its secured claim under section 1129(b)(2)(A)(iii) of the Bankruptcy Code if it receives stock in the reorganized enterprise as part of cramdown treatment under a chapter 11 plan."[38] The *EFH I* bankruptcy court was likewise unconvinced by DTC's argument that the spinoff transactions under the TCEH Debtors' plan were akin to a foreclosure, finding that various hallmarks of foreclosure transactions were absent.[39]

With respect to the remaining categories of Plan Distributions, the bankruptcy court held that (i) the Reorganized TCEH Debt Funds were "an obligation of Reorganized TCEH, not an *asset* of Reorganized TCEH into which collateral was converted"; (ii) the Preferred Stock Sale Funds were not collateral because, consistent with *Momentive I*, stock in a newly created subsidiary of a reorganized debtor was, like stock in the reorganized debtor, not "proceeds"; and (iii) the TRA Rights were not proceeds of collateral because they did not "derive from" assets constituting collateral, but were instead created under the plan pursuant to the tax receivable agreement belonging to Reorganized TCEH.[40] The bankruptcy court also noted that DTC's argument that the Plan Distributions constituted proceeds of Collateral to the extent they were not Collateral ignored the fact that the Security Agreement defined "Proceeds" as limited to (i) consideration received from the sale/disposition of assets, (ii) value received as a consequence of possessing the Collateral, or (iii) insurance proceeds.[41]

Second, the bankruptcy court concluded that the AP Payments were not subject to the waterfall provisions of the ICA because the payments were not "received by" the Collateral Agent, but were instead made to the administrative agent for the holders of the TCEH First Lien Bank Debt (on such holders' behalf), the indenture trustee for the holders of the TCEH First Lien Notes (on such holders' behalf), and the holders of the TCEH First Lien Swaps and Hedges (directly) pursuant to the terms of the final cash collateral order.[42]

Third, the bankruptcy court held that the Plan Distributions were not the result of a sale or other disposition of collateral.[43] The bankruptcy court found that DTC's attempt to distinguish the case before it from the debt-for-equity swap in *Momentive I*[44] on the grounds that the spin-off transaction contemplated under the TCEH Debtors' plan constituted a "sale" "elevat[ed] form over substance" where "[n]othing in the plan state[d] that Reorganized TCEH [wa]s 'purchasing' the Collateral, Reorganized TCEH [wa]s not a third-party purchaser, and there [wa]s not an 'economic event' that would create that sort of relationship."[45]

Fourth, the bankruptcy court determined that the AP Payments and the Plan Distributions had not resulted from an "exercise of remedies" by the Collateral Agent. DTC argued that the Collateral Agent was exercising remedies by (i) generally protecting and enforcing the TCEH First Lien Creditors' rights in the TCEH Debtors' bankruptcy cases; (ii) accepting the Plan Distributions on behalf of the First Lien Creditors; (iii) receiving the AP Payments; (iv) forbearing from exercising rights; and (v) filing a proof of claim, but the bankruptcy court rejected all of these arguments.[46] The bankruptcy court agreed with the Intervenors that simply holding liens was not an exercise of remedies, and noted that due to the existence of an event of default, any exercise of remedies would have required direction from the requisite majority of the First Lien Creditors, which the collateral agent had not received.

Finally, the bankruptcy court questioned whether DTC was correct in asserting that the postpetition interest DTC sought to recover satisfied the additional requirement under Section 4.1 of the ICA that such amounts be "due and payable in respect of the Secured Obligations" because "'due and payable' does not mean 'allowed as against the Debtors;' but means 'due and payable in the [ICA]."[47] However, the bankruptcy court expressly declined to determine whether amounts unrecoverable from the TCEH Debtors may nevertheless be recoverable from the other TCEH First Lien Creditors under the ICA given the bankruptcy court's finding that none of the threshold requirements for the application of the ICA's waterfall provisions had been met.

38 546 B.R. at 579 (quoting *Momentive I*, 518 B.R. at 756 (citations omitted)).

39 Specifically, the *EFH I* court noted that (i) there had been no disposal of assets; (ii) the TCEH First Lien Creditors had not filed a motion for relief from stay or otherwise sought to take control of the assets; and (iii) the transactions would not result in any deficiency claims on the part of the TCEH First Lien Creditors. *Id.*

40 *Id.* at 580.

41 *Id.*

42 *Id.* at 574, 581-82.

43 *Id.* at 582.

44 *In Momentive I*, the bankruptcy court held that "a secured creditor is not getting the proceeds of its collateral when it gets stock in the reorganized entity, unless, of course, that stock was paid by a third-party buyer in return for the debtor's assets comprising the collateral." Momentive I, 518 B.R. at 756.

45 546 B.R. at 582.

46 *Id.*

47 *Id.* at 584. Among other things, DTC argued that the clause of Section 4.1 of the ICA indicating that the allocation waterfall applied "regardless of any Insolvency or Liquidation Proceeding" indicated that the mere fact that the TCEH Debtors had filed for bankruptcy, or that postpetition interest might not be allowed to be collected from the TCEH Debtors in their bankruptcy cases, "ha[d] no bearing on the Waterfall in Section 4.1." *Id.*

DTC appealed the *EFH I* decision, but the district court remanded the proceedings to the bankruptcy court after the debtors' confirmed plan failed to go effective and was superseded by an amended proposed plan.[48] The proceedings remain pending before the bankruptcy court, which agreed to consider further briefing from the parties regarding the proper allocation method to be applied under the TCEH Debtors' new confirmed plan. Oral argument is scheduled for March 2, 2017.[49]

EFH II

In a subsequent decision involving a dispute between first lien and second lien noteholders ("*EFH II*"),[50] the EFH bankruptcy court likewise strictly construed the turnover provisions of another intercreditor agreement in addressing the question it had declined to answer in *EFH I* – namely, whether provisions entitling certain creditors to turnover of amounts "payable under the documentation" entitled those creditors to recover amounts from other creditors under the parties' intercreditor agreement where such amounts were not recoverable from the debtors. The bankruptcy court answered the question in the negative.

EFH II involved a dispute between the holders of first lien notes and second lien notes (the "EFIH First Lien Notes" and the "EFIH Second Lien Notes," respectively) issued by Energy Future Intermediate Holding Company LLC and EFIH Finance Inc. ("EFIH" and "EFIH Finance," respectively, and collectively, the "EFIH Debtors")[51] under a collateral trust agreement (the "CTA"). The indenture trustee for the EFIH First Lien Notes (the "EFIH First Lien Trustee") commenced an adversary proceeding against the EFIH Second Lien Trustee asserting that the EFIH First Lien Trustee was entitled to recover the amount of a "make-whole" premium alleged to be due to the holders of the EFIH First Lien Notes from the holders of the EFIH Second Lien Notes, who had received a partial paydown from the EFIH Debtors during the bankruptcy cases.

As discussed further below, during the pendency of the EFIH First Lien Trustee's adversary proceeding against the EFIH Second Lien Trustee seeking turnover of the amount of the make-whole premium, the bankruptcy court held in a separate proceeding that the EFIH First Lien Trustee was not entitled to recover the make-whole premium from the EFIH Debtors because the EFIH First Lien Notes were automatically accelerated upon the EFIH Debtors' bankruptcy filing and the indenture for the EFIH First Lien Notes did not provide for payment of the make-whole premium following a bankruptcy-based acceleration.[52] The EFIH First Lien Trustee asserted that even if it could not recover the make-whole premium from the EFIH Debtors, under the terms of the CTA, the EFIH Second Lien Trustee was required to turn over any funds received from the EFIH Debtors to the EFIH First Lien Trustee until the amount of the make-whole premium was paid in full.[53]

The CTA contained two separate restrictions on payments to the EFIH Second Lien Trustee (the "Payment Restrictions"), one of which applied generally and one of which applied after the commencement of a bankruptcy or certain default and remedy actions, both of which prohibited payments to the EFIH Second Lien Trustee "prior to the Discharge of Parity Lien Obligations."[54] The CTA required the EFIH Second Lien Trustee to hold any such payments in trust for the holders of the EFIH First Lien Notes and remit those amounts to the EFIH First Lien Trustee upon demand until all obligations under the indenture for the EFIH First Lien Notes were discharged in full in cash.[55] "Parity Lien Obligations" were defined under the CTA as including all "Obligations" in respect of the EFIH First Lien Notes; thus, the CTA required turnover of proceeds of collateral only to the extent that such amounts constituted "Obligations" as defined therein.[56] "Obligations" were defined in the CTA as including, among other things: any principal, interest (including all interest accrued thereon after the commencement of any Insolvency or Liquidation Proceeding at the rate including any applicable post-default rate, specified in the Secured Debt Documents, even if such interest is not enforceable, allowable or allowed as a claim in such proceedings), premium, penalties, fees, indemnifications, reimbursements, damages and other liabilities and guarantees of payment of such principal, interest, premium, penalties, fees, indemnifications, reimbursements, damages and other liabilities payable under the documentation governing the Indebtedness.[57]

In ruling on the EFIH Second Lien Trustee's motion to dismiss the EFIH First Lien Trustee's adversary proceeding, the bankruptcy court held that the EFIH Second Lien Trustee was not required to turn over the payments received from the EFIH Debtors to the EFIH First Lien Trustee because (due to the bankruptcy court's prior determination that the EFIH First Lien Notes had been automatically accelerated and that the EFIH First Lien Trustee was not entitled to relief from the automatic stay to rescind acceleration) the make-whole premium claims asserted by the EFIH First Lien Trustee were not recoverable from the EFIH Debtors – *i.e.*, "payable under the documentation," and, therefore, were not "Obligations" as defined under the CTA.

48 *See Del. Tr. Co. v. Wilmington Tr., N.A. (In re Energy Future Holdings Corp.),* Adv. Pro. No. 15-51239 (CSS), 2016 WL 6808958 (Bankr. D. Del. Nov. 17, 2016); Order, Del. Tr. Co. v. Morgan Stanley Capital Group, Inc., No. 16-189-RGA (D. Del. Nov. 23, 2016) [D.I. 57].

49 See Order Approving Stipulation to Establish Briefing Schedule, Del. Tr. Co. v. Wilmington Tr., N.A. (In re Energy Future Holdings Corp.), Adv. Pro. No. 15-51239 (CSS) (Bankr. D. Del. Dec. 8, 2016) [D.I. 148].

50 *Del. Tr. Co. v. Computershare Tr. Co., N.A. (In re Energy Future Holdings Corp.),* 551 B.R. 550 (Bankr. D. Del. 2016).

51 The *EFH* bankruptcy cases involved two silos of debtors under the parent debtor, Energy Future Holdings Corp. ("EFH"), each of which had different sets of creditors: (i) the "T-side" debtors, *i.e.*, those indirectly owned by EFH subsidiary TCEH (the TCEH Debtors) and (ii) the "E-side" debtors, i.e., those indirectly owned by EFH subsidiary EFIH. EFH I involved the T-side debtors, while *EFH II* involved certain of the E-side debtors.

52 *Id.* at 551.

53 *Id.* at 554.

54 *Id.*

55 *Id.*

56 *Id.* at 553.

57 *Id.* at 560

The EFIH First Lien Trustee argued that the CTA contemplated turnover of amounts that were "not . . . allowable or allowed" in bankruptcy, but the bankruptcy court noted that this parenthetical language only applied to "interest," and found that "[t]his [wa]s indicative of the parties' intent – the parties knew how to include such language and chose not to do so in relation to the other enumerated obligations set forth in the [CTA]."[58] The bankruptcy court similarly rejected the EFIH First Lien Trustee's argument that the make-whole premium amounts constituted Obligations under the CTA because they were "payable under the documentation" even if not "payable" from the EFIH Debtors. First, the bankruptcy court found that the make-whole premium was not, in fact, "payable under the documentation" due to the automatic acceleration that had resulted from the EFIH Debtors' bankruptcy filing. Rather, the make-whole premium claims of the holders of the EFIH First Lien Notes were contingent upon those holders receiving relief from the automatic stay to decelerate their notes, which the bankruptcy court had previously denied.[59] Second, the bankruptcy court found that the EFIH First Lien Trustee's interpretation would render the parenthetical language after "interest" redundant because "any payment provided for in the First Lien Indenture would be an obligation payable under the documentation."[60] The bankruptcy court acknowledged the EFIH First Lien Trustee's broader argument that the purpose of turnover provisions applicable in the bankruptcy and sale contexts was "to have an 'insurance policy' when the Second Lien Trustee might collect proceeds even though the First Lien Trustee was not receiving payment from the EFIH Debtors," but found that "[a]lthough, in general, this may be the purpose of turnover provisions, such requirement [wa]s not stated in the [CTA]."[61] The bankruptcy court therefore declined to expand the CTA's turnover requirements beyond their express terms and granted the EFIH Second Lien Trustee's motion to dismiss.[62]

The EFIH First Lien Trustee's appeal is currently pending in the district court, but has been stayed upon the agreement of the parties until the Third Circuit's disposition of the debtors' motion for rehearing or rehearing *en banc* in *EFH III* (involving a dispute over "make-whole" premium claims, as discussed below).[63] On December 19, 2016, the EFIH Debtors announced that they had reached agreements-in-principle (the "Plan Settlements") with certain holders of the EFIH First Lien Notes and the EFIH Second Lien Notes and were currently negotiating the terms of a plan support agreement.[64] Subject to certain terms and conditions, the Plan Settlements would result in the dismissal of the *EFH II* intercreditor litigation. However, the EFIH Debtors subsequently filed a disclosure statement stating that they were simultaneously negotiating an alternative plan support agreement with certain unsecured noteholders (the "PIK Noteholders") which would not resolve the above-described intercreditor litigation and which, if accepted, could require the EFIH Debtors to exercise their fiduciary out under the Plan Settlements.[65]

Takeaways

While the *EFH I* and *EFH II* decisions may come as a surprise to some, they represent the continuing trend of bankruptcy courts to strictly enforce the express provisions of the subject intercreditor agreement in favor of the subordinated creditor and against the senior creditor seeking payment priority (or the creditor seeking a greater proportionate share of the pari passu debt tranche's recovery) as to amounts recovered from the debtor under an intercreditor agreement – unless the parties' intent is crystal clear and consistent throughout the document. Such elaboration should ultimately benefit all market participants by promoting clear and consistent drafting and enhancing predictability, albeit slightly undermined by the potential absence of appellate rulings on the issues that may result if the Plan Settlements are ultimately effectuated. For the time being, the *EFH I* and *EFH II* decisions reflect that the rule of explicitness in the world of intercreditor agreements is alive and well – while bankruptcy courts will enforce intercreditor agreements under section 510(a) of the Bankruptcy Code,[66] they will not apply a broader interpretation of a contract absent a clear manifestation of the parties' intent. Accordingly, market participants should closely scrutinize all distribution waterfall-related provisions (including definitions) to ensure that such provisions consistently reflect their expected priorities and turnover rights throughout the intercreditor agreement.

Other Issues of Interest

Noteworthy decisions from 2016 also addressed other areas of interest to the loan market – specifically, developments related to (i) "make-whole" or "yield-protection" premiums compensating noteholders for interest lost on notes redeemed before their expected due dates, and (ii) allowance and payment of default interest.

58 *Id*.

59 *Id*. at 561.

60 *Id*. at 562.

61 *Id*. at 561-62.

62 *Id*. at 563.

63 See Oral Order, Del. Tr. Co. v. Computershare Tr. Co., N.A. (In re Energy Future Holdings Corp.), No. 16-cv-00461-RGA (D. Del. Nov. 28, 2016) [D.I. 27].

64 See Energy Future Holdings Corp., Current Report (Form 8-K) at 2-3 (filed Dec. 19, 2016).

65 See Disclosure Statement for the Sixth Amended Joint Plan of Reorganization of Energy Future Holdings Corp., Pursuant to Chapter 11 of the Bankruptcy Code as It Applies to the EFH Debtors and EFIH Debtors, No. 14-10979 (CSS) (Bankr. D. Del. Dec. 28, 2016) [D.I. 10446]. Both the EFIH First Lien Trustee and the EFIH Second Lien Trustee have objected to the EFIH Debtors' disclosure statement to the extent it incorporates the option to toggle to a settlement with the PIK Noteholders. See Obj. of Delaware Trust Co. and Certain Holders of EFIH First Lien Notes to Disclosure Statement for the Sixth Amended Joint Plan of Reorganization of Energy Future Holdings Corp., Et Al., Pursuant to Chapter 11 of the Bankruptcy Code as It Applies to the EFH Debtors and EFIH Debtors, In re Energy Future Holdings Corp., No. 14-10979 (CSS) (Bankr. D. Del. Dec. 29, 2016) [D.I. 10458]; EFIH Second Lien Indenture Trustee's Obj. to Debtors' Disclosure Statement, In re Energy Future Holdings Corp., No. 14-10979 (CSS) (Bankr. D. Del. Dec. 29, 2016) [D.I. 10459].

66 Section 510(a) of the Bankruptcy Code provides: "A subordination agreement is enforceable under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law." 11 U.S.C. § 510(a). Intercreditor agreements providing for lien/debt subordination have generally been deemed to constitute subordination agreements enforceable under this provision. See, e.g., ION Media Networks, Inc. v. Cyrus Select Opportunities Master Fund, Ltd. (In re ION Media Networks, Inc.), 419 B.R. 585, 595 (Bankr. S.D.N.Y. 2009).

Make-Whole Premiums

In late 2016, the Third Circuit issued an opinion ("*EFH III*") reversing the decisions of the district and bankruptcy courts in other related *EHF* bankruptcy proceedings and held, applying New York law, that the automatic acceleration of the EFIH First Lien and the EFIH Second Lien Notes caused by the debtors' bankruptcy filing did not negate the debtors' obligation to pay make-whole premiums due upon optional redemption of the notes under the applicable indentures.[67] The Third Circuit's decision in *EFH III* conflicts with the recent decisions of the bankruptcy[68] and district[69] courts in the Momentive bankruptcy proceedings in the Southern District of New York ("*Momentive II*" and "*Momentive III*," respectively), which had previously reached the opposite conclusion (also applying New York law) to substantially similar indenture provisions.

Between 2010 and 2012, the EFIH Debtors had issued the EFIH First Lien Notes (due 2020) and two series of EFIH Second Lien Notes (due 2021 and 2022, respectively). The indentures for the EFIH First Lien Notes and the EFIH Second Lien Notes (collectively, the "EFIH Notes") contained customary optional redemption provisions and provisions for automatic acceleration upon the EFIH Debtors' bankruptcy filing. The optional redemption provisions for the Notes contained identical language providing for their redemption at the EFIH Debtors' option prior to specific dates at 100% of the principal amount of the notes being redeemed plus an "Applicable Premium" (the make-whole premium). The provisions for automatic acceleration upon the EFIH Debtors' bankruptcy filing differed slightly – the indenture for the First Lien Notes made "all outstanding Notes . . . due and payable immediately" upon the EFIH Debtors' bankruptcy filing, while the indenture for the Second Lien Notes provided that "all principal of and *premium, if any*, interest . . . [,] and any other monetary obligations on the outstanding Notes shall be due and payable immediately[.]"[70] Both indentures also gave the holders of the Notes the right to "rescind any acceleration [of] the Notes and its consequences."[71]

After filing for bankruptcy in 2014 (which the EFIH Debtors indicated in their SEC filings was in part for the specific purpose of refinancing the Notes without paying the make-whole premiums that would otherwise be required under the indentures), the EFIH Debtors sought to repay settling holders of EFIH First Lien Notes who agreed to waive their make-whole premium claims with proceeds of debtor-in-possession financing, and later sought to refinance a portion of the EFIH Second Lien Notes – again, without payment of any make-whole premium. The indenture trustees for the Notes opposed the refinancing and sought (in separate adversary proceedings) declaratory judgments that the refinancing of their respective notes would trigger the EFIH Debtors' make-whole premium obligations, as well as relief from the automatic stay to exercise their contractual right under the indentures to rescind acceleration of the notes. The bankruptcy court approved both refinancings and denied the indenture trustees' requests for relief from the automatic stay, without prejudice to the indentures trustees' rights to pursue their make-whole premium claims in their respective adversary proceedings. After the refinancing, the bankruptcy court held in the adversary proceedings that no make-whole premiums were owed to the holders of the Notes, and the district court affirmed on appeal.

Both the bankruptcy court[72] and the district court[73] relied on the reasoning applied by the lower courts in *Momentive II* and *Momentive III*. They held that the EFIH Debtors were not required to pay the make-whole premiums because the indentures did not specifically provide for such premiums following automatic acceleration due to the bankruptcy filing. They reasoned that the EFIH Debtors' refinancing of the Notes did not constitute an "optional redemption" because the Notes had already matured. Further, the lower courts viewed the make-whole premium as a "prepayment" premium, and concluded that because the Notes had already matured due to their automatic acceleration, there could be no prepayment and, consequently, no right to a prepayment premium in the absence of express language providing for post-acceleration payment of such premium.

On appeal, the Third Circuit reversed. Emphasizing that its "primary objective" was "to give effect to the intent of the parties as revealed by the language of their agreement,"[74] the Third Circuit concluded that the EFIH Debtors' make-whole premiums were triggered by the postpetition refinancing of the Notes under the language of the Notes' indentures. First, the Third Circuit rejected the notion that only a pre-maturity repurchase of bonds could constitute a "redemption" (which was not a defined term under the indentures), noting that New York state and federal courts had deemed "redemption" to include both pre- and post-maturity repayments of debt.[75]

Second, the Third Circuit rejected the EFIH Debtors' argument that the redemption was not "optional," finding that "this contention d[id] not match the facts."[76] The Third Circuit noted that (i) the EFIH Debtors had

67 *See Del. Tr. Co. v. Energy Future Intermediate Holding Co. LLC (In re Energy Future Holdings Corp.)*, 842 F.3d 247 (3d Cir. 2016) ("*EFH III*").
68 *See In re MPM Silicones, LLC*, No. 14-22503-rdd, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014) ("*Momentive II*").
69 *See U.S. Bank, N.A. v. Wilmington Sav. Fund Society, FSB (In re MPM Silicones, LLC)*, 531 B.R. 321 (S.D.N.Y. 2015) ("*Momentive III*").
70 842 F.3d at 254, 257.
71 *Id.* at 251.
72 Computershare Tr. Co., N.A. v. Energy Future Intermediate Holding Company LLC (In re Energy Future Holdings Corp.), 539 B.R. 723 (Bankr. D. Del. 2015).
73 Computershare Tr. Co., N.A. v. Energy Future Intermediate Holding Company LLC (In re Energy Future Holdings Corp.), No. 15-1011-RGA, 2016 WL 1451045 (D. Del. Apr. 12, 2016).
74 842 F.3d at 261.
75 *Id.* at 254-55.
76 *Id.* at 255.

publicly announced their strategy to redeem the Notes in bankruptcy before maturity and without paying the make-whole premium; (ii) the EFIH Debtors had publicly asserted, postpetition, that they were "under no obligation" to redeem the EFIH Second Lien Notes; and (iii) the holders of the Notes had not only not demanded redemption, but had actively opposed it. Moreover, the Third Circuit observed, the EFIH Debtors had the option of reinstating the accelerated Notes' original maturity date under section 1124 of the Bankruptcy Code[77] and chose not to do so.

Third, the Third Circuit rejected the notion that the automatic acceleration provisions and the optional redemption provisions of the Notes' indentures represented "different pathways" that it must choose between. With respect to the EFIH First Lien Notes, the EFIH Debtors pointed to the absence of any reference to a premium in the automatic acceleration provisions, and argued that this omission indicated that no make-whole premium was payable post-acceleration. The Third Circuit was unconvinced, finding that it "surpasse[d] strange to hold that silence in [the automatic acceleration provision] surpassed [the optional redemption provision's] simple script."[78] The Third Circuit was similarly not persuaded by the EFIH Debtors' argument that the automatic acceleration and optional redemption provisions conflicted because the former made the Notes "due and payable immediately without further action or notice" while the latter prescribed detailed notice procedures for the EFIH Debtors to follow to redeem the Notes. The Third Circuit noted that the EFIH Debtors offered no reason why they could not have complied with the optional redemption notice procedures, and found that in any event, the EFIH Debtors "cannot use [their] own failure to notify to absolve [their] duty to pay the make-whole."[79]

With respect to the EFIH Second Lien Notes, for which the indenture did in fact provide that a "premium, if any" would be payable upon acceleration, the EFIH Debtors argued that the language was not specific enough in that it failed to expressly reference the make-whole premium due upon an optional redemption. The Third Circuit acknowledged that the courts in *Momentive II* and *Momentive III* had adopted this reasoning, but rejected it nevertheless, finding that "the result in Momentive conflict[ed] with that indenture's text and fail[ed] to honor the parties' bargain."[80] The Third Circuit found that the language in the EFIH Second Lien Notes' indenture left "no doubt" that the automatic acceleration and optional redemption provisions "work[ed] together" and "both remained applicable following bankruptcy."[81]

In concluding that the refinancing of the Notes triggered the EFIH Debtors' obligation to pay the make-whole premiums under the Notes' indentures, the Third Circuit distinguished between the right to "prepayment premiums," which, under New York law, could not be exercised post-maturity, and the right to "premium[s] tied to a 'redemption,'" which could be exercised either at or before maturity.[82] The Third Circuit found that by extending the rule that automatic acceleration negates make-whole premium rights from the prepayment premium context into the redemption premium context, the lower courts, and the *Momentive II* and *Momentive III* decisions on which they relied, had "pushed the . . . rule beyond its language and underlying policy concerns."[83] Although the EFIH Debtors argued that the redemption premium under the Notes' indentures was "in substance a prepayment premium," the Third Circuit held that it "must give effect to the 'words and phrases' the parties chose."[84] The Third Circuit therefore reversed with instructions to the district court to remand the proceedings to the bankruptcy court.

On December 15, 2016, the EFIH Debtors filed a petition requesting that the Third Circuit (i) grant rehearing or rehearing en banc and certify the issue of whether a premium tied to "redemption," as opposed to prepayment, will remain payable post-acceleration to the New York Court of Appeals in light of the conflict between the Third Circuit's ruling and the lower courts' decisions in *Momentive II* and *Momentive III* (the latter of which has also been appealed and taken under submission by the Second Circuit[85]), or, at a minimum, hold the EFIH Debtors' petition until the Second Circuit has ruled on the *Momentive III* appeal.[86] The parties have yet to confirm the impact, if any, of the recently-announced Plan Settlements (which provide, among other things, for payment of slightly-discounted make-whole premium claims to the holders of the Notes) on the pending *EFH III* appellate proceedings.

Takeaways

While the Third Circuit's decision offers some comfort that yield-protection rights will be respected in bankruptcy, the issue of bankruptcy treatment of make-whole premium claims is far from settled. Even after the Second Circuit issues its decision in the pending appeal of the Momentive III decision, substantial questions may remain unanswered, including but not limited to (i) whether make-whole premium claims are otherwise disallowable as penalties or unmatured interest, and/or as unreasonable under 11 U.S.C. § 506(b),[87] and (ii) the impact, if any, of the debtor's solvency on the analysis. Unless and until courts provide further guidance on the make-whole premium issue,

77 *See* 11 U.S.C. § 1124(2) (providing that a debtor may leave a class of claims unimpaired under a plan "notwithstanding any contractual provision or applicable law that entitles the holder of such claim . . . to demand or receive accelerated payment of such claim . . . after the occurrence of a default" if the plan "reinstates the maturity of such claim . . . as such maturity existed before such default" and satisfies various other requirements).
78 842 F.3d at 257.
79 *Id.*
80 *Id.*
81 *Id.* at 257-58.
82 *Id.* at 259.
83 *Id.* at 260.
84 *Id.*
85 The Second Circuit appeal of the make-whole premium ruling is being heard along with certain related appeals of other issues from the *Momentive* confirmation proceedings, including, among others, rulings on cramdown requirements. *See In re MPM Silicones, LLC, Nos.* 15-1682, 15-1771, 15-1824 (2d Cir.).
86 *See Pet. for Reh'g or Reh'g En Banc* for Appellees, Del. Tr. Co. v. Energy Future Intermediate Holding Co. LLC (In re Energy Future Holdings Corp.), No. 16-1351 (3d Cir. Dec. 15, 2016).
87 See 11 U.S.C. § 506(b) (providing that fully- or over-secured creditors may recover postpetition interest and "reasonable fees, costs, or charges" provided for in the agreement under which their claims arise) (emphasis added).

the good news is that the confusion highlighted in the EFH III and Momentive III appeals can be avoided through careful drafting. With respect to existing debt documents, issuers and noteholders under indentures providing for significant make-whole premiums should carefully review the contractual language in assessing their respective rights and risks in the event of a bankruptcy filing, and should bear in mind that such rights and risks may vary depending on the jurisdiction in which the issuer files for bankruptcy.

Default Interest – New Investments

In *New Investments*,[88] the Ninth Circuit held that a debtor proposing to "cure" the debtor's default under a chapter 11 plan under 11 U.S.C. § 1123[89] was required to pay interest at the contractual default rate as part of such cure. The *New Investment*s decision overturned the long-standing rule under the Ninth Circuit's 1988 *Entz-White* decision,[90] wherein the Ninth Circuit had previously held that "the power to cure under the Bankruptcy Code authorizes a plan to nullify all consequences of default, including avoidance of default penalties such as higher interest," such that a debtor could "cure" a default under a loan agreement by paying arrearages at the lower, pre-default rate of interest, even if the loan agreement provided for a higher interest rate upon default.[91] In *New Investments*, the Ninth Circuit held that the *Entz-White* rule was no longer good law in light of intervening amendments to the Bankruptcy Code – a conclusion that had been reached by a number of courts in other jurisdictions, but repeatedly rejected by lower courts within the Ninth Circuit.

In *New Investments*, the corporate debtor had borrowed approximately $3 million from a lender ("Pacifica") to purchase a hotel property prior to filing for bankruptcy. The note, which was secured by a deed of trust, provided for an interest rate of 8%, which would increase by 5% upon default. The debtor defaulted on the note in 2009 and filed for chapter 11 relief after Pacifica commenced non-judicial foreclosure proceedings. The debtor's chapter 11 plan of reorganization proposed to cure the default by selling the hotel property to a third party and using the sale proceeds to pay Pacifica the outstanding amount under the note at the pre-default interest rate. Pacifica objected, arguing that it was entitled to be paid at the higher post-default interest rate of 13%.

The bankruptcy court confirmed the debtor's plan over Pacifica's objection and authorized the sale of the hotel property for approximately $6.9 million, of which approximately $2.8 million was to be paid to Pacifica, reflecting the pre-default interest rate and any other late penalties. However, in anticipation of Pacifica's appeal, the bankruptcy court ordered that $100,000 of the sale proceeds be reserved for Pacifica's attorney's fees on appeal and $670,000 be set aside as a disputed claim reserve for Pacifica. Pacifica timely appealed directly to the Ninth Circuit pursuant to 28 U.S.C. § 158(d).

On appeal, the Ninth Circuit reversed. The Ninth Circuit noted that after its decision in *Entz-White*, Congress had added section 1123(d) to the Bankruptcy Code, which provided:

Notwithstanding subsection (a) of this section and sections 506(b), 1129(a)(7), and 1129(b) of this title, if it is proposed in a plan to cure a default the amount necessary to cure the default shall be determined in accordance with the underlying agreement and applicable nonbankruptcy law.[92]

The Ninth Circuit held that the "plain language" of section 1123(d) "render[ed] void" its prior holding in *Entz-White* and "compel[led] the holding that a debtor cannot nullify a preexisting obligation in a loan agreement to pay post-default interest solely by proposing a cure."[93]

The Ninth Circuit acknowledged that the legislative history to section 1123(d) indicated that Congress was primarily concerned with overruling Rake v. Wade[94] (wherein the Supreme Court had held that a chapter 13 debtor proposing to cure a default was required to pay interest on his arrearages even if the underlying loan agreement did not provide for such interest), which Congress viewed as providing "an unbargained-for windfall to creditors."[95] However, the Ninth Circuit reasoned, "[t[he fact that Congress may not have foreseen all of the consequences of a statutory enactment is not a sufficient reason for refusing to give effect to its plain meaning."[96] Noting that payment of applicable penalties would typically be required to cure a default outside of bankruptcy, the Ninth Circuit found that the result in *New Investments* was also "consistent with the intent of § 1123(d) because it h[eld] the parties to the benefit of their bargain."[97] Thus, the Ninth Circuit, found, because "the parties had bargained for a higher interest rate on the note in the event of default, Pacifica [wa]s entitled to the benefit of that bargain under the terms of § 1123(d)."[98]

88 Pacifica L 51 LLC v. New Investments, Inc. (In re New Investments, Inc.), 840 F.3d 1137 (9th Cir. 2016).

89 Section 1123 of the Bankruptcy Code provides, among other things, that a plan shall "provide adequate means for the plan's implementation, such as . . . curing or waiving of any default . . ." 11 U.S.C. § 1123(a)(5)(G).

90 *Great W. Bank & Tr. v. Entz-White Lumber & Supply, Inc. (In re Entz-White Lumber & Supply, Inc.)*, 850 F.2d 1338, 1340 (9th Cir. 1988).

91 *Id.* at 1342.

92 11 U.S.C. § 1123(d).

93 840 F.3d at 1140.

94 *Rake v. Wade*, 508 U.S. 464 (1994).

95 840 F.3d at 1141.

96 *Id.*

97 *Id.*

98 *Id.* at 1142.

Takeaways

While the New Investments decision is consistent with the majority of lower courts and at least one other circuit court[99] that have similarly held that creditors are entitled to payment of interest at the post-default rate as part of a proposed "cure" in bankruptcy, it represents a significant development for the Ninth Circuit, which had long been an outlier jurisdiction on the issue. Debtors may lament their resulting loss of leverage in plan negotiations, but secured creditors should derive comfort from the knowledge that the long-standing issue of whether Entz-White survived the 1994 amendments to the Bankruptcy Code[100] has now been conclusively resolved, and their rights to default interest upon the reinstatement of debt under section 1124 are enforceable in the Ninth Circuit (among other jurisdictions). The *New Investments* decision is also consistent with the general theme of emphasis on express terms and intent reflected in the decisions described above to the extent that the Ninth Circuit focused on the "plain language" of section 1123(d) and the broader intent behind that provision's enactment.

2017 should bring some additional appellate-level guidance on the various issues described herein. Regardless of what those forthcoming decisions may hold, market participants would do well to bear in mind the general principle that careful and consistent drafting at the outset of their transactions is critical to avoiding ambiguities leading to significant litigation – and ultimately significant losses – in the event of a bankruptcy filing. To be sure, what the applicable documents do ***not*** say can be as important as what the documents ***do*** say – both of which can and likely will be held against you in a bankruptcy court. ■

99 *See JPMCC 2006-LDP7 Miami Beach Lodging, LLC v. Sagamore Partners, Ltd. (In re Sagamore Partners, Ltd.),* 620 Fed. App'x 864, 869 (11th Cir. 2015) ("[W]here, as here, 'the underlying agreement' calls for default-rate interest and the 'applicable nonbankruptcy law' permits it, a party cannot cure its default without paying the agreed-upon default-rate interest.").

100 *See, e.g., Gen. Growth Props., Inc.*, 451 B.R. 323, 327 (Bankr. S.D.N.Y. 2011) (noting "conflicting authority" regarding whether the validity of Entz-White's reasoning survived the 1994 amendments).