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Client Alert Commentary

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The Weakest Link in Intercreditor Agreements Breaks Again in Momentive

The U.S. Bankruptcy Court's recent decision highlights the pitfalls of ambiguous intercreditor agreements for senior creditors.

Why the *Momentive* case is important

Intercreditor agreements among secured creditors with respect to common collateral are often limited to lien subordination, so as to govern each secured creditors' rights over the common collateral, without imposing claim subordination that would require junior creditors to subordinate their claims and turn over all of their recoveries, whether or not derived from proceeds of collateral. Intercreditor agreements that provide only for lien subordination typically include a reservation of rights for junior creditors to retain all of their rights as unsecured creditors; however, the formulation of this reservation varies from agreement to agreement, and as discussed below, the exact language used can be critical in a court's analysis.

The recent decision in *In re MPM Silicones, LLC*, Case No. 14-22503 (RDD) (Bankr. S.D.N.Y. Sept. 30, 2014) (*Momentive*) reflects the emerging trend of courts narrowly interpreting restrictions on junior creditors in these intercreditor agreements, where the restrictions are ancillary to the distribution of the common collateral's value. In *Momentive*, the bankruptcy found that the general reservation of rights as unsecured creditors serves to "ameliorate obligations that [junior secured creditors have] undertaken elsewhere in the agreement."

Senior creditors bear the risk of ambiguity in intercreditor agreements

A high stakes example of what can happen with generalized drafting in intercreditor agreements bore out in the chapter 11 cases titled *In re Boston Generating, LLC* (*Boston Gen*).[1] In that case, the bankruptcy court read prohibitions on junior creditor actions narrowly, so as to allow the junior creditors to object to bidding procedures for a sale of substantially all assets, despite a loosely-drafted prohibition on objecting to assets sales to which senior creditors had consented.

The court explained that the purpose of the intercreditor agreement was to put the senior creditors "'in the driver's seat' when it came to decisions regarding collateral." Nevertheless, the court held that waivers of rights to object to the procedures used for a sale of assets "must be clear beyond peradventure." The court acknowledged that the case was a "close call" and that the outcome was the result of a "perfect storm of a poorly drafted agreement" and other facts and equitable circumstances particular to that case.

In contrast, courts tend to uphold express prohibitions on specific types of actions. For example, courts often enforce agreements by a junior creditor not to contest liens of a senior creditor.[2] Similarly, courts have upheld an agreement by a junior creditor to authorize the senior creditor to vote both creditors'

claims,[3] although some courts find such assignments of voting rights to be unenforceable as a matter of policy.[4]

Courts are more likely to enforce prohibitions on actions by junior creditors when the provisions that reserve a junior creditor's rights as unsecured creditors are drafted carefully so as not to modify other obligations under the agreement. Such clauses should be formulated with an introductory clause along the lines of "Except as otherwise specifically set forth in this Agreement, . . .", as opposed to "Notwithstanding anything to the contrary in this Agreement, ..."[5]

The *Momentive* decision is another example of the emerging trend

As background, in the *Momentive* case, the chapter 11 plan provides, generally speaking, for junior creditors to receive new equity in the debtors in exchange for their claims, and for senior creditors to receive new debt secured by the same collateral that secured their prepetition loans. The senior creditors rejected the plan, and the debtors sought confirmation on a cram down basis. In addition, the debtors objected to the senior creditors' make-whole claims. Certain of the junior creditors entered into a restructuring support agreement with the debtors and extended a backstop commitment for the equity rights offering in connection with the plan.

The senior creditors contested the plan through objections to confirmation and litigation over their make-whole claim. The senior creditors also filed a complaint in state court against the junior creditors for breach of the intercreditor agreement. The junior creditors removed the action to the district court, which automatically referred the matter to the bankruptcy court.

The bankruptcy court confirmed the debtors' chapter 11 plan on a cram down basis and, at the same time, disallowed the senior creditors' make-whole claim and denied the senior creditors' motion to remand their litigation over the intercreditor agreement back to state court. The bankruptcy court then held a subsequent hearing on motions to dismiss the senior creditors' complaint for breach of the intercreditor agreement.

The legal question in the *Momentive* case was whether to dismiss causes of action — asserted by senior creditors — for breach of contract against junior creditors arising from several types of alleged actions by junior creditors, which were, generally speaking:

- Opposition to requests for adequate protection and payment of financial advisors of senior creditors, and support for priming debtor-in-possession (DIP) financing without consent of senior creditors
- Opposition to a make-whole claim of senior creditors, support for a plan that crams down senior creditors, and entry into a restructuring support agreement in favor of the cram down plan
- Receipt of alleged proceeds of collateral that were not held in trust for senior creditors, comprised of a US$30 million backstop fee, reimbursement of professional fees and expenses, and new equity in the debtors to be distributed under the plan

The bankruptcy court dismissed all of the senior creditors' causes of action. The court dismissed the first type of claims without prejudice, so as to permit the senior creditors to replead the claims to cure their pleading deficiencies — to the extent the facts of the case allowed. The court noted that, based on its review of the intercreditor agreement, there was no provision prohibiting support for a priming loan; rather, the only prohibition was a prohibition on objecting to a priming loan supported by the senior creditors. On these causes of action, the court essentially found that the senior creditors had not adequately alleged exactly what actions the junior creditors took to breach the intercreditor agreement.

The bankruptcy court dismissed the second and third types of causes of action with prejudice, so as to bar the senior creditors from pursuing those claims as a matter of law, unless the bankruptcy court is reversed on appeal. In particular, the senior creditors conceded that they would have no cause of action against the junior creditors for opposition to the senior creditors' make-whole claim, unless the bankruptcy court's decision disallowing that claim is reversed.

Senior creditors should draw several key lessons from the decision:

Restrictions on action should be specific: The *Momentive* court followed the reasoning of *Boston Gen* and held that rights to object to a secured creditor's claim and rights with respect to treatment of a claim though a plan (*i.e.*, cram down of senior creditors) should not be curtailed "unless very clearly precluded or constrained by an intercreditor agreement of this nature." The court, based on its own review of the agreement, found that the language generally prohibiting actions to "hinder any exercise of remedies" by the senior creditors did not provide a clear basis to deprive a junior creditor of its rights as an unsecured creditor to contest claims.

Furthermore, because the debtors and not the junior creditors themselves objected to make-whole claims and proposed the cram down plan, the court found that the junior creditors' actions were limited to encouraging the debtors to take these actions. In this manner, the debtors' role in leading the prosecution of matters adverse to the senior creditors insulated the junior creditors from liability under the loose terms of the intercreditor agreement at issue.

As the *Momentive* decision exhibits, if the senior creditors have the market leverage to do so, intercreditor agreements should clearly restrict the actions of junior creditors by explicit language rather than relying exclusively on general language to provide confidence that junior creditors will be constrained from supporting action adverse to senior creditors.

New equity and certain other distributions are not the proceeds of collateral: The bankruptcy court rejected causes of action that the junior lenders improperly received and retained the proceeds of collateral in the form of a US$30 million backstop fee, reimbursement of professional fees and expenses, and new equity in the debtors to be distributed under the plan.

The bankruptcy court determined, as a matter of New York law, that new equity in the reorganized debtors that continue to own the same collateral is not a receipt of proceeds of collateral. The court held that proceeds of collateral are essentially "whatever is the result of the transformation of the collateral." Under the facts of this case, the court found that there was no change to the senior creditors' collateral and therefore no proceeds as a result of the plan.

In contexts where the parties have agreed to lien subordination but not claim subordination, this holding underscores the need to define specifically the relative rights of senior and junior creditors.

Conclusion

At present, an order has not yet been entered in the *Momentive* chapter 11 cases that will formally dismiss the senior lenders' claims. Upon entry of that order, the senior lenders will be entitled to appeal the bankruptcy court's decision and/or file a motion to amend their complaint with respect to claims that were dismissed without prejudice.

All participants in complex commercial financing transactions should continue to follow the *Momentive* proceedings closely. Senior creditors would be well advised to consider the lessons of this case as they draft new intercreditor agreements. In particular, senior creditors seeking to avoid the result in *Momentive* should consider how to make their intercreditor agreements more precise, whether to take a pledge of shares in the holding company, and, in the event of disputes, whether to advance other legal arguments on the question of whether new equity constitutes proceeds of common collateral.

If you have questions about this *Client Alert*, please contact one of the authors[6] listed below or the Latham lawyer with whom you normally consult:

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Endnotes

1 440 B.R. 302 (Bankr. S.D.N.Y. 2010).

2 *See, e.g., In re Ion Media Networks, Inc.*, 419 B.R. 585 (Bankr. S.D.N.Y. 2009).

3 *See, e.g., In re Aerosol Packaging, LLC*, 362 B.R. 43 (Bankr. N.D. Ga. 2006).

4 *See, e.g., In re SW Boston Hotel Venture, LLC*, 460 B.R. 38 (Bankr. D. Mass. 2011) (holding an assignment of plan voting rights to be unenforceable).

5 *Compare In re Ion Media Networks, Inc.*, 419 B.R. at 597-98 (denying junior creditors standing to object to chapter 11 plan), with *Momentive*, Hearing Tr. Sept 30, 2014 102:12-22 (dismissing claims by senior creditors for breach of intercreditor agreement).

6 The authors of this Client Alert were not involved in representation of any party in connection with the *Momentive* bankruptcy cases.