

Client Alert

Financial Restructuring Practice Group

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Southern District of New York holds that intercreditor agreement allows for payment of subordinated lender's post-petition interest prior to repayment of the outstanding principal amount of senior debt

On January 27, 2017, the United States District Court for the Southern District of New York ruled that the subordinated creditor was entitled to payment of post-petition interest prior to repayment of the senior lender's outstanding principal.¹ Interpreting the loan documents under applicable state law, the Court determined that the documents were sufficiently explicit as to entitle the subordinated lender to receive post-petition interest, notwithstanding the Bankruptcy Code's general prohibition on post-petition interest for unsecured claims.

Background

The plaintiff, U.S. Bank National Association ("Plaintiff"), and the defendant, T.D. Bank, N.A. ("Defendant"), were both senior lenders of Bionol Clearfield, LLC ("Bionol") under a senior credit agreement (the "Credit Agreement") that covered five tranches of secured loans. Defendant was a lender under three of the tranches (the Tranche A Loans, the Tranche B Loans, and the Working Capital Loans), and was appointed as collateral agent and administrative agent. Plaintiff was the sole lender under a separate tranche, the Tranche TEX Loans.² The parties entered into an intercreditor agreement (the "Intercreditor Agreement") which set forth the following waterfall for application of proceeds upon the exercise of remedies. For purposes of this dispute, the priority of payments were: (1) fees, costs and expenses then due and payable under the loan documents; (2) any interest then due and payable under the loan documents to all lenders (including Plaintiff); and (3) any principal amounts then due and payable with respect to the five tranches of loans in order of priority (with the Plaintiff's Tranche TEX Loans only receiving principal distributions after repayment of all other loans).³

During Bionol's chapter 7 bankruptcy proceeding, the trustee released \$10,561,452.93 of collateral proceeds to Defendant in its capacity as agent.⁴ Both parties agreed that the payment waterfall in the Intercreditor Agreement applied, but Plaintiff argued that the funds should be distributed on account of interest accruing after the commencement of Bionol's bankruptcy case. Defendant argued that applicable bankruptcy law prevented post-petition

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interest from accruing and thus the proceeds should be distributed on account of outstanding principal (in which case Plaintiff would not receive any of the proceeds). Unable to reach an agreement, Plaintiff brought suit in the Southern District of New York seeking a declaratory judgment that post-petition interest was due and owing and should be paid prior to any distributions on account of principal.⁵

Arguments Before the Court

Plaintiff claimed that the Intercreditor Agreement, when read together with the Credit Agreement's provision that lenders shall be entitled to receive post-petition interest during the pendency of an insolvency or liquidation proceeding, clearly required the distribution of post-petition interest to the lenders before repayment of principal given the Intercreditor Agreement's prioritization of interest "then due and payable" over repayment of principal. Under the Credit Agreement and interpretive principles applicable to both agreements, Plaintiff argued that "due and payable" interest included interest that accrued during Bionol's bankruptcy regardless of whether such interest would be allowable as a claim in the bankruptcy proceeding.⁶

Defendant in turn argued that post-petition interest was not to be included in the Intercreditor Agreement's waterfall because, under the Credit Agreement, interest is only payable to the "extent permitted by law", and bankruptcy law and state law do not permit the payment of post-petition interest. Specifically, Defendant claimed that the "Rule of Explicitness"—a principle of both bankruptcy law and New York contract law which requires that post-petition interest provisions in subordination agreements be unequivocal before they are enforced—barred the payment of post-petition interest. Because no interest accrued post-petition, the distributions should be applied to outstanding principal.⁷

The Court's Decision

The Court determined that post-petition interest was included in the meaning of interest in the loan documents. While case law suggests some confusion over the interaction between section 510 of the Bankruptcy Code and the Rule of Explicitness,⁸ the Court ruled that it need not address the viability of the rule under federal bankruptcy law because, while the disputed funds came from a bankrupt entity, no party to the dispute was actually in bankruptcy and, thus, bankruptcy law did not govern.⁹ Rather, under applicable New York case law, the Rule of Explicitness is a recognized interpretative principle of contract law that is applicable outside of bankruptcy and which requires unambiguous language that the contract abrogates the general rule that interest stops on the date of the filing of a bankruptcy petition.¹⁰ The Court acknowledged that the Rule of Explicitness usually protects subordinated creditors from the accrual of post-petition interest on a senior creditor's claim and that this case is somewhat unique in that the accrual of post-petition interest benefits the subordinated creditor under the payment waterfall. However, the Court concluded that the Rule of Explicitness still applies even though it potentially limits the subordinated creditor's right to recover post-petition interest.¹¹

The Court further concluded that the loan documents satisfied the Rule of Explicitness and made it unambiguously clear that interest included post-petition interest. Thus, such interest was entitled to distribution under the Intercreditor Agreement's waterfall.¹² Here, the Court reasoned that, because the Credit Agreement provided that post-petition interest would accrue regardless of whether such interest was allowed as a claim in bankruptcy and that agreement was incorporated by reference into the Intercreditor Agreement, the documents expressly provided that the waterfall provision required distributions be made to post-petition interest due and payable before distributions were made to principal amounts. Accordingly, the Court granted Plaintiff's application for a declaratory judgment that the distributions should be applied to post-petition interest payable to all lenders under the Credit Agreement (including Plaintiff).¹³

Conclusion and Lessons Learned

This case serves as a good reminder that lenders should carefully consider the interplay between loan documents in order to ensure that the agreements when read together correctly represent the intent of the parties. Under applicable state law, the Rule of Explicitness may apply to intercreditor disputes outside of bankruptcy, not just to disputes within a bankruptcy proceeding. Accordingly, lenders entering into intercreditor agreements (particularly under New York law) and wishing to include post-petition interest notwithstanding the general rule that interest stops accruing on the petition date should draft carefully and explicitly as to make their intent clear.

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¹ *U.S. Bank Nat'l Ass'n v. T.D. Bank*, 2017 U.S. Dist. LEXIS 14954 (S.D.N.Y. Jan. 27, 2017).

² *Id.* at *2-4.

³ *Id.* at *3-4.

⁴ *Id.* at *4.

⁵ *Id.* at *2.

⁶ *Id.* at *7-8.

⁷ *Id.* at *8.

⁸ *Id.* at *13-15 (discussing *In re Ionosphere Clubs, Inc.*, 134 B.R. 528, 533 (S.D.N.Y. 1991); *In re Southeast Banking Corp.*, 156 F.3d 1114, 1123-23 (11th Cir. 1998); *In re Bank of New England Corp.*, 364 F.3d 355, 365 (1st Cir. 2004)).

⁹ *Id.* at *12-16.

¹⁰ *Id.* at *16-17.

¹¹ *Id.* at *18.

¹² *See id.* at *21-30.

¹³ *Id.*