Insolvency and Restructuring Update

Momentive Ruling Highlights Risks to Senior Creditors Under Intercreditor Agreements

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As we discussed in our recent client memorandum *(available **here**)*, the oversecured senior lien creditors of chapter 11 debtor Momentive Performance Holdings and its affiliates failed in the context of the plan confirmation hearing to persuade the bankruptcy court that the debtors' chapter 11 plan did not satisfy the cramdown standard, even though the replacement notes proposed to be distributed to them had below-market interest rates. The senior lien creditors also lost a dispute with Momentive—and with second lien noteholders that intervened in the dispute—regarding their entitlement to a make-whole payment.

Following these confirmation rulings, on September 30, 2014, the bankruptcy court rejected the senior lien creditors' efforts to make up their losses by obtaining a recovery from Momentive's second lien noteholders under an intercreditor agreement that prohibits the second lien noteholders from receiving any recovery from the "common collateral" until the senior lien creditors are "paid in full in cash" and from taking certain actions in opposition to the senior lien creditors. The court dismissed the senior lien creditors' core claims, holding that (1) the equity distributed to second lien noteholders did not constitute *"proceeds" of common collateral* and (2) intervening in the make-whole dispute and supporting the debtors' cramdown plan did not violate the intercreditor agreement because the second lien noteholders were acting as unsecured creditors and disputing the *amount* of the senior lien creditor' claims and the adequacy of their proposed distribution, not their entitlement to *collateral.*

The court's holdings highlight the limited protection offered by lien subordination, as compared to payment subordination, unless the relevant agreement is carefully drafted to protect the senior creditor, which the market often does not permit. Furthermore, the decision shows that the carefully crafted prohibitions on second lien creditors can be swallowed by overbroad language preserving those creditors' rights to participate in the bankruptcy proceedings as "unsecured creditors".

The Senior Lien Creditors' Arguments

In July 2014, Momentive's senior lien creditors filed state court actions against certain second lien noteholders that, under the debtor's plan of reorganization, were slated to receive the equity of the reorganized debtor. These actions were ultimately removed to federal court over the senior lien creditors' opposition, where they were referred to the bankruptcy court to be heard by the bankruptcy court.

In their complaints, the senior lien creditors pressed two primary theories. The first was that the second lien noteholders could not receive the payments and distributions they were slated to receive, including the equity of the reorganized company, reimbursement of professional fees and (potentially) a $30 million fee for backstopping a rights offering, so long as the senior lien creditors were not paid in full in cash. Since the senior lien creditors were to receive replacement notes that could not be sold for the full value of their claims, the senior lien creditors argued that the second lien noteholders are required to turn over a portion of their recovery to make the senior lien creditors whole. The second theory was that the second lien noteholders had, by signing a restructuring support agreement in respect of the debtors' plan and intervening in the make-whole dispute, violated the intercreditor agreement's strictures prohibiting the second lien noteholders from enforcing rights or exercising remedies, or objecting to relief sought by the senior lien creditors. As a remedy, the senior lien noteholders sought turnover of equity and backstop fees distributed to the second liens until they are paid in full in cash, in addition to unspecified damages to compensate them for violations of the intercreditor agreement.

The Second Lien Noteholders' Motion to Dismiss

The second lien noteholders' primary response to both of the senior lien creditors' theories was that the intercreditor agreement concerns only rights with respect to collateral or proceeds of collateral. In other words, they emphasized that the intercreditor agreement provides for lien subordination and not payment subordination, arguing that none of the challenged actions relate to the common collateral. With respect to receipt of stock in the reorganized debtors, professional fee reimbursement and a potential backstop fee, the second lien noteholders argued that none constituted proceeds of the collateral, noting that the company in fact retained all collateral under the plan and would repledge it to the senior lien creditors in connection with their replacement notes. And with respect to intervention in the make-whole dispute, they argued that the dispute "has nothing to do with remedies in respect of Common Collateral" and that "[s]imply put, there is no prohibition against questioning the amount of the [senior lien creditors'] claims."

With respect to the claim that they were to receive proceeds of collateral before the first lien obligations were discharged, they argued that "[o]nce the Senior Lien Lenders receive the Replacement Notes, they will have been paid in full as a matter of law," and therefore will not be entitled to any additional payment irrespective of what the intercreditor agreement provides. Additionally, they highlighted that the intercreditor agreement only prohibits a second lien noteholder from receiving proceeds "in the context of its role as secured creditor," arguing that none of the payments or distributions were owed to them in that capacity. With respect to the backstop fee and professional fees, they pointed out that these were being paid to them in their capacity as backstop parties, not as secured creditors. And with respect to the equity distribution, they insisted that they could have "achieved exactly the same result that they achieved here" had they merely been unsecured creditors. Finally, the second lien noteholders argued that their intervention in the make-whole dispute and participation in the bankruptcy case might have been as unsecured creditors, and therefore was permitted under section 5.4 of the intercreditor agreement, which provides that "[n]otwithstanding anything to the contrary in this Agreement," the second lien noteholders "may exercise rights and remedies as an unsecured creditor."

The Court's Decision

After lengthy oral argument, the court announced its decision from the bench, observing at the outset that "[t]he ICA is very clearly an intercreditor agreement pertaining to the parties' collateral rights. That is the overall context of the agreement, and it is in that context that the claims should be evaluated." The court also embraced the position, previously espoused by the court in the *Boston Generating* case, that waivers of a secured creditor's rights under an intercreditor agreement "must be clear beyond peradventure." These two ideas—the collateral-specific nature of the intercreditor arrangements and the principle that waivers of creditors' rights should be construed narrowly—animated the court's views with respect to the bulk of the issues in front of it.

First, the court held that in supporting the debtors' plan and intervening in the make-whole dispute, the second lien noteholders were not interfering with the senior lien creditors' rights in the collateral. In the make-whole dispute, they were disputing the amount of the claims, and by supporting the plan they were merely supporting permissible treatment of the senior lien claims under the cramdown provision of the Bankruptcy Code. Importantly, the court pointed out that the intercreditor agreement at issue did not contain more sweeping provisions, known as "silent second lien" provisions, that would have precluded the second lien noteholders from taking a broad array of actions in the bankruptcy case that do not concern the collateral, such as supporting or objecting to a plan of reorganization. According to the court, by preserving the second lien noteholders' rights as unsecured creditors, the intercreditor agreement precluded a broad construction that would mandate silence on non-collateral related issues.

Second, the court dismissed the senior lien creditors' assertion that the equity distribution, professional fee reimbursement and potential backstop fees were proceeds of collateral and thus subject to turnover. The court rejected with particular force the idea that the equity distribution constituted proceeds of the senior lien creditors' collateral, reasoning that the equity was received in exchange for the second lien noteholders' liens, not for the assets encumbered by those liens. Moreover, the court found that the distribution of equity, rather than diminishing the senior lien creditors' collateral, reduced the amount of debt by which it was encumbered. With respect to the backstop fee, the court reasoned that although the cash may be collateral, the second lien noteholders were not receiving it "in connection with the exercise of any right or remedy relating to Common Collateral," as required to violate the intercreditor agreement. With respect to the professional fees, the court dismissed the claim without prejudice, on the grounds that the complaint was insufficiently specific because it did not make clear on what basis (and therefore in what capacity) the second lien noteholders were receiving these fees. Importantly, although the parties' briefs devoted significant attention to the question of whether the senior lien noteholders had in fact been "paid in full," the court's findings on these points rendered that issue irrelevant, as the court found that the distributions to the second lien noteholders at issue were permitted regardless of whether the senior lien debt had been paid or not.

The majority of the alleged violations of the intercreditor agreement were thus dismissed with prejudice on the basis that the agreement narrowly concerns collateral, and that the second lien noteholders, in their capacity as such, did not receive proceeds of collateral or take any other actions in respect of collateral. With respect to the second lien noteholders' alleged opposition to adequate protection, the court dismissed the claim without prejudice, holding that the claim was not pled with sufficient specificity. However, the court also indicated ambivalence about whether, if pled sufficiently, this opposition was a permissible exercise of the rights of unsecured creditors, giving credence to the second lien noteholders' broad reading of this provision, while acknowledging that their construction could undermine many of the more specific provisions of the agreement.

Implications and Takeaways

This most recent *Momentive* decision highlights important issues for secured creditors with respect to the establishment of priority and other intercreditor rights by agreement. First and foremost, the decision offers a striking example of the limitations of lien subordination and the limited protections it offers to senior lien creditors if intercreditor agreements are not drafted to clearly protect the senior creditors, a circumstance that is frequently dictated by market pressures. Here, lien subordination did not assure a full value recovery by the senior lien creditors, despite the fact that they were oversecured. Lien subordination also did not prevent junior creditors from receiving substantial distributions in respect of their secured claims, including equity, fees and potentially a significant backstop fee, in spite of the fact that the senior lien creditors were not being paid in full in cash or in value. Lien subordination also failed to prevent the junior creditors from mounting a broad attack on the rights of the senior creditors in the bankruptcy case. More broadly, the case is a reminder of the inherent uncertainty and litigation risk that lien subordination carries as to the division of distributable value between collateral and non-collateral value, especially where the lien subordination does not expressly include subordination in respect of distributions on secured claims in bankruptcy, regardless of source or form, even if not from collateral or proceeds of collateral.

The decision also demonstrates that carveouts preserving the rights of subordinated creditors to act as unsecured creditors can be construed broadly to undo more specific senior creditor protections in the rest of the agreement, particularly if not drafted to clearly preserve those protections for senior creditors. Although the court did not rest its decision entirely on this provision, at oral argument Judge Drain noted that preserving the right to act as unsecured creditors might "trump" the more specific prohibitions in the agreement.

Finally, in the wake of the court's cramdown ruling, it is noteworthy that the question of whether the senior lien creditors had in fact been paid in full was not ultimately relevant to the court's decision, given the court's view of the limitations of lien subordination. Although the second lien noteholders argued that the senior claims were "discharged" as a matter of law and therefore were discharged under the intercreditor agreement, the court did not reach that issue. In fact, the court even showed sympathy for the senior lien creditors on this point, noting that the agreement requires "payment in full in cash" and asking: "How much more explicit can you get?" This specificity as to "payment in full" however, was not relevant because of the court's view of the narrowness of the lien subordination agreement, ultimately allowing significant distributions to and aggressive actions by the junior lien creditors.

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