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Poor Foresight on an Intercreditor Agreement Waterfall Provision

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The United States Court of Appeals for the Third Circuit issued an opinion in *Delaware Trust Company v. Morgan Stanley Capital Group, Inc., Wilmington Trust, N.A. (In re Energy Future Holdings Corp.)* on June 19, 2019, in which it addressed distributions of assets pursuant to the waterfall provision of an intercreditor agreement in a chapter 11 reorganization. In a critical-to-Delaware but nonprecedential case, the Court held that the intercreditor agreement between two groups of noteholders on the same collateral did not apply to distributions under the reorganization plan, turning on the specific language of the waterfall provision within the intercreditor agreement.

The opinion involved two creditors: one group with debt from 2007 ("2007 Creditors") and another with debt from 2011 ("2011 Creditors"). The 2007 Creditors' debt carried a lower interest rate than that of the 2011 Creditors. Both Creditors are of equal priority and secured by identical collateral, which consists of nearly all the debtor's assets.

The intercreditor agreement between the Creditors provides a waterfall provision which states that if the debtor defaults, and if the Creditors must collect on collateral or liquidate it, the waterfall provision is triggered. Due to the varied interest rates, the 2011 Creditors stand to collect a substantial windfall over the 2007 Creditors of approximately $90 million upon a distribution pursuant to the waterfall provision.

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The waterfall provision strictly applies to "(1) Collateral or (2) proceeds thereof received in connection with the sale or disposition of Collateral upon the exercise of **remedies by the Collateral Agent**." That provision proved to be dispositive to the allocation of assets to these Creditors.

During the pendency of the bankruptcy, the debtor made adequate protection payments to these Creditors. Two years into bankruptcy, a plan was confirmed which called for corporate restructuring during which both the 2007 Creditors and 2011 Creditors would give up all claims to the Collateral. In exchange, the Creditors received cash, stock, and tax benefits (the "Distributions"). The Creditors sued to determine how the adequate protection and Distributions would be fairly distributed pursuant to the intercreditor agreement.

The bankruptcy court found, and the Third Circuit affirmed, that the waterfall provision's language did not apply to adequate protection payments or Distributions because they do **not** qualify as Collateral. The court reasoned that payment of Collateral necessarily reduces the amount of money owed. Adequate protection payments were for the use of Collateral but did not reduce debt and are therefore not payments of Collateral.

Likewise, the Distributions were not made from assets upon which the Creditors held liens but instead were derived from assets created by the plan on which the Creditors held no liens. Section 552(a) provides that assets acquired after bankruptcy generally are not "subject to any lien resulting from" a prior agreement. 11 U.S.C. § 552(a).

The bankruptcy court went further and stated that, even if adequate protection payments and Distributions may have otherwise applied to the waterfall provision, neither constituted proceeds received in connection with both the sale or disposition of Collateral **and** upon the exercise of remedies **by the Collateral Agent** as required.

The adequate protection payments and Distributions were part of the restructuring plan voted upon by both Creditors and approved by the bankruptcy court. The restructuring was not a remedy implemented **by the Collateral Agent** pursuant to and as contemplated by the underlying loan agreements.

Therefore, the waterfall provision does not apply, and each Creditor is entitled to adequate protection payments and Distributions based on what was owed at the time of bankruptcy. In other words, the 2011 Creditors will not benefit from the increased interest rate.

While nonprecedential, the result is that, in Delaware, distributions under a plan may not constitute distributions of collateral. Practitioners would be well advised to tailor intercreditor agreements to be sufficiently precise to receive distributions as intended.

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