

DE Bankruptcy Court Enforces 'X-Clause'

Clause Enforced in Subordinated Note Indenture over Objections of Subordinated Noteholders

By Daniel J. DeFranceschi

Recently, in *Kurak v. Dura Automotive Sys., Inc.*, the United States Bankruptcy Court for the District of Delaware enforced subordination provisions against certain out-of-the-money subordinated noteholders. The latter had asserted that the so-called "x-clause" in the indenture provided them with a right to recovery under the plan of reorganization despite the fact that the senior noteholders would not be paid in full. The decision is significant for several reasons, including the fact that its holding is consistent with other cases that have considered different x-clauses, and that its pragmatic result recognized the significance to the commercial markets of

enforcing these kinds of subordination provisions. The discussion that follows covers the specific ruling in *Dura*, as well as describing the way practitioners should expect courts to decide issues concerning x-clauses in general in subordination agreements.

SUBORDINATION AGREEMENTS

Before addressing the specific facts of the *Dura* case, it is helpful to consider the basic promise of a subordination agreement. In a typical debt offering, a subordination agreement will establish the priority of repayment between two or more otherwise equal groups of unsecured creditors. Thus, in a notes offering, the subordination agreement will provide that the senior noteholders will be repaid on their notes prior to the subordinated noteholders being paid. Typically, the economics and pricing of the senior and subordinated debt will reflect the greater risk of nonpayment facing the subordinated debt by higher interest rates than those applied to the senior debt. Section 510(a) of the Bankruptcy Code provides that subordination agreements such as the one at issue in *Dura* are "enforceable under applicable nonbankruptcy law." 11 U.S.C. § 510(a).

In many subordinated notes indentures, the subordination provisions contain an exception to the basic subordination promise that may apply in

certain narrowly specified circumstances. These exceptions, which have come to be known as the "x-clause," come in many varieties, and there is a long history to the development of the various permutations. In general, these x-clauses serve a very distinct purpose. The most often cited general discussion on the x-clause was offered by Judge Posner:

X-Clause[s] ... are common in bond debentures, although there is no standard wording. Without the clause, the subordination agreement that it qualifies would require the junior creditors to turn over to the senior creditors any securities that they had received as a distribution in the reorganization, unless the senior creditors had been paid in full. Then, presumably, if the senior creditors obtained full payment by liquidating some of the securities that had been turned over, the remaining securities would be turned back over to the junior creditors. The X-Clause shortcuts this cumbersome procedure and enhances the marketability of securities received by the junior creditors, since their right to possess (as distinct from pocket the proceeds of) securities is uninterrupted.

In re Envirodyne Indus., Inc., 29 F.3d 301, 306 (7th Cir. 1994), aff'g 1993 U.S. Dist. LEXIS 21201 (N.D. Ill. Dec.

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28, 1993).

Each case that has considered the x-clause issue since *Envirodyne* has ruled the same way, based on the same rationale. See *In re PWS Hldgs. Corp.*, 228 F.3d 224 (3d Cir. 2000)(Becker, J.), *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136 (2d Cir. 2005), *In re Envirodyne Indus., Inc.*, 161 B.R. 440 (Bankr. N.D. Ill. 1993), and *In re Adelphia Communications*, Case No. 02-41729 (Bankr. S.D.N.Y. April 6, 2006) (Gerber, J.). See also Edward Everett, Analysis of Particular Subordination Provisions, 23 *Bus.Law.* 41, 44 (1967).

THE CASE

With this basic backdrop, in *Kurak v. Dura Automotive Sys., Inc.*, the Delaware Bankruptcy Court issued its opinion granting the defendant/debtors' motion for summary judgment and holding, *inter alia*, that the x-clause at issue did not relieve the subordinated note holders of their basic contractual promise to subordinate their right to payment or distribution from the debtors until after the debtors' senior note holders were paid in full. The basic subordination clause in the *Dura* case provided:

[t]he Company agrees, and each [Subordinated] Holder by accepting a Note agrees, that the Indebtedness evidenced by the Notes is subordinated in right of payment, to the extent and in the manner provided in this Article 10, to the prior payment in full of all Senior Debt of the Company, including Senior Debt incurred after the date of this Indenture, and that the subordination is for the benefit of the holders of Senior Debt.

The Subordinated Notes Indentures in *Dura* also provided for the payment in full to Senior Debt in a Chapter 11 bankruptcy case. The following lan-

guage defines that right, as well as the x-clause language in issue (which language is italicized in the following quote):

[u]pon any distribution to creditors of the Company in ... a bankruptcy, reorganization ... or similar proceeding relating to the Company or its property ...

holders of Senior Debt shall be entitled to receive payment in full of all Obligations due in respect of such Senior Debt (including interest after the commencement of any such proceeding at the rate specified in the applicable Senior Debt) before Holders of the Notes shall be entitled to receive any payment with respect to the Notes (*except that Holders may receive (i) Permitted Junior Securities ...*; and

until all Obligations with respect to Senior Debt (as provided in subsection (i) above) are paid in full, any distribution to which Holders would be entitled but for this Article 10 shall be made to the holders of Senior Debt (*except that Holders of Notes may receive (i) Permitted Junior Securities ...*

The Subordinated Notes Indentures define "Permitted Junior Securities" to mean:

- i) Equity Interests in the Company ... or
- ii) debt securities that are subordinated to all Senior Debt and any debt securities issued in exchange for Senior Debt to substantially the same extent as, or to a greater extent than, the Notes and Guaranties are subordinated to Senior Debt under this Indenture.

Furthermore, the Subordinated Notes Indentures provide that:

[a]fter all Senior Debt is paid in full and until the Notes are paid in full, Holders of Notes shall be subrogated (equally and ratably with all

other Indebtedness *pari passu* with the Notes) to the rights of holders of Senior Debt to receive distributions applicable to Senior Debt to the extent that distributions otherwise payable to the Holders of Notes have been applied to the payment of Senior Debt. A distribution made under this Article 10 to holders of Senior Debt that otherwise would have been made to Holders of Notes is not, as between the Company and the Holders, a payment by the Company on the Notes.

The court's opinion was issued in an adversary proceeding brought by certain of the debtors' subordinated note holders (the "Subordinated Holders"). The Subordinated Holders' complaint sought, *inter alia*, a declaratory judgment that: 1) the x-clause did not subordinate their right to receive payment or distribution from the debtors under a proposed plan which provided distributions through an equity-rights offering; and 2) in any event, the debtors' proposed plan unfairly discriminated against the Subordinated Holders under Section 1129 of the Bankruptcy Code because it transferred the benefit of the Subordinated Holders' distribution and other rights to the senior note holders (the "Senior Holders"). According to the Subordinated Holders, the x-clause at issue excepted "Permitted Junior Securities" (as defined in the subordinated note indenture) from their subordination promise even where the Senior Holders were not paid in full, and the debtors' proposed equity offering constituted the distribution of "Permitted Junior Securities." The debtors (and the intervening Senior Holders) sought to dismiss the complaint the grounds, *inter alia*, that the x-clause did not affect the basic subordination promise inherent in the subordinated note indenture and required subordination because the Senior Holders

were not being paid in full under the debtors' proposed plan.

THE OPINION'S SIGNIFICANCE

The court's opinion is notable for several reasons. First, while observing that the x-clause lacked "utter clarity," the court nevertheless agreed with the parties that the x-clause was not ambiguous. The court also agreed with the debtors (and other courts that have considered x-clauses) that the court may consider other sources, such as the model indenture provisions and commentaries, when construing the subordination provisions and the x-clause.

Second, the court found that applicable New York law required it to consider the x-clause within the overall purpose of the indenture and not in isolation. In the court's words, the x-clause "must be read in context" and, as such, the court rejected an analysis (proffered by the Subordinated Holders) that focused on "grammatical structure alone." Further, the court accepted the proposition that an x-clause is intended to create only a limited exception to the basic subordination promise and must be construed narrowly.

Third, according to the court, the subordinated note indenture as a whole supported the conclusion that the Subordinated Holders were not expected to receive any payment or distribution from the debtors: 1) until the Senior Holders were paid in full; or 2) unless the Senior Holders consented to such distribution. As such, the Court rejected the Subordinated Holders' grammar-based argument that the debtors' anticipated equity-rights offering constituted "Permitted Junior Securities," because the Subordinated Holders' argument would "eviscerate the purpose of the subordination provisions" in the subordinated note indenture. Indeed, the court noted that

the Subordinated Holders' argument defied "explanation and logic" because a "senior creditor simply would not agree to a subordination agreement in which its priority depended upon the form of consideration chosen by the debtor."

Fourth, although the court did not reach the Subordinated Holders' Section 1129 arguments, the court also noted that generally a plan which proposes disparate treatment of creditors with the same priority level "based upon subordination rights is viewed as fair."

Fifth, the court did agree with the Subordinated Holders' proposition that "each x-clause is different and must be considered only in the specific context of the applicable contract." Accordingly, while the court's opinion provides persuasive authority for the meaning, purpose and interpretation of an x-clause, it also suggests that other courts may analyze the provisions of an x-clause on their own terms.

Sixth, the court's opinion is important as it decided the issue consistent with the expectations of the credit markets, thus providing greater comfort to financial institutions investing in both senior and subordinated debt. Although there are many permutations of the x-clause found in commercial agreements and indentures, each of the courts that have considered efforts by subordinated notes holder to broaden the exception to the basic subordination promise have held consistently with the credit market's expectation that subordination promises are enforceable, and that the exception to it found in the x-clause will be read narrowly to effect its limited purposes. Following an approach that is consistent with the expectations of the credit markets is particularly important these days given the current general distress found in the credit markets.

CONCLUSION

The *Dura* case should provide necessary caution to those parties who trade in distressed debt. The terms of these types of instruments must be closely scrutinized before making an investment, as the provisions of these agreements require considerable analysis. If an investor, upon fully considering the ramifications of subordination and the narrow scope of an x-clause decides nonetheless to make the investment, it is particularly critical that an solid valuation of the debtor be performed. In the *Dura* case, under the plan of reorganization that was at issue, the subordinated noteholders were completely out of the money and would receive no recovery on their investment. Given that each case that has considered the x-clause has ruled similarly to the *Dura* decision, great caution is advised before investing in distressed subordinated debt, and reliance on a x-clause to provide a means for recovery must be carefully considered both in light of its specific terms and the value placed on the debtor.

