Intercreditor Issues and Relative Priorities among Creditors

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Rules of Thumb for Intercreditor Agreements

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Intercreditor agreements set out the relative rights and remedies of creditors extending financing to a common borrower. Some agreements coordinate the collection efforts of a syndicate of lenders with equal priority. These "syndication agreements" will appoint an agent with exclusive power to enforce the creditors' rights against the borrower and allow a majority of creditors to direct the agent's debt collection decisions. The legal issues emerging from syndication agreements have been addressed in previous King-Seligson Workshops (an example is attached).[1]

Here I focus on issues emerging from intercreditor agreements that establish payment priorities, particularly among secured creditors. These agreements commonly go far beyond simply subordinating the repayment rights of subordinated creditors. These creditors commonly give up collection rights. For example, the agreement may impose a standstill period during which only senior creditors may exercise remedies against a defaulting borrower. It may also allow senior creditors to release the subordinated creditors' lien during a foreclosure sale. More controversially, an intercreditor agreement may waive or reassign rights that subordinated creditors would ordinarily possess in the event of the borrower's bankruptcy filing. These creditors may waive their rights to object to DIP financing provided by senior creditors, to object to the sale or use of collateral, to seek adequate protection, or to file a plan of reorganization. An intercreditor agreement may even authorize senior creditors to vote the claims of subordinated creditors.

These agreements are reordering the Code's bargaining environment. Courts have been unsure whether to go along. The caselaw reveals conflicting views on intercreditor agreements, with some courts willing to enforce agreements that waive or assign bankruptcy rights,

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[1] *See* Edward R. Morrison, "Collective Action Clauses," 2010 King/Seligson Workshop on Bankruptcy and Business Reorganization.

others less sure, and still others deeply skeptical of these agreements. Courts have good reason to be cautious about enforcing waivers and assignments of bankruptcy rights. Agreements with these provisions present a tradeoff. The upside is that they mitigate intercreditor conflict, thereby reducing costs of restructuring and reorganization (and reducing the debtor's cost of capital *ex ante*). The downside is that these agreements give senior creditors influence over the reorganization process that exceeds their economic stake in the outcomes of the process. They can vote the claims of both senior and subordinated claims, for example, even though they have an economic stake only in the senior claims. When senior creditors have influence that exceeds their economic stake, courts should worry that seniors may use that influence in ways that are harmful to creditors who were not party to the intercreditor agreement. Seniors, for example, may strategically block an efficient plan of reorganization in an attempt to extract a higher recovery.

Because waivers and assignments of bankruptcy rights present a tradeoff, the challenge for courts is to enforce them when benefits outweigh costs. It is therefore unsurprising to see mixed outcomes in the caselaw: The cost-benefit tradeoff will vary by case. But balancing costs and benefits is very hard because it requires information—and time to study it—that may not be available to judges. Rules of thumb would be helpful here. In the paragraphs that follow, I discuss the caselaw, the tradeoff facing the courts, and potential rules of thumb.

Judicial Impulses

Looking across the cases, we see different impulses when judges face intercreditor agreements that waive or assign bankruptcy rights. One impulse is to ignore provisions that reorder the bargaining environment, leaving aggrieved senior creditors to seek breach-of-contract damages in state court actions. This impulse seems to derive from an intuition that Congress carefully designed a bankruptcy process with many checks and balances, such as the right of any party in interest to object to DIP financing motions, the best interests test, class-based voting rules, voting rules that combine majority and super-majority thresholds, and the absolute priority rule. An intercreditor agreement that bargains around these checks and balances may be sensible to the parties signing the agreement, but harmful to non-signatories because it eliminates resistance (by subordinated creditors) and prevents coalition-building (between subordinated creditors and non-signatories).

This impulse can seen in an early case addressing intercreditor agreements under the 1978 Code, *In re Hart Ski Manufacturing Co*.[2] There the intercreditor agreement governed the rights of creditors with liens on the same collateral. The court refused to enforce the agreement to the extent that it waived the subordinated creditors' right to seek adequate protection or file a lift-stay motion. Enforcing such a waiver would be "totally inequitable":

> The intent of § 510(a) (subordination) is to allow the consensual and contractual priority of payment to be maintained between creditors among themselves in a bankruptcy proceeding. There is no indication that Congress intended to allow creditors to alter, by a subordination agreement, the bankruptcy laws unrelated to distribution of assets.
>
> The Bankruptcy Code guarantees each secured creditor certain rights, regardless of subordination. These rights include the right to assert and prove its claim, the right to seek Court ordered protection for its security, the right to have a stay lifted under proper circumstances, the right to participate in the voting for confirmation or rejection of any plan of reorganization, the right to object to confirmation, and the right to file a plan where applicable. The above rights and others not related to contract priority of distribution pursuant to Section 510(a) cannot be affected by the actions of the parties prior to the commencement of a bankruptcy case when such rights did not even exist.[3]

Similar intuition was expressed in *In re 203 N. LaSalle Street Partnership*,[4] on remand from the Supreme Court. There the agreement gave the senior lender the right to cast votes on behalf of the subordinate

[2] 5 B.R. 734 (Bankr. D. Minn. 1980).

[3] *Id.* at 736.

[4] 246 B.R. 325 (Bankr. N.D. Ill. 2000).

lender.[5] The court refused to enforce the vote-reassignment, emphasizing that the reassignment would destabilize the bargaining environment of the Code:

> [S]ince bankruptcy is designed to produce a system of reorganization and distribution different from what would obtain under nonbankruptcy law, it would defeat the purpose of the Code to allow parties to provide by contract that the provisions of the Code should not apply. …
>
> Subordination affects only the priority of payment, not the right to payment. If the assets in a given estate are sufficient, a subordinated claim certainly has the potential for receiving a distribution, and Congress may well have determined to protect that potential by allowing the subordinated claim to be voted. This result assures that the holder of a subordinated claim has a potential role in the negotiation and confirmation of a plan, a role that would be eliminated by enforcing contractual transfer of Chapter 11 voting rights.[6]

The impulse—to be deeply skeptical of efforts to contract around the Code's bargaining environment—continues to influence bankruptcy courts.[7]

A very different impulse is to enforce intercreditor agreements in the same way that a court enforces any other agreement. Absent a prohibition in nonbankruptcy law or the Code, these agreements are fully enforceable in bankruptcy thanks to Section 510(a), which explicitly honors subordination agreements in bankruptcy. A good il-

[5] The agreement stated that the "[Subordinate Lender] hereby irrevocably agrees that the [Senior Lender] may, at its sole discretion, in the name of [Subordinate Lender] or otherwise, … file, prove, and vote or consent in any [bankruptcy] proceedings with respect to, any and all claims of [Subordinate Lender] relating to the [Subordinate Lender's claims]." *Id*. at 328.

[6] *Id*. at 331-32.

[7] *See, e.g.*, *In re Croatan Surf Club*, 2011 WL 5909199 (Bankr. E.D. N.C. 2011) (refusing to enforce a vote-reassignment provision, citing *In re Hart Ski Mfg. Co.* and *In re 203 N. LaSalle Partnership*); *In re SW Boston Hotel Venture*, 460 B.R. 38 (Bankr. D. Mass. 2011) (same), *vacated in part on other grounds by In re SW Boston Hotel Venture, LLC,* 2012 WL 4513869 (B.A.P. 1st Cir. 2012).

lustration comes from *In re Aerosol Packaging, LLC*.[8] The court allowed senior creditors to vote the claims of subordinated creditors:

> Section 1126(a) grants a right to vote to a holder of a claim, but does not expressly or implicitly prevent that right from being delegated or bargained away by such holder. Section 510(a) renders a subordination agreement enforceable to the extent enforceable under applicable nonbankruptcy law. The Subordination Agreement appears to be enforceable under Georgia law, which is the applicable nonbankruptcy law. Federal Rules of Bankruptcy Procedure 3018 and 9010 explicitly permit agents and other representatives to take actions, including voting, on behalf of parties.[9]

Several other cases have applied similar logic.[10]

Another line of cases takes the middle road. These cases don't involve voting rights. They deal with intercreditor agreements that force the subordinate creditors to remain silent during the Chapter 11 case. Courts have enforced these agreements to bar subordinated from seeking appointment of an examiner,[11] objecting to use of cash collateral,[12] and objecting to a reorganization plan.[13] Initially, these cases look a lot like the previous decisions allowing senior creditors

[8] 362 B.R. 43 (Bankr. N.D. Ga. 2006).

[9] *Id.* at 47.

[10] *See, e.g., In re Coastal Broadcasting Systems, Inc.*, 2013 WL 3285936 (D. N.J. 2013); *In re Curtis Center Ltd. Partnership*, 192 B.R. 648 (Bankr. E.D. Pa. 1996).

[11] *See In re Erickson Retirement Communities, LLC*, 425 B.R. 309, 316 (Bankr. N.D. Tex. 2010) ("The Michigan Retirement System Entities are sophisticated commercial entities who knowingly waived all legal and statutory rights that would be in conflict with their obligation to 'standstill' until [senior lender debt] is paid in full.").

[12] *See Aurelius Capital Master, Ltd. v. TOUSA Inc.*, 2009 WL 6453077 at *8 (S.D. Fla. 2009).

[13] *See In re Ion Media Networks, Inc.*, 419 B.R. 585, 597 (Bankr. S.D.N.Y. 2009) ("The Transaction Documents make clear that [the subordinate lender], by purchasing second lien debt that was expressly subject to the Intercreditor Agreement, agreed to remain silent in the event of a Chapter 11 case.").

to vote the claims of subordinate creditors. The courts begin with familiar analysis: These intercreditor agreements are unambiguous, enforceable under non-bankruptcy law, enforceable in bankruptcy thanks to Section 510(a), and not at odds with any provision of the Code. Why should a court "disturb the bargained-for rights" of senior lenders pursuant to a "plainly worded contract[] establishing priorities and limiting obstructionist, destabilizing and wasteful behavior" by subordinated creditors?[14]

But the courts don't stop there. They have gone on to consider the merits of the motions or objections raised by subordinated creditors. In *In re Erickson Retirement Communities, LLC*, the court found that subordinated creditors had bargained away the right to seek appointment of an examiner, but nonetheless went on to consider the bona fides of the motion.[15] We see the same move in *In re Ion Media Networks, Inc.* There the court held that the intercreditor agreement barred subordinate creditors from objecting to the reorganization plan. It then held that, even if the subordinate creditors had standing to object, their objections lacked merit.[16]

Thus, while these cases purport to enforce the intercreditor agreement, they give subordinate creditors precisely what they bargained away—the opportunity to object. To be sure, senior creditors retain the right to sue subordinated creditors for breach-of-contract damages. Measuring those damages is difficult. In *Ion Media Networks*, the court suggested that senior creditors could at least recover the increase in administrative costs attributable to the objections filed by subordinate creditors.[17] But demonstrating a causal connection between administrative costs and these objections will be hard, especially in a case like *Ion Media Networks*. When it considered the merits of the objections in that case, the court explained that it had an "in-

[14] *In re Ion Media*, 419 B.R. at 595.

[15] *In re Erickson Retirement Communities,* 425 B.R. at 316-17.

[16] *In re Ion Media Networks,* 419 B.R. at 598-603. See also *Aurelius Capital Master,* 2009 WL 6453077 (first finding that the subordinate creditors lacked standing to object to the use of cash collateral, but holding that that objection was equitably moot, non-justiciable, and lacked merit).

[17] *In re Ion Media Networks,* 419 B.R. at 590 n. 4.

dependent obligation to review the Plan to make sure that it satisfies the standards for plan confirmation set forth in section 1129."[18] How, then, should we characterize the administrative costs associated with flyspecking the plan? Are they attributable to the subordinate creditors' violation of the intercreditor agreement, or do they arise from the court's independent duty to review the plan?

But the more important question is whether courts should ever enforce intercreditor agreements that waive or assign bankruptcy rights. We see different impulses in the caselaw, but the principles guiding these impulses are unclear. What harm arises when the parties write contracts that vary the Code's bargaining environment? Is the harm greater in some contexts than others?

A Tradeoff

It may be helpful to focus on a tradeoff presented by intercreditor agreements. These agreements reduce decisionmaking costs in the event of default, but also give senior lenders power to exploit subordinated creditors and potentially other investors in the firm.[19] They reduce decisionmaking costs by preventing subordinate creditors from objecting to proposals or otherwise increasing administrative costs, and by giving senior lenders power to act on the subordinate creditors' behalf. These effects on decisionmaking (or administrative) costs are important to the courts. In *In re Ion Media Networks*, for example, the court highlighted the "public policy" served by enforcing waivers of bankruptcy rights in these agreements: "Affirming the legal efficacy of unambiguous intercreditor agreements leads to more predictable and efficient commercial outcomes and minimizes the

[18] *Id*. at 598.

[19] This tradeoff is presented by all decisionmaking rules, including majority rule, as Buchanan and Tullock emphasized. Majority rule reduces decisionmaking costs (relative to unanimous rule), but exposes the losing minority to exploitation. *See* James M. Buchanan and Gordon Tullock, *The Calculus of Consent: Logical Foundations of Constitutional Democracy* ch. 8 (Univ. Michigan Press 1958).

potential for wasteful and vexatious litigation."[20] The caselaw is littered with examples of such "vexatious litigation."[21]

But intercreditor agreements expose other creditors to exploitation because senior creditors can use their control over the subordinated claims to block efficient plans of reorganization, silence potentially important resistance to the sale or use of collateral, and prevent coalition building between subordinated and other creditors. Because senior creditors control the bankruptcy rights of subordinated claims, but do not own those claims, they are undeterred from using those rights to destroy value for those claims and other investors. That's not worrisome if the only parties suffering harm are the subordinated claims who bargained away their rights to object, presumably for compensation. But it is worrisome if the harm extends to other investors—creditors and equityholders—who were not party to the intercreditor agreement.

By silencing subordinated creditors, an intercreditor agreement can eliminate the most important resistance to collateral sales or financing motions, particularly first-day motions. Subordinated creditors may have superior information to general unsecured creditors because they have security interests in the debtor's collateral and therefore more closely monitored the debtor's condition prior to bankruptcy. If junior creditors become "silent second liens," they will not object to case developments that benefit senior lenders at the expense of all other creditors.

The intercreditor agreement may also allow senior creditors to exercise "hold up" power. Any creditor can threaten to hold up the bankruptcy process—by filing objections, demanding valuations, seeking appointment of trustees or examiners—in order to extract

[20] *In re Ion Media Networks,* 419 B.R. at 595. *See also In re Erickson Retirement Communities,* 425 B.R. at 315 ("This is the very type of obstructionist behavior that the agreements are intended to suppress.").

[21] *See, e.g., In re Adelphia Communications, Corp.*, 359 B.R. 54, 63 (Bankr. S.D.N.Y. 2006) ("[A] culture has developed in large chapter 11 cases in which many consider it acceptable, and indeed expected, to use the litigation process as a means to assert or follow through on threats, and to seek various kinds of relief, to secure 'leverage' in efforts to increase recoveries.").

better treatment (or a bribe). But the threat is not credible in many cases, because the threatened action may harm the creditor as much (or more) than it harms others. Think of the unsecured creditor who wants a higher recovery and threatens to file numerous objections that will slow the case and burn firm value. Filing objections is costly, and any burn in firm value will cause greatest harm to junior creditors. The unsecured creditor's threat will be credible, then, only when the threatened action will disproportionately harm other creditors who are expected to receive recoveries through the reorganization process. When the threat is credible, these creditors might be willing to pay the unsecured creditor to settle the objections.

Senior creditors can make credible threats when they control the bankruptcy rights of subordinated creditors. They can vote these claims, or prevent these creditors from filing objections, even if doing so reduces recoveries for these and all other junior creditors. Actions that would be irrational for a subordinated creditor will be rational for a senior creditor that controls but has no economic stake in the subordinated creditor's claims.

In re SW Boston Hotel Venture, LLC,[22] offers an illustration. The debtor's proposed plan had been accepted by all classes except the bank, which held a secured claim and filed many objections to cramdown. The bank was party to an intercreditor agreement that gave it power to vote the claims of subordinated secured creditors. Although these creditors had submitted their own vote in favor of the plan, the senior creditors sought to override their vote and vote their claims against the plan. The only effect of doing this was to raise the cost of cramming down a plan that had been accepted by all other classes, including several impaired classes, and that offered full repayment of the bank's claim. Although the bank disputed the interest rate, the subordination agreement allowed it to recover any deficiency from the subordinated creditors, who were also being paid in full. Here, then, it appears that the senior creditors attempted to use the intercreditor agreement to hold-up the reorganization process.

[22] 460 B.R. 38 (Bankr. D. Mass. 2011), *vacated in part on other grounds by In re SW Boston Hotel Venture, LLC,* 2012 WL 4513869 (B.A.P. 1st Cir. 2012).

The risk of exploitation by senior creditors is very similar to the risks associated with "empty voting,"[23] which occurs when investors acquire influence in a bankruptcy case—voting rights, standing to file objections—without owning claims or interests. They can do this through the use of financial derivatives. An investor, for example, can simultaneously purchase and short-sell a debtor's shares or notes. Although it formally owns shares (or notes), and therefore has voice in the bankruptcy process, the creditor has no meaningful economic interest in those shares. It has fully hedged its exposure to ups and downs in share price: If the price rises, the creditor owns a more valuable stock, but also has a more costly liability (the short). The two offset.[24] Empty voting occurs when an investor votes or otherwise influences the bankruptcy case, but does not fully bear the costs or benefits of its influence. The investor can adversely affect the bankruptcy process by fostering inefficient plans or blocking efficient ones.[25]

The downside of intercreditor agreements (and empty voting) is that they potentially allow an investor to harm other creditors and the estate in an effort to increase its own payoffs. Intercreditor agreements, in other words, foster a dictatorship by senior lenders. But a democracy may be no better. The upside of intercreditor agreements is that they constrain the ability of junior lenders to increase the cost of reorganization.

Hence the tradeoff. The court's job is to strike the right balance between minimizing decision costs and avoiding senior creditor exploitation.

[23] *See generally* Henry T. C. Hu and Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. Penn. L. Rev. 625 (2008).

[24] Examples from recent cases are collected by Jonathan Lipson, *The Shadow Bankruptcy System*, 89 B.U. L. Rev. 1609, 1649-1650 (2009).

[25] To be sure, empty voting may be substantially more worrisome than vote-assignment provisions because empty voting is much less detectible. Intercreditor agreements can be read by all parties. It may be impossible to know whether a creditor has fully hedged its exposure to a particular claim. Due to this lack of transparency, empty voting can make it much harder for parties to negotiate in bankruptcy.

Balancing the Tradeoff?

Because intercreditor agreements present a tradeoff, neither extreme—always enforce or never enforce—is sensible. An ideal court would enforce waivers or assignments of bankruptcy rights when benefits outweigh costs, but an ideal court has complete information and the time and expertise to process it instantaneously. In a world without ideal courts, rules of thumb probably make sense.

One potential rule of thumb is to enforce waivers or assignments of bankruptcy rights when enforcement is unlikely to affect the outcome of the Chapter 11 process (sale versus reorganization, or confirmation of one plan versus another) and primarily to affect the distributions of parties to the agreement. *In re Aerosol Packaging, LLC*,[26] offers an illustration. There the debtor proposed a plan that offered alternate treatment to certain subordinated secured creditors. They could accept the proposed distribution without a judicial valuation of the collateral, or they could demand a valuation. The subordinated creditors voted for a valuation. But the senior creditors overrode that vote by exercising their rights under the intercreditor agreement to vote the claims of subordinated creditors. The seniors voted those subordinated claims in favor of the plan, eliminating the need for a valuation. The court permitted seniors to do this. Here was a context in which the same reorganization plan would have been confirmed regardless of the vote-assignment provision. The only effect of enforcing the intercreditor agreement was to avoid a costly valuation dispute that would have affected the payoffs to subordinated creditors relative to senior creditors. As the court noted, the subordinated creditor was "not without a remedy": it could "free itself from the ongoing effect of the Subordination Agreement by paying the [senior creditor] claim in full in cash."[27]

Another potential rule of thumb is to ignore waivers or assignments of bankruptcy rights when the senior creditors can obtain an adequate remedy in litigation against the breaching subordinate creditors. When subordinate creditors have violated the agreement by filing motions or objections, senior creditors can recover the in-

[26] 362 B.R. 43 (Bankr. N.D. Ga. 2006).

[27] *Id*. at 47.

crease in administrative costs, as suggested in *In re Ion Media Networks*. To be sure, agitation by the subordinate creditors might also affect the outcome of the Chapter 11 process and cause harm above and beyond higher administrative costs. For example, a court might void the senior creditor's liens as a result of challenges raised by the subordinate creditors. It may be difficult to compute the harm suffered by senior creditors in cases like this, because the court needs to compute the recoveries the senior creditors would have obtained in the counterfactual world where subordinate creditors respected the intercreditor agreement. But in cases where the subordinate creditors actually change the course of the Chapter 11 process, it's not clear that a bankruptcy court should care whether senior creditors can prove their losses in state court proceedings. If subordinate creditor agitation convinces the court that it should change the course of the Chapter 11 process, the subordinate creditor has benefited the estate.

A senior creditor is least likely to obtain an adequate remedy in state-court litigation when the bankruptcy court prevents senior creditors from voting subordinate creditor claims. When subordinate creditors are allowed to vote, they change the course of the Chapter 11 process. But they do so without convincing a judge that changing course is sensible. The estate may be harmed by allowing subordinate creditors to vote. This suggests that courts should be particularly reluctant to ignore agreements that allocate voting rights.

Perhaps another rule of thumb is to enforce intercreditor agreements when the senior creditor has a security interest in virtually all of the debtor's assets, and its claims are undersecured. In this context, it is highly unlikely that value can be distributed to any class of creditors below the subordinated creditors. Thus, the Chapter 11 boils down to a fight between the senior and subordinated creditors, who are already party to an intercreditor agreement.

Similar logic would imply that intercreditor agreements should be enforced whenever the bankruptcy case is primarily a battle between senior and subordinated creditors. That may have been the case in *In re 203 N. LaSalle Partnership*.[28] The debtor's creditors included a bank with a non-recourse mortgage ($93 million), insiders with a

[28] 246 B.R. 325 (Bankr. N.D. Ill. 2000).

non-recourse mortgage ($11.3 million), priority tax claims ($2.3 million), and a small amount of unsecured debt (amounting to $90,000).[29] If a judge were satisfied that, regardless of the outcome of the Chapter 11 case, priority tax and unsecured claims would be paid in full, this is just a fight between senior and subordinated creditors. The intercreditor agreement should be enforced because it harms no creditors who weren't party to the agreement.

But what should a court do when rules of thumb are unhelpful? One defensible approach is to ignore waivers and assignments of bankruptcy rights. The Code already implements a complex, if not Byzantine, process for balancing decisionmaking costs against exploitation risks. Intercreditor agreements could (and probably often do) improve on this balance, but they do so without the knowledge or consent of creditors who have not entered the agreement. A primary virtue of the Code's balancing is that it applies to and is expected by all parties.

[29] These numbers are reported in *Bank of America Natl. Trust & Savings Ass'n v. 203 N. LaSalle Street Partnership*, 526 U.S. 434 (1999).

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Collective Action Clauses

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2010 King/Seligson Workshop on Bankruptcy and Business Reorganization

2

What are collective action clauses?

- Syndicated loan agreements commonly designate an Agent to administer the loan on behalf of participating lenders.
  - "Each of the Lenders hereby irrevocably appoints the Administrative Agent as its agent and authorizes the Administrative Agent to take such actions on its behalf and to exercise such powers as are delegated to the Administrative Agent by the terms hereof, together with such actions and powers as are reasonably incidental thereto." (McGraw-Hill Cos., 8-K, Ex-10, 8/10/10)
- **Unanimous** lender approval is generally required for any amendment to the agreement that would change core terms of the loan, such as duration, interest rate, and principal balance.
  - "Neither this Agreement nor any provision hereof may be waived, amended or modified except pursuant to an agreement … in writing entered into by the Borrower and the Required Lenders; provided that no such agreement shall … reduce or forgive the principal amount … or reduce the rate of interest thereon, or reduce or forgive any interest or fees payable hereunder, without the written consent of each Lender directly affected thereby …" (Lifetime Brands, 8-K, Ex-99, 6/15/10)
- **Majority** approval—simple- or super-majority—is generally sufficient to direct the Agent's response to events of default, such as acceleration, forbearance, and release of collateral.
  - "Upon the occurrence and during the continuance of an Event of Default, the Administrative Agent may, and at the request of the Required Lenders shall, exercise any rights and remedies provided to the Administrative Agent under the Loan Documents or at law or equity, including all remedies provided under the UCC." (Kaiser Aluminum, 8-K, Ex-10, 3/24/10)
  - "To the extent the Required Lenders waive the provisions of this Section 9.02 with respect to the sale or other disposition of any Collateral, … such Collateral … shall be sold or otherwise disposed of free and clear of the Liens created by the Security Documents and the Administrative Agent shall take such actions … as are appropriate in connection therewith. " (Dole Food Co, 8-K, Ex-10, 1/11/10)

3

Why have collective action clauses?

- They are "intended to prevent the possibility of a multiplicity of suits by individual banks perhaps working at cross-purpose – a situation that could be chaotic." Beal Savings Bank v. Sommer, 8 N.Y.3d 318 (2007).

- "Allowing the agent to pursue collective enforcement in the event of a default allows for unified action and prevents any single lender from being preferred over another." In re Enron Corp., 302 B.R. 463, Bankr. SDNY (2003).

- Majority rule also ensures that a minority cannot exercise the kind of hold-up power it would possess if the Agreement were subject to a unanimous rule.

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Collective action clauses generate (at least) three types of controversies

1. **Collective vs. individual action**: When do these clauses bar individual action?
   - Controversy typically arises when a majority of lenders directs the Agent not to pursue enforcement rights, but a minority attempts to enforce these rights individually.
   - Example: if the Agent offers forbearance in response to borrower default, can objecting minority lenders sue the borrower independently?
2. **Majority rule vs. unanimous consent**: When do unanimous-consent provisions restrict the Agent's discretion pursuant to collective action clauses?
   - Controversy typically arises when a majority of lenders directs the Agent to take certain actions in response to borrower default, but a minority objects and argues that these actions require unanimous approval.
   - Example: can majority lenders direct the Agent to release liens on collateral during a 363 bankruptcy sale even though the loan Agreement requires unanimous approval for any amendment that releases liens on collateral?
3. **Collective action vs. the Bankruptcy Code**: Can collective action be used as an alternative means of cramdown?
   - Collective action clauses establish thresholds for class approval (lenders holding 50% of debt) that are lower than the Code's threshold (two thirds in value, half in number).
   - Example: Debtor and majority lenders agree to a plan that reinstates the secured debt, subject to the Agent's commitment to forbear perpetually on 25 percent of the remaining balance. Can a substantial minority (holding over one third of the debt) object?

5

Controversy 1: Collective vs. Individual Action

- The leading case here is Beal Savings, 8 N.Y.3d 318 (2007).
- There, a parent company had guaranteed the debtor's obligations pursuant to a "Keep-Well" agreement.
  - After debtor's bankruptcy filing (an event of default), 95.5% of lenders directed the Administrative Agent to enter a settlement agreement.
  - Terms of the settlement included:
    - Agent will forbear from enforcing the Keep-Well agreement against debtor's parent company.
    - Participating lenders will turn over certain cash to the parent.
    - Parent will convey an interest in real estate to the Agent and will facilitate sale of the debtor's property.
  - Objecting minority lenders attempted to enforce the Keep-Well agreement individually.
- Nothing in the Agreements expressly permitted or prohibited individual action after an event of default.

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Beal Savings, continued

- The Court of Appeals focused on four provisions of the loan documents:
  - **Delegation of authority to agent**: "in the absence of other written instructions from the Required Lenders . . . [the Agent may] exercise such powers . . . as are specifically delegated to or required of the Administrative Agent by the terms [of the Loan Documents], together with such powers as may be reasonably incidental thereto."
  - **Agent's authority after events of default**: "Administrative Agent, upon the direction of the Required Lenders, shall by notice to the Borrower declare all or any portion of the outstanding principal amount of the Loans and other Obligations . . . to be due and payable … . In addition …, the Administrative Agent upon direction of the Required Lenders may … exercise any or all rights and remedies at law or in equity… , including … recover[ing] judgment on the … Keep-Well Agreement …"
  - **Relationship between Keep-Well Agreement and Credit Agreement**: the Keep-Well is "executed pursuant to the Credit Agreement" and should be "construed, administered and applied" in accordance with the Credit Agreement, absent terms to the contrary.
  - **Unanimity requirement**: Credit Agreement cannot be amended to "release the Sponsors under the Keep-Well Agreement … without the consent of all Lenders."

7

Beal Savings, continued

- The Court concluded that Beal lacked standing to enforce the Keep-Well agreement independently.
  - The Agent had sole authority, upon direction of a majority of lenders, to exercise "any or all remedies," including enforcement of the Keep-Well Agreement.
  - "An interpretation favoring Beal's view would render [provisions of the Credit Agreement] meaningless because there would be no reason to provide that the Required Lenders could enforce the agreements by a supermajority directing the Administrative Agent to act."

8

The Beal presumption

- Beal establishes a presumption: "Had the parties intended that an individual have a right to proceed independently, the Credit Agreement … should have expressly so provided."
- This presumption appears in pre-Beal caselaw of lower courts.
  - In Credit Francais (490 NYS2d 670, Sup. Ct. 1985), the court held that an individual lender lacked standing to accelerate the amount due after the debtor defaulted.
    - Under the terms of the Agreement there, acceleration occurred when the Agent, "with the consent or at the direction of the Majority Depositors," declared the loan due and payable.
    - In the absence of language to the contrary, the court held, this provision precluded individual lender action: "When an individual Depositor bank is given the right to proceed independently and directly against the defendant, the Agreement expressly so provides."
  - Similarly, in Enron (302 B.R. 463, Bankr. SDNY 2003), the court held that individual lenders lacked standing to enforce rights against collateral pledged by defaulting borrower.
    - There, a key provision in the Agreement stated: "Agent may, and at the request of the Required Lenders shall, … declare the Loans then outstanding to be due and payable."
    - In the absence of language to the contrary, the court held, this provision precluded individual action by lenders.

9

Was Beal rightly decided?

- A strong argument supports the opposite presumption, favoring individual action absent express provisions to the contrary.
  - In that case, dissenting Justice Smith distinguished between rights created by contract and those created by background law: Collective action clauses do apply to rights created by the Agreement, unless Agreement says otherwise. But they do not apply to rights created by background law, unless Agreement says otherwise.
  - A similar approach was previously taken by some lower courts, including New Bank of New England (768 F. Supp. 1017, SDNY 1991): "although acceleration and foreclosure are contractual remedies which may not be exercised without a majority vote of the lenders, [an individual lender] is free to pursue its own remedies at law by suing [the defendant] to collect on its debt to [the lender]."
- The Keep-Well agreement itself arguably supported the opposite conclusion
  - It stated that the agreement "shall inure to the benefit of and be enforceable by the Administrative Agent and each Lender."
- Court's approach is highly formalistic: Could the majority lenders direct the Agent to forbear in perpetuity?
  - Logic of court's opinion suggests that the answer is "yes."

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Controversy 2: Majority vs. unanimous rule

- Credit agreements typically require unanimous lender consent to amendments affecting the interest rate, duration, principal balance, collateral subject to liens, and other core terms.
  - On the other hand, the typical credit agreement also permits a majority of lenders to dictate the Agent's response to events of default.
- If majority lenders direct the Agent to forbear after an event of default or to consent to a 363 sale of collateral, are they (implicitly) amending the Agreement—by extending loan maturity and releasing liens on collateral—without unanimous lender consent?

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Beal Savings said "no" in the context of a forbearance

- The settlement agreement there was not an "end-run" around the rule barring amendments without unanimous lender consent because the settlement did not formally amend or modify the Agreements:
  - "[E]ven if the Settlement has a 'similar effect' to a release, the supermajority of Lenders exercised their rights by restructuring the debt of a financially troubled Borrower."
- The same logic was recently applied by the SDNY bankruptcy court in Delphi (plan confirmation transcript, Dec. 1, 2008).
  - There the debtor sought permission to extend the maturity of a syndicated DIP loan. Realizing they could not obtain unanimous consent to an amendment extending the loan's duration, a majority of lenders (holding 68.37% of the debt) consented directed the Agent to forbear from exercising collection remedies after the loan matured. A substantial minority of lenders objected.
  - The parties pointed to two provisions of the Agreement:
    - One declared that the Agreement could not be amended to "extend the final maturity of the Borrower's obligations" without unanimous lender consent.
    - The other declared that, upon occurrence of an event of default, "the administrative agent may and, at the request of the required lenders, shall … exercise any and all remedies under the loan documents and under applicable law available to the administrative agent and the lenders."
  - The court held that the second provision, interpreted in light of Beal Savings, gave the agent authority to enter the accommodation agreement.
    - Although accommodation was similar to extending maturity, it was not identical: "The consequences of the nonextension of the maturity date have a material economic effect on the debtor," including termination of certain lending commitments, accrual of interest at a higher rate, and cash collateralization of letters of credit.

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Three recent bankruptcy cases also say "no," but in the context of §363 sales

- In each case, the debtor sought permission to sell substantially all assets free and clear of liens and interests, including security interests supporting syndicated debt.
  - Majority lenders holding at least 90% of the secured debt directed the Agent to approve the sale; minority creditors objected.
  - See Chrysler, 405 B.R. 84 (Bankr. SDNY 2009); GWLS, 2009 WL 453110 (Bankr. D. Del. 2009) (unreported); Metaldyne, 409 B.R. 671 (Bankr. SDNY 2009).
- The parties pointed to (roughly) the same two provisions in each case:
  - One forbade amendments that "release all or substantially all of the Collateral from the Liens of the Security Documents, without the written consent of each Lender."
  - The other empowered the Agent to act at the direction of a majority of lenders, and authorized it both to "exercise any and all rights afforded to a secured party under the [UCC] or other applicable law" and to "sell or otherwise dispose of all or any part of the Collateral for cash, upon credit or future delivery as the Collateral Agent shall deem appropriate."
- Each court concluded that the second provision, interpreted in light of Beal Savings, gave Trustee authority to consent to the §363 sale.
  - "[N]othing in the agreements prohibits the Agent from exercising rights that are consistent with 363(k) of the Bankruptcy Code." (Metaldyne)
  - This "is not a 'release' of collateral because the lien attaches to the proceeds of the sale, which remain as collateral to secure the loan made by the Lenders." (Chrysler)

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Are there constraints on majority rule?

- The preceding cases apply a formalist "plain meaning" approach to contract interpretation: The Agent's discretion under collective action clauses is constrained only by the literal terms of the unanimous-consent provisions.
  - New York courts are well-known for rigorous adherence to a plain-meaning approach. See, e.g., W.W.W. Associates v. Giancontieri, 77 N.Y.2d 157 (1990), cited by Beal.
- The duty of "good faith" can constrain majority rule, but will do little work here.
  - This non-waivable duty applies here, notwithstanding provisions in the typical agreement stating that "no implied covenants, functions, responsibilities, duties, obligations or liability shall be read into this Agreement."
  - But because perpetual forbearance harms (or benefits) the majority as well as the minority, it will generally be hard to prove that the majority is acting to "benefit themselves" at the minority's expense.
  - Instead, disagreements over perpetual forbearance will likely be viewed only as evidence "that the two sides disagree on which course of action will produce a better recovery on the troubled loan." (New Bank of New England, at 1022-23)
- After Beal, then, there appears to be little that would stop majority lenders from, say, ordering the Agent to forbear perpetually with respect to an unpaid balance.

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Controversy 3: Collection Action vs. Bankruptcy Code

- Can collective action clauses bind minority lenders to a plan even if they hold more than one-third of the debt?
- Two scenarios:
  - **Reinstatement:** the reorganization plan reinstates the debt, subject to the Agent's agreement to forbear perpetually on the overdue balance.
  - **Cramdown:** the reorganization plan impairs the debt by offering less than full payment of allowed secured claims, but the majority directs the Agent to forbear perpetually on the unpaid balance.

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A reinstatement strategy

- This could be accomplished by reinstating the debt under 1124(1), which requires that the plan's treatment of a claim "leave[] unaltered the legal, equitable, and contractual rights to which such claim … entitles the holder of such claim … ."
  - Debtor need not cure past defaults. See, e.g., In re Texas Baseball Partners, 2010 WL 3155998 (Bankr. N.D. Tex, Jun. 22, 2010) ("[U]nlike treatment under section 1124(2), section 1124(1) is prospective: section 1124(1) does not require that a plan provide for the cure of defaults—i.e., recreation of the situation as it was before default. Rather it requires that, as of the plan's effective date, an unimpaired creditor be able thereafter to exercise all its rights *vis-à-vis* its debtor.").
- After confirmation, minority lenders would be free to exercise pre-petition contractual rights, subject to collective action clauses.
  - Unless the bankruptcy filing itself triggered rights of individual action, the minority lenders would be bound by the majority's decision directing the Agent to forbear perpetually.

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A cramdown strategy

- To survive cramdown under 1129(a), a plan must be "fair and equitable," a condition that "includes" the following requirements of 1129(b)(2): Holders of secured claims must receive either …
  - Continuing liens in the original collateral (or in proceeds from its sale) plus payment with a present value equal to the secured claims, [1129(b)(2)(A)(i), (ii)], or
  - "[R]ealization by such holders of the indubitable equivalent of such claims." 1129(b)(2)(A)(iii)
- Secured claimants arguably receive the "indubitable equivalent" of their claims if they receive what those claims are worth outside of bankruptcy.
  - After Beal, a plan that offers less full payment, combined with the Agent's commitment to forbear perpetually with respect to the unpaid balance, would appear to offer creditors the "indubitable equivalent" of their claims.
  - This line of argument finds support in Pacific Lumber, 584 F.3d 229 (5th Cir. 2009) and Philadelphia News, 599 F.3d 298 (3d Cir. 2010), which interpret subsections (i) and (ii) of 1129(b)(2)(A) as safe harbors, not as minimum requirements for cramdown. Other methods of cramdown are permissible as long as "those methods sufficiently protect[] the secured creditor's interests."

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A potential difficulty with a cramdown strategy

- Are claimants really receiving the “indubitable equivalent” of their claims?
  - Through the reorganization plan, they will receive new securities with a face value that is less than the value of their secured claims (e.g., the plan will promise payment equal to 75 percent of allowed secured claims).
  - Once the plan is confirmed, these securities will memorialize the Agent’s commitment to perpetual forbearance (e.g., the Agent will commit to forbear perpetually with respect to the remaining 25 percent). That commitment will be irreversible.
- Contrast this with the Agent’s discretion outside bankruptcy
  - Although the majority can direct the Agent to announce perpetual forbearance with respect to an unpaid balance, it seems difficult for the majority to commit themselves never to revoke that direction to the Agent. For example, can they prevent members of the majority from transferring their claims to third parties who were not party to the original direction to the Agent?
  - It therefore seems difficult for the majority to bind the Agent to an irreversible commitment to forbear, absent unanimous consent. This might suggest that cramdown offers claimants less than the “indubitable equivalent” of their claims.

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Another difficulty with a cramdown strategy

- “Fair and equitable” are “words of art,” Case v. Los Angeles Lumber Products Co., 208 U.S. 106 (1939), encompassing requirements beyond those mentioned in 1129(b). For example:
  - There may or may not be a “new value exception.”
  - Senior classes cannot receive more than full payment while junior classes are impaired.
  - A plan cannot unreasonably shift risk from junior to senior claims by, for example, paying senior creditors with very long-lived securities (or securities with negative amortization periods) while paying juniors with short-term debt. See, e.g., In re D&F Construction Inc., 865 F.2d 673 (5^{th} Cir. 1989)
- In light of this caselaw, courts may resist efforts to use the Code in ways that are consistent with non-bankruptcy rights but inconsistent with the principles of bankruptcy law.
  - Example: Armstrong World Industries, 432 F.3d 507 (3d Cir. 2005) prohibited “gifting” from unsecured creditors to old shareholders because “[a]llowing this type of transfer would encourage parties to impermissibly sidestep the carefully crafted strictures of the Bankruptcy Code … .”

Multiple Debtor Issues

AMERICAN BANKRUPTCY INSTITUTE

NYU LAW

New York University School of Law

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NYU POLLACK CENTER FOR LAW & BUSINESS

Presented by

Marshall Huebner

September 18, 2013

Davis Polk

Davis Polk & Wardwell LLP

NYU Workshop on Bankruptcy and Business Reorganization

Multiple Debtor Issues

- Large corporate enterprises, and therefore large debtors, frequently have complex legal structures, with dozens of legal entities doing business with one another.
- The Bankruptcy Code was drafted with a simpler legal structure in mind.
- An increasing number of cases reflect substantial focus on the legal implications and strategic possibilities presented by the intercreditor issues that arise with large, complex debtor families.

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Summary

- **Claims Trading**
- **Multiple Debtor Issues**
  - Intercompany Claims
  - Disqualification of Counsel and Chapter 11 Trustees
  - Substantive Consolidation
  - Recharacterization
- **Responses**
  - Settlements of Multiple Debtor Issues
  - Case Study: Lehman

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Claims Trading

- Claims trading allows investors to buy positions in bankruptcies and try to influence the outcome, and therefore their recovery.
- Multiple debtor issues are often raised by claims traders who have purchased positions based on their legal analysis of the intercompany relationships and claims
  - Tribune: bondholders advocated for, among other things, invalidation of subsidiary guarantees of parent debt resulting from a leveraged buyout
  - Charter Communications: plan of reorganization that resulted in bondholders owning the reorganized debtor confirmed over objections of other creditors that treatment of the intercompany claims violated the debtors' fiduciary duties
  - Washington Mutual: claims traders purchased blocking positions in the capital structure and participated directly in global settlement negotiations
- Increasingly vigorous participation by bondholders and other creditors whose recovery can vary greatly based on the resolution of multiple debtor issues.

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Intercompany Claims

- Intercompany claims can arise out of, inter alia, centralized cash management systems, consolidated sales systems, intercompany guarantees or the sales of goods or services among affiliates.
  - Although intercompany transactions create legal obligations that become claims in bankruptcy, intercompany dealings may not be fully or accurately documented or reflected.
  - Like third party claims, intercompany claims are subject to preference or fraudulent conveyance attack. Intercompany claims can also be eliminated through substantive consolidation, recharacterization or the terms of a plan of reorganization.
- Taking the enterprise as a whole, intercompany claims neither grow nor shrink the pie available for distribution—they raise intercreditor issues.

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Treatment of Intercompany Claims through Plans of Reorganization

- Many large cases have addressed the issues presented by intercompany claims either by eliminating such claims outright or reserving the right of the debtors to adjust or eliminate intercompany claims.
  - Frontier Airlines: intercompany claims were unimpaired but debtors retained the right to adjust or eliminate the claims as of the effective date.
  - Kodak: on the effective date, intercompany claims were reinstated, cancelled or otherwise compromised at the debtors' discretion.
  - GM: the Administrator was empowered to reduce or eliminate intercompany claims as he saw fit in good faith judgment .
  - Lehman: global compromise included settlement of intercompany claims

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Disqualification of Counsel and Chapter 11 Trustees

- Courts generally allow the retention of a single law firm by multiple related debtors and are extremely hesitant to force changes in counsel or control once the bankruptcy is underway.
- Creditors sometimes request that the court disqualify counsel or to appoint a chapter 11 trustee in order to apply pressure in settlement negotiations or to get a new, presumably more favorably disposed, counterparty with whom to negotiate.
  - Courts have been highly critical of the use of disqualification and trustee motions as litigation tactics. In a number of cases, an unexplained delay in bringing such a motion has been considered a sufficient basis to deny the motion.

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Disqualification of Counsel and Chapter 11 Trustees

- Motions to disqualify counsel, particularly if the movant does not bring them promptly, generally are not granted.
  - Enron Corp.: motion to disqualify creditors committee counsel due to its prepetition connections with the debtors and several creditors. Denied because of adequate disclosure by counsel, and as a litigation tactic, based on the creditors' three month delay in objecting.
  - Adelphia Comm. Corp: motion to disqualify debtors' counsel. While denying most of the relief requested, the court did direct the debtors and their counsel to remain neutral in the resolution of certain interdebtor disputes. Court surveyed 16 multi-debtor cases where interdebtor disputes existed, finding that representation by a single firm was both common and appropriate.
  - Residential Capital LLC: secured noteholders moved for limited disqualification of debtors' counsel, among others, on the basis that they were unable to settle intercompany claims due to inherent conflicts of interest. The court denied the motion because none of the conflicts identified rose to the requisite level, and because the motion was a litigation tactic.

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Disqualification of Counsel and Chapter 11 Trustees

- Motions to appoint a chapter 11 trustee on intercompany grounds also face a high bar.
  - Adelphia Comm. Corp: motion for a trustee denied because noteholders failed to demonstrate fraud, mismanagement or misconduct. Held that "the mere presence of interdebtor conflicts" is not sufficient to justify appointment of a trustee.
  - WorldCom, Inc.: motion by creditors of WorldCom's MCI subsidiaries for immediate appointment of a trustee on the grounds that the debtors asserted billions of dollars of intercompany claims against the MCI subsidiaries without any evidence. Denied on the basis that debtors had provided movants with accurate information and because appointment would impede administration.
  - Enron Corp.: creditors of one debtor subsidiary, alleged to be more profitable than the others, moved for appointment of a trustee to prevent the other debtors from siphoning funds from the profitable debtor. Although an examiner was appointed, no trustee was appointed.
- There appears to have been only one large bankruptcy where a trustee has been granted
  - Marvel Entertainment Group: motion for trustee granted where the controlling shareholder of the debtor was also a very substantial creditor who allegedly used his dual positions to propose settlements that favored his own interests as a creditor at the expense of other groups of creditors.

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Disqualification of Counsel and Chapter 11 Trustees

- Some recent objections to retention under section 327(a) have been successful
  - JMK Construction Group: creditors successfully opposed joint retention of counsel to debtors who, by reason of joint and several liability on a tort judgment, had contribution claims against each other.
  - Project Orange Assoc. LLC: debtor's counsel denied retention due to their representation of the debtor's largest creditor in unrelated matters where that creditor's claim was disputed and unliquidated and its resolution was pivotal to the successful reorganization of the debtors.
- These cases are similar in that the motions to disqualify we brought early in the process, and did not revolve around intercompany relationships that were purely the result of ordinary intercompany dealings.

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Substantive Consolidation and Recharacterization—Effects on Intercompany Claims and Plan Process

- **Substantive Consolidation**
  - Benefits the creditors of thinly capitalized or highly levered entities at the expense of the creditors of well-capitalized entities
  - Eliminates intercompany claims
- **Recharacterization**
  - Not typically applied to ordinary intercompany transactions, but could be argued to be equally relevant and appropriate
  - Possibility of multiple motions to recharacterize intercompany debt by the creditors of thinly-capitalized entities could influence a court to approve substantive consolidation

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Substantive Consolidation

- Substantive consolidation is a rarely applied equitable remedy that allows a bankruptcy court to merge the assets and liabilities of two or more otherwise separate entities for purposes of voting and distribution in bankruptcy when necessary to ensure equitable treatment of creditors.
  - Typically, substantive consolidation is only "deemed" for purposes of voting and distributions under a plan of reorganization, and the debtor entities otherwise retain their distinct legal identities.
- Substantive consolidation will almost always eliminate intercompany claims, and pool the creditors of the various debtors for voting and distributions, although bankruptcy courts are free to tailor substantive consolidation to further the goals of equity.
- The total amount of assets recoverable by creditors does not change.
- Generally, substantive consolidation benefits creditors of debtors with a low asset-liability ratio at the expense of creditors of debtors with a high asset-liability ratio.
- Even if not granted, the risk of substantive consolidation is increasingly taken into account in settlements incorporated in plans of reorganization.

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Substantive Consolidation—Reliance Test

1. Reliance Test: creditors dealt with the various debtor entities as a single economic unit and did not rely on their separate identities in extending credit.

- The Reliance Test focuses on whether creditors dealt with the entities as a single economic unit in deciding whether to extend credit. Courts make this determination on a case-by-case basis, examining numerous factors, including:
  - Presence or absence of consolidated financial statements
  - Unity of interests and ownership between the various corporate entities
  - Existence of parent and inter-corporate guarantees on loans
  - Degree of difficulty in segregating and ascertaining individual assets and liabilities
  - Transfer of assets among affiliates without formal observance of corporate formalities
  - Comingling of assets and business locations
  - Profitability of multiple debtor entities operating from the same location

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Substantive Consolidation—Entanglement Test

2. Entanglement Test: the affairs of the debtor entities are so hopelessly entangled that consolidation will benefit all creditors.

- Seeks to do justice for all creditors, even if they were aware at the time they extended credit that they were dealing with only one of the debtor entities
- In the Second Circuit, courts have made clear that substantive consolidation is appropriate under this test only when the fees would be so costly as to render every creditor worse off than they would otherwise have been.
- Recharacterization analysis may feed into an Entanglement Test analysis, because the added analytical layer of appropriately treating all intercompany claims under that equitable theory may unjustifiably increase the cost and difficulty of untangling the affairs of the debtor.

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Recharacterization

- Typically arises when a major shareholder or parent corporation invests additional capital in a distressed company in the form of a loan, but with characteristics of an equity infusion.
- The Bankruptcy Code does not expressly empower courts to use recharacterization, but most courts have found that the equitable powers of Section 105(a) allow bankruptcy courts to recharacterize debt as equity under appropriate circumstances.
- Courts must balance competing policy goals in applying recharacterization, because it is important for courts not to discourage stakeholders from undertaking legitimate efforts to keep flagging businesses afloat, but it is equally important to prevent end runs around the priority scheme through mere formalism.
- Most Circuits use multi-factor tests that ultimately boil down to two overarching inquiries:
    1. Whether or not the terms of the loan resemble those that would arise out of an arm's-length transaction
    2. Whether or not the parties intended for such transaction to be a loan or an equity contribution at the time it was effectuated

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Recharacterization

- *Autostyle* Factors for Recharacterization
    - Names given to the intercompany loan instruments
    - The presence or absence of a fixed maturity date and payment schedule intercompany loans
    - The presence or absence of an interest rate and interest payments
    - The source of repayments
    - Whether or not the company is adequately capitalized
    - The identity of interest between the creditor and stockholder (i.e. are advances made by stockholders in proportion to their ownership interest)
    - The security, if any, for the advances
    - The company's ability to obtain financing from third-party lending institutions
    - The extent to which the advances were subordinated to the claims of third-party creditors
    - The extent to which the advances were used to acquire capital assets; and
    - The presence or absence of a sinking fund to provide repayments

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Recharacterization—Developing Minority Approach

- The Ninth and Fifth Circuits have adopted an approach to recharacterization based on state law.
  - Under the minority approach, recharacterization is available to the extent that it exists under applicable state law.
  - This approach finds recharacterization permissible under the Bankruptcy Code's definitions of "claim" and "debt," rather than relying on the bankruptcy court's equitable powers.
- The Fifth Circuit first announced this approach in 2011, and the Ninth Circuit followed in 2013.
- There has long been a circuit split regarding whether recharacterization exists, so the importance of the appearance of a new theory remains to be seen.

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Settlements of Multiple Debtor Issues

- Enron: plan of reorganization included a compromise of substantive consolidation issues, calculating the amount certain creditors would receive based on a 30% chance of substantive consolidation. Some debtors were not included in the calculation.
- WorldCom: initial plan of reorganization proposed substantive consolidation, ultimately settled in a compromise whereby the noteholders opposing substantive consolidation agreed to receive an 80% payout, compared to 36% for the noteholders in favor.
- Kmart: settlement accounted for the uncertainty of the claim for substantive consolidation. The 38 cases remained unconsolidated for confirmation, but creditors who benefited from certain subsidiary guarantees agreed to a partial reallocation to the creditors of the parent.
- Tribune: legal and financial advisors engaged in a comprehensive review and analysis of intercompany claims to determine which should be allowed and disallowed; their detailed recommendations were documented in the Intercompany Claims Settlement.
- A Report to the ABI evaluating the prevalence of substantive consolidation in large public companies found that of 75 mega cases identified as substantive consolidation cases, 27 expressly stated that the plan involved a compromise and settlement of substantive consolidation claims.

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Lehman Brothers—Multiple Debtor Issues

- Thousands of legal entities across 40 countries
- Numerous intercompany claims relating to firm-wide risk management, funding using a centralized paymaster, secured and unsecured intercompany lending and routine intercompany transactions
- There was colorable substantive consolidation risk under both the Entanglement Test and Reliance Test
- Recharacterization risk affecting billions of dollars of intercompany claims held by Lehman Brothers Holdings Inc. ("LBHI")
- Domestic only versus worldwide added further complexities

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Lehman Brothers—Substantive Consolidation Risk

- Like virtually all large businesses, Lehman arguably satisfied many announced Entanglement Test factors for substantive consolidation
  - LBHI guaranteed many of its subsidiaries' obligations
  - Lehman was managed as a group
  - Intercompany transactions were often documented only by electronic entries of payables and receivables, although interest was usually charged
  - Excess cash was moved up to LBHI at the end of each day
  - Lehman operated under a centralized cash management system and, on a daily basis, LBHI would transfer funds to subsidiaries to cover their obligations on an as-needed basis

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Lehman Brothers—Recharacterization Risk

- LBHI engaged in millions of intercompany transactions each month.
- The intercompany balances at risk of recharacterization included those that did not relate to specific transactions, such as derivatives or repurchase agreements.
  - Affiliates would draw on funds from LBHI as necessary throughout the day, creating payables to LBHI, and would upstream excess cash at the close of business, creating a receivable from LBHI
  - There was no allocation of debits to particular transactions, and so no way to determine whether particular amounts due were ever satisfied.
- In 2008, the recorded balance payable from Lehman Brothers Special Financing Inc. to LBHI ranged from $3.4 billion to as high as $15 billion.

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Lehman Brothers—Plan and Settlements

- The Lehman Brothers plan of reorganization (the "Lehman Plan") incorporated settlements addressing many economic issues, including the risk of substantive consolidation of LBHI with certain domestic subsidiaries (the "Participating Subsidiary Debtors") and recharacterization of LBHI claims against the Participating Subsidiary Debtors.
- For purposes of distributions to the creditors of the Participating Subsidiary Debtors, the Lehman Plan used a weighted average of hypothetical distributions under a substantive consolidation scenario (weighted 20%) and non-substantive consolidation scenario (weighted 80%).
- At the same time, in settlement of the recharacterization issue, the Lehman Plan reduced LBHI's claims based on non-transaction specific funding against the Participating Subsidiary Debtors by 20%.

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Conclusions/Questions

- Multiple debtor issues are presenting themselves in bankruptcy with increasing frequency and complexity, and the rise of claims trading has led to more litigation around these issues.
- Intercompany claims and issues often have material distributional effects, and their resolution can pose sensitive conflicts issues.
- Real and apparent conflicts related to intercompany claims sometimes form the basis for litigation over control of all or part of the bankruptcy process.
- Recharacterization and substantive consolidation provide alternative theories for parties interested in challenging the plan or distributions proposed by debtors.
- Risk-weighted settlements have been developed to address the complexities introduced by these issues.

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The Enigmatic Plan Support Agreement and Its Role in the Chapter 11 Epic

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Willy Wonka and the Chocolate Factory (Warner Bros. 1971)

"There's no earthly way of knowing … Which direction they are going...
And they're certainly not showing .. Any sign that they are slowing…"

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Basic Principles of Bankruptcy Reorganization

William Hogarth, *The Rake in a Debtors' Prison,* 1753

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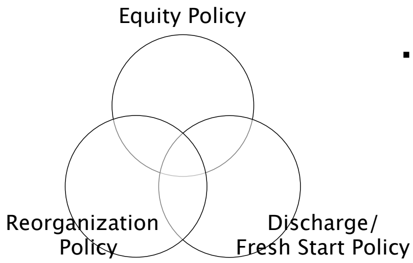
Basic Principles of Bankruptcy Reorganization



- Equity Policy
  - Provide similar treatment to similarly situated creditors
- Reorganization Policy
  - Reorganization vs. liquidation
  - Maximize value with "going concern" value rather than "liquidation value"
  - Jobs and public interest
  - Survival of competitive entity
  - Possible return for owners or opportunity to continue investment
- Discharge/Fresh Start
  - Property transferred to reorganized debtor
  - Discharge of prepetition debt
  - Debtor's only obligations are those set forth in plan

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Goals and Values of Bankruptcy

The federal system of bankruptcy is designed not only to ***distribute the property of the debtor***, not by law exempted, ***fairly and equally among his creditors***, but as a main purpose of the act, intends to ***aid the unfortunate debtor by giving him a fresh start in life***, free from debts, except of a certain character, after the property which he owned at the time of bankruptcy has been administered for the benefit of creditors. Our decisions lay great stress upon this feature of the law — as one not only of private but of great public interest in that it secures to the unfortunate debtor, who surrenders his property for distribution, a new opportunity in life.

–*Stellwagen v. Clum*, 245 U.S. 605, 617 (1918)

The primary goal of Chapter 11 is the ***financial resuscitation of an ailing business***.

–*Brodsky v. Indep. Cement Corp. (In re Marine Pollution Serv., Inc.)*, 99 B.R. 210, 215 (Bankr. S.D.N.Y. 1989)

[T]he Bankruptcy Code affords one forum for resolution of all disputes affecting the administration of the estate. The ***policy is to centralize all disputes for the benefit of all parties.***

–*Knepp v. Cred. Acceptance Corp. (In re Knepp)*, 229 B.R. 821, 844-45 (Bankr. N.D. Ala. 1999)

[Chapter 11] is a collective proceeding in which the Bankruptcy Court is charged with applying the Bankruptcy Code and other applicable law to achieve ***the overarching goal of chapter 11 — to maximize the value of the Debtors' estates for the benefit of all stakeholders and guide the Debtors, if at all possible, through chapter 11 and beyond to emergence as a stronger company, financially and operationally***.

–*In re Patriot Coal Corp.*, 482 B.R. 718, 722 (Bankr. S.D.N.Y.2012)

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Goals and Values of Bankruptcy (cont.)

Selected Goals and Values

- Breathing spell
- Opportunity for debtor to rehabilitate itself; remain in control during the reorganizing process
- Retain a firm's going-concern value
- Opportunity for a fresh start
- Fair treatment of all creditors and parties in interest
- Equal treatment of similarly situated creditors
- Centralize disputes, claims; prevent a race to the courthouse
- Due process; public interest in clarity and transparency

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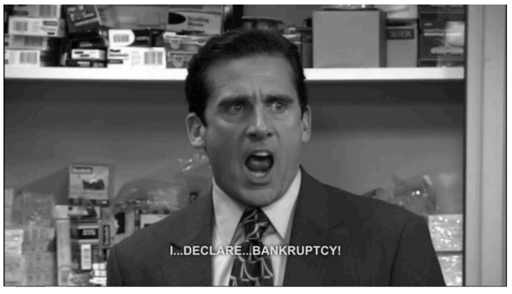
Chapter 11 Reorganization, Part I



The Office, "Money" (NBC 2007)

Creed Bratton: Listen, I got the answer. You declare bankruptcy, all your problems go away . . . Bankruptcy, Michael, is nature's do-over. It's a fresh start. It's a clean slate.
Michael Scott: Like the Witness Protection Program.

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Key Participants: Traditional Model

Bankruptcy Court

Debtor and Debtor in Possession

Committee of Unsecured Creditors

Secured Lender

United States Trustee

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"Traditional" Chapter 11

- Debtor negotiates with Official (Statutory) Committee of Unsecured Creditors (representing interests of all unsecured creditors)
- Debtor in possession administers the debtor's estate with powers of a Trustee
- Debtor and Creditors' Committee agree on elements of a proposed plan of reorganization; Creditors' Committee also agrees to support and recommend the plan to its constituency
- Debtor and creditors secure requisite acceptances of proposed plan and pursue confirmation, effective date of plan and emergence from chapter 11
- Occasionally other parties would become involved (e.g., secured creditors, unions, landlords, regulatory agencies (EPA, IRS, etc), litigation counterparties), but the reorganization was driven primarily by the debtor and the Creditors' Committee

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Chapter 11 Reorganization, Part II

Jarndyce and Jarndyce drones on. This scarecrow of a suit has, in course of time, become so complicated that no man alive knows what it means. The parties to it understand it least; but it has been observed that no two Chancery lawyers can talk about it for five minutes without coming to a total disagreement as to all the premises. Innumerable children have been born into the cause; innumerable young people have married into it; innumerable old people have died out of it. Scores of persons have deliriously found themselves made parties in Jarndyce and Jarndyce, without knowing how or why; whole families have inherited legendary hatreds with the suit. The little plaintiff or defendant, who was promised a new rocking-horse when Jarndyce and Jarndyce should be settled, has grown up, possessed himself of a real horse, and trotted away into the other world. Fair wards of court have faded into mothers and grandmothers; a long procession of Chancellors has come in and gone out; the legion of bills in the suit have been transformed into mere bills of mortality; there are not three Jarndyces left upon the earth perhaps, since old Tom Jarndyce in despair blew his brains out at a coffee-house in Chancery Lane; but Jarndyce and Jarndyce still drags its dreary length before the Court, perennially hopeless.

–Charles Dickens, *Bleak House*

Bleak House (BBC World 2005)

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Key Participants: Modern Regime

Ad Hoc Committees

Creditors' Committee

Equity Committee

First Lien Lender

Second Lien Lender

DIP Lender

Debtor and Debtor in Possession

Future Claimants

Gov't and Regulatory Agencies

Insurers

Unions and Retirees

Trustee/ Examiner

United States Trustee

Bankruptcy Court

+Attorneys

+Financial Advisors

+Investment Bankers

+Tax Advisors

+Special Counsel

+Valuation Experts

+Fee Examiner

+Examiner

+Mediator

Selected Changes to Chapter 11 Reorganization

- Proliferation of parties in interest (and advisors/costs)
- Encompassing secured debt has changed dynamics of chapter 11; fulcrum security is often at second- or third-lien
- Distressed debt investors (hedge funds) become major players, rather than firms doing ongoing business with the debtor with resulting change in objectives
- Unsecured trade debt is dwarfed by secured lenders and bondholders
- Increased entitlements for special interest groups increase administrative expenses and sometimes priority claims
- Complex capital structures and corporate forms lead to intercreditor disputes; Creditors' Committee increasingly unable to speak for "unsecured creditors" as a whole
- Broad expansion of administrative expenses – to cover professional fees and expenses of multitude of parties beyond those contemplated by chapter 3 of the Bankruptcy Code

The Emergence of the Plan Support Agreement

Plan Support Origins

- In a consensual (or mostly consensual) reorganization, debtors and Creditors' Committees would reach a general understanding for the debtor's plan to exit chapter 11
- The Creditors' Committee would then recommend and solicit their constituents to accept the chapter 11 plan
- As reorganization cases became more complex and diverse as to creditor interests, multi-faceted negotiations resulted and conclusions were often memorialized in a writing, e.g., a term sheet
- These term sheets typically included a "fiduciary out," whereby plan supporters could retract their support should any material changes or disclosures be made, or should any other circumstances militate in favor of a changed approach

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Plan Support Agreements

- More formal plan support agreements or so-called "lockup agreements" began to emerge

- "Plan Support Agreements"
  - *See, e.g., Trans World Airlines, Inc. v. Texaco, Inc. (In re Texaco)*, 81 B.R. 813, 819-20 (Bankr. S.D.N.Y. 1988) (debtor and creditor agreed to (i) "use their best efforts to obtain confirmation of the Plan in accordance with the Bankruptcy Code . . ."; (ii) take all action to achieve confirmation; (iii) refrain from supporting any proposed modifications to the plan unless the other party agreed to the modification as well; and (iv) refrain from voting for any other possible competing plan)

- "Lockup Agreements"
  - *See, e.g., In re Kellogg Square P'ship*, 160 B.R. 336, 338 (Bankr. D. Minn. 1993) (creditor voted in favor of debtor's plan pursuant to postpetition agreement requiring it to vote to accept the plan, in consideration for certain treatment of executory contracts and unexpired leases).

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Premature Solicitation

- Postpetition plan support agreements lie outside the four corners of the Bankruptcy Code

- 11 U.S.C. 1125(b) provides:
  - *An acceptance or rejection of a plan may not be solicited after the commencement of the case* under this title from a holder of a claim or interest with respect to such claim or interest, *unless, at the time of or before such solicitation, there is transmitted to such holder the plan or a summary of the plan, and a written disclosure statement* approved, after notice and a hearing, by the court as containing adequate information. . . . (emphasis added)

- 11 U.S.C. 1125(e) then provides:
  - *On request of a party in interest*, and after notice and a hearing, *the court may designate any entity whose acceptance or rejection of such plan* was not in good faith, or *was not solicited or procured in good faith or in accordance with the provisions of this title.*(emphasis added)

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Premature Solicitation

- The prohibition against solicitation in the absence of a court-approved disclosure statement serves two interests:
  - Protects the debtor's presumptive right to an exclusive period to file and solicit votes in favor of a chapter 11 plan. *See* 11 U.S.C. 1121(b). *See also Century Glove, Inc. v. First American Bank of New York*, 860 F.2d 94, 95-96 (3d Cir. 1988).
  - Safeguards against the "undesirable practice . . . of soliciting acceptance or rejection at a time when creditors and stockholders were too ill-informed to act capably in their own interests." *In re Indianapolis Downs, LLC*, 486 B.R. 286, 295 (Bankr. D. Del. 2013) (citing *In re Clamp-All Corp.*, 233 B.R. 198, 208 (Bankr. D. Mass. 1999).

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Premature Solicitation

- Notwithstanding these concerns, most courts construed solicitation very narrowly and did not designate votes of parties to plan support agreements based upon alleged violations of section 1125 of the Bankruptcy Code
  - *See, e.g.*, *In re California Fidelity Inc.*, 198 B.R. 567, 571-72 (9th Cir. 1996) ("Most courts have reasoned that a broader construction of ["solicitation"] would curtail free and honest negotiations among creditors and, therefore, inhibit creditor participation in the debtor's reorganization."); *Century Glove, Inc. v. First American Bank of New York*, 860 F.2d 94, 100-101 (3d Cir. 1988) (finding that there is no "principled, predictable difference between negotiation and solicitation of future acceptances" and "reject[ing] any definition of solicitation which might cause creditors to limit their negotiations"); *In re Heritage Org., L.L.C.*, 376 B.R. 783, 792-93 (Bankr. N.D. Tex. 2007) ("solicitation" should be construed very narrowly, in deference to a clear legislative policy encouraging negotiations among creditors and stakeholders in chapter 11 cases); *see generally* Robert J. Keach, *A Hole in the* Glove*: Why "Negotiation" Should Trump "Solicitation,"* 22 AM. BANKR. INST. J. 22 (June 2003)

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The Intended Enhancement of Plan Support Agreements as Sanctioned by Court Approval

My Cousin Vinny (20th Century Fox 1992)

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PSAs: The Next Step -- Court Approval

- The Intended Enhancement of PSAs as Sanctioned by Court Approval
  - *See, e.g., In re Residential Capital, LLC,* 2013 WL 3286198 (Bankr. S.D.N.Y. June 27, 2013); *In re AMR Corp.,* Case No. 11-15463 (SHL) (Bankr. S.D.N.Y. June 4, 2013) (ECF #8577); *In re General Maritime Corp.,* Case No. 11-15285 (MG) (Bankr. S.D.N.Y. Apr. 2, 2012) (ECF #421); *In re Great Atl. & Pac. Tea Co.,* Case No. 10-24549 (RDD) (Bankr. S.D.N.Y. Dec. 19, 2011) (ECF #3060); *In re Chemtura Corp.,* Case No. 09-11233 (REG) (Bankr. S.D.N.Y. Aug. 9, 2010) (ECF #3527); *In re Tronox, Inc.,* Case No. 09-10156 (ALG) (Bankr. S.D.N.Y. Dec. 23, 2009) (ECF #1030)
  - *See also In re Innkeepers USA Trust*, 442 B.R. 227 (Bankr. S.D.N.Y. 2010) (denying a motion to assume a prepetition PSA, and stating that "without the burden of the restrictions imposed by the PSA, the Debtors will have a wide berth to fulfill their fiduciary duties to conduct a plan process which maximizes value for all of the estates and treats the various tranches of debt with greater neutrality")
  - The motivation to require court approval is murky and undisclosed. What does the imprimatur of the court mean?
  - What are the standards for court approval?
  - What significance should be given to the fiduciary duties of the negotiators and signatories to the PSA?
  - What are remedies for breach of a court-approved PSA? Are they different from an ordinary PSA such as those executed in the Lehman cases?

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PSAs: The Next Step -- Court Approval

- If a court approved PSA has no more temporal effect than a non-approved but executed PSA – why should a court entertain an approval motion or approve a PSA?
  - *See, e.g., In re Residential Capital, LLC,* 2013 WL 3286198 (Bankr. S.D.N.Y. June 27, 2013)
    - "[T]o be clear, approval of the PSA does *not* assure that a plan embodying its terms will be confirmed. Approval of the PSA does *not* bind the objecting parties or the Court from challenging … or rejecting … a plan substantially on the terms set forth in the PSA. Some of the objections raise difficult issues, but, unless they are consensually resolved, those are issues for another day."
    - "While the parties to the PSA agreed to support a plan consistent with the terms of the PSA and accompanying term sheets, the Agreement includes the right to withdraw support for a plan under a variety of circumstances. Perhaps most importantly, if the PSA is approved by the Court, it is an *interlocutory* order that provides no assurance that the Court will approve a reorganization plan on the terms provided in the PSA. The real impact of the PSA, after nearly one year with little progress in this large and complicated case, is that the case will move forward towards possible resolution."

    (emphasis added)
- Is court approval of PSAs negotiated by a limited group of purportedly sophisticated claimants without transparency intended to set the momentum of the chapter 11 case and subsume the section 1125 disclosure hearing and preordain confirmation?

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PSAs: The Next Step -- Court Approval

- Dangers of Plan Support Agreements Subject to Court Approval
  - May inhibit or extract limitations on the application of Bankruptcy Code provisions and principles, *e.g.*, ResCap, *supra*. The ResCap PSA precluded the court from unsealing the Examiner's Report prior to the approval of the PSA. The PSA specifically provided that an unsealing prior to PSA approval would cause the rescission of the described agreement in the PSA. In effect, the ResCap PSA limited the discretion of the bankruptcy court. Accepting the principle of the ResCap PSA, what would prevent PSA signatories from imposing other restrictions on the discretion and duties of the bankruptcy court because of the threat that the PSA would self-destruct?
  - Accepting the rationale of the ResCap decision approving the PSA as having no binding effect as to disclosure and confirmation of a chapter 11 plan, as well as the emphasis that the order of approval is an interlocutory order (3X) and, therefore, not appealable as of right – what was the necessity for the approval process? What was the danger of unsealing the Examiner's Report that sufficed to inhibit the free exercise of the bankruptcy court's powers and resulted in a 48-page opinion rationalizing the issuance of an interlocutory order? Would the lack of court approval of an executed PSA limits its bidning effect on the parties thereto? *See, e.g., Trans World Airlines, Inc. v. Texaco Inc. (In re Texaco Inc.)*, 81 B.R. 813, 815-818 (Bankr. S.D.N.Y. 1988)

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PSAs: The Next Step -- Court Approval

- Do court-approved PSAs predetermine the disclosure and confirmation process contemplated by the Bankruptcy Code?

- Consensual resolution of chapter 11 cases is a desired and salutary goal, but are there any limitations on consensual arrangements that may directly or indirectly conflict with statutory provisions or underlying principles of law?
  - *See, e.g.*, *Togut v. Deutsche Bank A.G. (In re Anthracite Capital Inc.),* 492 B.R. 162 (Bankr. S.D.N.Y. 2013). In the *Anthracite* case, Chief Judge Morris analytically denied a motion to seal certain documents relating to a compromise and settlement for a period of 30 years, despite the lack of opposition thereto and the condition of the major settling party that the requirement of sealing was "non-negotiable" and "no seal, no deal," as being in conflict with section 107 of the Bankruptcy Code and the public policy of open access to court documents. In effect, the court ruled that unanimous consent cannot override congressionally mandated duties and principles that must be implemented by bankruptcy courts. Consent must square with the statutory parameters of the Bankruptcy Code and applicable principles thereto.

The Enigmatic Plan Support Agreement and its Role in the Chapter 11 Epic

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Chapter 11, as enacted in 1978 to facilitate the reorganization of business organizations, contemplates a public collaboration in a collective process.[1] The objective of a chapter 11 case is a consensual plan of reorganization.[2] Consent is to be obtained through a process of negotiations among the debtor and the appointed creditors' committee, as the representative of the general unsecured creditors.[3] The negotiations are to lead to the formulation of a plan that would obtain the acceptances of the requisite majorities of the impaired creditors. These negotiations are prosecuted privately with the guidance of attorneys, financial advisors and other professionals. The process was conceived in a financial environment in which the great bulk of credit extended to a debtor was unsecured.[4]

Since the effective date of the Bankruptcy Code, the financing of businesses and the financial markets have changed radically.[5] In today's environment, most credit extended to businesses is secured by liens against and security interests in substantially all of the debtor's assets. The position of trade debt and unsecured debt has been significantly reduced. As a consequence, the negotiation and formulation of a chapter 11 plan have likewise changed.[6] The constituents involved in such negotiations have expanded to include an array of secured lenders, distressed debt traders, ad hoc groups or committees and, in some cases, committees of equity interest holders.[7]

During the first 30 or so years of chapter 11 cases under the Bankruptcy Code, the negotiations with the appointed creditors' committee usually resulted in an agreement as to the elements and proposed provisions of the chapter 11 plan. As a part of those negotiations and the ultimate agreement, the creditors' committee would agree to support the acceptance and confirmation of the plan and it was often understood that the members of the creditors' committee would, in turn, vote to

1 *See* Slides 6-7. *See also -Knepp v. Cred. Acceptance Corp. (In re Knepp)*, 229 B.R. 821, 844-45 (Bankr. N.D. Ala. 1999) ("[T]he Bankruptcy Code affords one forum for resolution of all disputes affecting the administration of the estate. The policy is to centralize all disputes for the benefit of all parties.").

2 *In re Dana Corp.*, 2007 WL 4589331, at *7 (Bankr. S.D.N.Y. Dec. 26, 2007) (stating that "the goal of consensual reorganization" is "embodied by the Bankruptcy Code"); *see also Stellwagen v. Clum*, 245 U.S. 605, 617 (1918) ("The federal system of bankruptcy is designed not only to distribute the property of the debtor, not by law exempted, fairly and equally among his creditors, but as a main purpose of the act, intends to aid the unfortunate debtor by giving him a fresh start in life, free from debts, except of a certain character, after the property which he owned at the time of bankruptcy has been administered for the benefit of creditors. Our decisions lay great stress upon this feature of the law — as one not only of private but of great public interest in that it secures to the unfortunate debtor, who surrenders his property for distribution, a new opportunity in life.").

3 *See* Slide 10.

4 *Id*.

5 *See* Slides 12-13.

6 The president of the National Conference of Bankruptcy Judges has remarked:

> "Today, most chapter 11 debtors are leveraged with secured debt far beyond asset values, often in complex tiers. They arrived at bankruptcy court close to, if not dead on arrival; hemorrhaging money with few prospects other than liquidation. A quick sale to the highest bidder is often promoted as the only option. The world of corporate finance has changed. Secured creditors and distressed debt traders who have purchased debt pre-petition are often in control of the Chapter 11 case. And they seek to advance their own agenda and interests; inter-creditor agreements that were entered into pre-petition purport to bind all parties.
>
> The prospects for unsecured creditors getting anything are abysmal. The Chapter 11 debtor in possession is often in a corner, and has agreed to terms and cash collateral and borrowing stipulations that are onerous and oppressive out of desperation. . . ."

Remarks of Hon. Joan Feeney (Bankr. D. Mass.) at public hearing of the ABI Commission to Study the Reform of Chapter 11, April 19, 2012, *available at* 31 Am. Bankr. Inst. J. *10 (June 2012).

7 See generally Harvey R. Miller & Shai Y. Waisman, *Is Chapter 11 Bankrupt?*, 47 B.C. L. Rev. 129 (December 2005) (describing the evolution of chapter 11); *see also* Slide 12.

accept the plan. This appeared to be fulfillment of the objective of consensus. However, generally, the members of the creditors' committee were not bound to accept the proposed chapter 11 plan. In effect, they could opt out of the committee's recommendation.[8]

The creditors' committee's support for the negotiated plan provisions was not subject to court approval, other than through the normal chapter 11 process of disclosure and confirmation. As chapter 11 cases became more complex and involved more constituents, and negotiations were conducted on multiple levels, parties became concerned about the effectiveness and closure as to the elements and provisions of the negotiated (and agreed-upon) chapter 11 plan. Plan proponents sought more definitive commitments.[9] However, they had to confront the disclosure and solicitation limitations imposed by the Bankruptcy Code.

The disclosure requirements of section 1125 of the Bankruptcy Code are intended to provide disclosure of adequate information that would be necessary to enable a claimant to make an informed judgment as to whether to accept or reject a chapter 11 plan.[10] Section 1125 prohibited solicitation of acceptances prior to the approval of a disclosure statement in accordance with that provision.[11] This represented a complication in connection with pre-disclosure statement plan support agreements. As bankruptcy courts have noted, the public aspects of a chapter 11 case are represented primarily by proceedings in the bankruptcy court that are very much like the tip of the iceberg.[12] Much of the chapter 11 administration is private and not exposed to public review until the approval of the disclosure statement.

Initially, the conundrum created by the conflicting interests of support agreements and disclosure and solicitation limitations was purportedly solved by the use of lock-up agreements. The terms of such agreements were intended to bind the claimant to vote to accept the proposed plan, provided that it contained the elements specified in the lock-up agreement.[13] The emergence of such agreements raised once again the issues of improper solicitation and circumvention of the chapter 11 process of disclosure and confirmation.[14] In the attempt to refute objections based upon inade-

8 *See* Slide 15.

9 *See* Slide 16. *See also Century Glove v. First Am. Bank of N.Y.*, 860 F.2d 94, 101-102 (3d Cir. 1988) finding that there is no "principled, predictable difference between negotiation and solicitation of future acceptances" and "reject[ing] any definition of solicitation which might cause creditors to limit their negotiations"); *In re Dow Corning Corp.*, 227 B.R. 111, 118 (Bankr. E.D. Mich. 1998) ("[N]egotiation over the terms of a plan and disclosure statement do not violate the prohibition of §1125(b). Rather, solicitation relates to the formal polling process through which plan acceptance or rejection is sought.") (internal citation omitted)

10 *See In re Indianapolis Downs, LLC*, 486 B.R. 286, 295 (Bankr. D. Del. 2013) (citing *In re Clamp-All Corp.*, 233 B.R. 198, 208 (Bankr. D. Mass. 1999) (noting that section 1125 of the Bankruptcy Code is designed to prevent the "undesirable practice . . . of soliciting acceptance or rejection at a time when creditors and stockholders were too ill-informed to act capably in their own interests").

11 *See* 11 U.S.C. 1125(b) ("An acceptance or rejection of a plan may not be solicited after the commencement of the case under this title from a holder of a claim or interest with respect to such claim or interest, unless, at the time of or before such solicitation, there is transmitted to such holder the plan or a summary of the plan, and a written disclosure statement approved, after notice and a hearing, by the court as containing adequate information. . . ."); *see also* Slides 17-18.

12 *See In re Bearingpoint, Inc.*, 453 B.R. 486, 493 (Bankr. S.D.N.Y. 2011) ("It's a cliché, but still a correct observation, that what we bankruptcy judges see in our chapter 11 cases is the tip of an iceberg. Much goes on in a chapter 11 case, and (even more so) in connection with the management of a chapter 11 debtor, that the judge never sees.")

13 *See* Slide 16.

14 *See, e.g.*, *In re NII Holdings, Inc.*, 288 B.R. 356 (Bankr. D. Del. 2002); *In re Stations Holdings Co., Inc.*,

quate information or changing circumstances, lock-up agreements included the so-called "fiduciary out."[15] This provision enabled the claimant to opt out of the "binding" commitment to support the chapter 11 plan and vote to accept it. The conditions enabling the exercise of the fiduciary out were specified in the lock-up agreement.

Because of the controversy as to the legality of lock-up agreements over a period of time, their popularity faded. The issue of plan support in the negotiations contemplated by chapter 11 persisted, particularly as cases got larger, more complex and involved more constituents. The normal practice of negotiating with claimants prevailed and plan proponents became more and more concerned with certainty in the proposal and acceptance of a chapter 11 plan. This led to the reemergence of lock-up agreements, but now characterized as plan support agreements.[16]

Plan support agreements are the result of the give and take negotiations that are inherent in chapter 11 cases. They represent an understanding among the negotiators, generally large and sophisticated claimants, as to the elements and provisions of the plan to be proposed. Purportedly they are based upon knowledge of the material facts pertaining to the plan proposal and represent a consensus among the parties thereto. In substance, they are very similar to the type of agreements that would be reached with a creditors' committee during the initial 30 years of chapter 11 administration under the Bankruptcy Code.

Over the recent past, plan support agreements have attained a significance beyond the normal understandings and agreements that were negotiated among a debtor, its creditors' committee and, sometimes, secured creditors. They are still subject to the requirements of the Bankruptcy Code in terms of solicitation, disclosure, etc.[17]

Plan support agreements do not require court approval.[18] They are deemed to be a part of the negotiating scheme of chapter 11. In the pursuit of more certainty and a more binding effect, a new approach is being taken as to plan support agreements – court approval!!! Plan support agreements have become more encompassing in spelling out the terms and conditions that would be incorporated into a chapter 11 plan, including, among other things, compromises and settlements of avoidance actions and other claims.[19]

The motivation to condition plan support agreements on court approval is not stated or obvious and

Case No. 02-10882, 2002 WL 31947022 (Bankr. D. Del. Sept. 30, 2002); *see generally* Daniel J. DeFranceschi, *Delaware Bankruptcy Court Announces Bright-Line Rule For Use of Lock-Up Agreements in Chapter 11 Cases,* 22 Am. Bankr. Inst. J. 16 (Feb. 2003).

15 *See* Slide 15.

16 *See In re The Heritage Org., LLC*, 376 B.R. 783, 792-93 (Bankr. N.D. Tex. 2007) (observing that a broad reading of "solicitation" would frustrate the purposes of the Bankruptcy Code); *see generally* Robert J. Keach, *A Hole in the* Glove*: Why "Negotiation" Should Trump "Solicitation,"* 22 Am. Bankr. Inst. J. 22 (June 2003)

17 *See, e.g.*, *In re Dow Corning Corp.*, 227 B.R. 111, 118 (Bankr. E.D. Mich. 1998) (noting that "negotiation over the terms of a plan and disclosure statement do not violate the prohibition of §1125(b)") (internal citation omitted).

18 *See Trans World Airlines, Inc. v. Texaco (In re Texaco)*, 81 B.R. 813 (Bankr. S.D.N.Y. 1988)

19 *See, e.g., In re Residential Capital, LLC*, 2013 WL 3286198 (Bankr. S.D.N.Y. June 27, 2013); *In re AMR Corp.*, Case No. 11–15463 (SHL) (Bankr. S.D.N.Y. June 4, 2013) (ECF #8577); *In re General Maritime Corp.*, Case No. 11–15285 (MG) (Bankr. S.D.N.Y. Apr. 2, 2012) (ECF #421); *In re Great Atl. & Pac. Tea Co.*, Case No. 10–24549 (RDD) (Bankr. S.D.N.Y. Dec. 19, 2011) (ECF #3060); *In re Chemtura Corp.*, Case No. 09–11233 (REG) (Bankr. S.D.N.Y. Aug. 9, 2010) (ECF #3527); *In re Tronox, Inc.*, Case No. 09–10156 (ALG) (Bankr. S.D.N.Y. Dec. 23, 2009) (ECF #1030); *see also* Side 21.

from one perspective might be deemed suspicious. What does the imprimatur of the court mean in approving a plan support agreement? Does a plan support agreement executed on behalf of a significant number of claimants (and amount of claims) subsume other requirements of the Bankruptcy Code such as disclosure, solicitation, etc.?[20]

If a plan support agreement has no binding effect as to the approval of compromises and settlements, adequacy of disclosure and similar provisions, what is the objective and effect of court approval?[21]

What are the consequences of court approval of a plan support agreement?

What are the remedies for breach of a court approved plan support agreement? Is the remedy for breach against a claimant limited to designation of the claimant's claim pursuant to section 1126(e) of the Bankruptcy Code? What is the remedy if the plan proponent breaches the court approved plan support agreement?[22]

Is the plan support agreement different than the informal agreement among the plan proponent and the creditors' committee to support the proposed plan and recommend acceptances of the plan to the committee's constituents?[23]

What is the function of the court in connection with a motion to approve and make binding a plan support agreement?

Is court approval of a plan support agreement prior to an approved disclosure statement and solicitation consistent with the provisions of the Bankruptcy Code?

The plan support agreement and the effect of its court approval is "a riddle wrapped in a mystery inside an enigma."[24]

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20 *See, e.g., Togut v. Deutsche Bank A.G. (In re Anthracite Capital Inc.)*, 492 B.R. 162 (Bankr. S.D.N.Y. 2013) (emphasizing the "strong presumption" and "public policy" in favor of public access to court records); *see also* Slide 23.

21 *See, e.g., In re Residential Capital LLC*, 2013 WL 3286198 (Bankr. S.D.N.Y. June 27, 2013); *see also* Slide 22.

22 *See* Slide 21.

23 *See* slides 20-24

24 *See* Winston Churchill, *His Wit and Wisdom; Selections from his Works and Speeches*, 136 (Hyperion Books) (from an October 1, 1939 broadcast).

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Senior/Subordinated Claims Issues

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I. Introduction

When borrowers tap the capital markets for debt financing, senior lenders may seek to protect their priority of repayment or recovery over junior lenders who are providing or may provide financing. Such junior lenders may include yield-hungry investors who are willing to accept a lower priority of repayment or recovery in exchange for higher interest rates on their loans. Thus, when two or more lenders extend credit to a common borrower or against common collateral, the lenders often use contractual subordination agreements, which may be embedded in an indenture or spelled out in an intercreditor agreement,[1] to establish their relative rights and remedies as to priority of repayment or recovery.

Because subordination agreements are intended to govern, among other things, two or more lenders' priority of repayment from a common borrower or recovery from common collateral, the effect of such agreements in bankruptcy is of utmost concern, as a besieged borrower is subject to competing claims over its assets. Indeed, even though a debtor may not be party to a dispute among creditors, the debtor is drawn into the conflict as the party responsible for proposing, in the first instance, a plan of reorganization or liquidation under title 11 of the United States Code (the "Bankruptcy Code"). Such plans are the primary means of lender repayment and recovery under chapter 11 of the Bankruptcy Code, so plan-related decisions made by the debtor are both informed by, and impact, the rights and entitlements of creditors and equity holders and the disputes surrounding them.

As a debtor[2] formulates its plan of reorganization or liquidation, one of the debtor's main responsibilities is classifying creditors' claims against, and equity holders' interests in, the debtor's estate. A debtor's classification decisions have wide-ranging consequences for the debtor and its creditors and equity holders. Classification is a key determinant in whether the debtor's plan may be confirmed, as holders of claims and interests vote to accept or reject the plan according to class. Classification also defines the parameters for distributions to creditors and equity holders under the plan. Subordination agreements may make classification itself trickier, as debtors do not have unfettered discretion to classify claims. Debtors must abide by certain provisions set forth in the Bankruptcy Code and developed by case law.

Subordination agreements add various twists to these generally applicable bankruptcy principles, including with respect to voting and distributions under a plan. While certain key questions regarding a plan begin with classification – whether there are sufficient acceptances to confirm the plan, whether there are enough rejections to block it, and what creditors and equity holders will recover from the debtor's estate – those questions become more complicated when creditors are party to subordination agreements.

[1] Intercreditor agreement and subordination agreement are used interchangeably herein.

[2] Following the expiration, by Court order or operation of statute, of the debtor's exclusive periods for filing a plan and soliciting acceptances thereto, other parties may file plans. For ease of reference, debtor is generally used herein, but the same principles hold true for any plan proponent.

Creditors vote on plans according to their class and in order to confirm a plan, confirmation requires the acceptance of one impaired class of claims, so a senior creditor may seek to ensure that a subordinated creditor respects the senior creditor's wishes regarding acceptance or rejection of a plan. A senior creditor's wishes regarding a plan could be thwarted (and potentially undermine the subordination agreement) if a subordinated creditor voted for a plan the senior creditor disfavored or against a plan the senior creditor favored. Thus, intercreditor agreements may contain a provision ensuring that the subordinated creditor does not vote inconsistently with the senior creditor or that assigns the subordinated creditor's voting rights to the senior creditor. Courts disagree on whether such provisions are enforceable in bankruptcy.

Before delving into Courts' consideration of classification and voting assignments in the context of subordination agreements, some background on subordination agreements is helpful.

A. Relevant statute

1. Section 510(a) of the Bankruptcy Code provides that "[a] subordination agreement is enforceable in a case under [the Bankruptcy Code] to the same extent that such agreement is enforceable under applicable nonbankruptcy law." 11 U.S.C. § 510(a).

2. Courts generally look to state contract law to determine the enforceability of subordination agreements. *See, e.g.*, *In re Plymouth House Health Care Ctr.*, 2005 WL 2589201, at *6 (Bankr. E.D. Pa. March 15, 2005) ("Non-bankruptcy law, typically state law, would govern any dispute concerning the enforceability of a subordination agreement.") (citation omitted); *In re Best Prods. Co.*, 168 B.R. 35, 69 ("The applicable non-bankruptcy law to which Section 510(a) refers is that of contracts. . . . [U]nder New York law, when a contractual subordination agreement is unambiguous, the parties' rights are governed exclusively by that agreement and the words of that agreement are given their plain, ordinary and usual meaning.") (citations omitted).

a. Subordination agreements often contain provisions – beyond mere arrangement of priorities – that seek to bolster senior creditors' priority rights by abridging certain bankruptcy rights of subordinated creditors, including their right to vote on a plan. Courts disagree on whether, in bankruptcy, a subordination agreement may do anything more than arrange priorities.

b. Commentators have noted the difficultly in looking to state law to determine if certain provisions of subordination agreement are enforceable in bankruptcy: "[T]here are seldom any state laws that address enforcement of the waiver or assignment in a subordination agreement of a subordinate lender's ancillary bankruptcy rights [*e.g.*, voting rights]. State courts can be expected to have addressed enforcing the relative priorities to payment or to collateral as between the senior and subordinated lenders, but given that they don't have jurisdiction over bankruptcy cases, and that most contested business reorganizations take place in bankruptcy court rather than state court, it is not realistic to expect that state courts have ever addressed, or will in the future ever address, the enforceability of an ancillary bankruptcy right, i.e. a right that should be peculiar to the bankruptcy case and a right granted by the Bankruptcy Code, and, therefore, not be addressed in state court." Mark N. Berman and David

Lee, *The Enforceability in Bankruptcy Proceedings of Waiver and Assignment of Rights Clauses Within Intercreditor or Subordination Agreements*, 20 J. BANKR. L. & PRAC. 6 Art. 1, Nov. 2011, at § I.A.3 [hereinafter Berman, *Enforceability*] (citation omitted). In addition, to the extent a state did seek to address a bankruptcy matter without it being a general principle of state contract law, "the Supremacy Clause of the U.S. Constitution would dictate that such law cannot apply because it has been superseded by the Bankruptcy Code in the context of a bankruptcy case." *Id*. at § II.A; *see also infra* n.13 (discussion of postpetition interest).[3]

c. On the other hand, commentary has also noted that "[o]nly occasionally is a bankruptcy court asked to look at an intercreditor agreement to determine a matter of strict priority as between the senior and junior lenders. While cases addressing distribution priority can be interesting and instructive for those who draft future intercreditor agreements, they do not often impact the reorganization process, the prospects for the debtor's business or have an impact on creditors of the debtor who are not party to the intercreditor agreement." Berman, *Enforceability*, *supra*, at § II (citing, *inter alia*, *In re Dura Auto. Sys., Inc.*, 379 B.R. 257 (Bankr. D. Del. 2007) and *In re Bank of New Engl. Corp.*, 364 F.3d 355, 361 (1st Cir. 2004), discussed below).

B. What is being subordinated?

1. Subordination agreements arrange creditors' rights to repayment from a common borrower or their rights to recovery from common collateral. The subordination of one creditor's right to repayment to another creditor's right to repayment from the same borrower is known as debt or claim subordination. The subordination of one creditor's right to recovery to another creditor's right to recovery from same collateral is known as property interest or lien subordination.

2. One Bankruptcy Court has explained the two types of subordination as follows:

a. **Debt (claim) subordination**. "In a debt subordination, the agreement provides that the subordinated creditor's right to payment and collection will be subordinate to the rights of another claimant. If the debt subordination is 'complete,' the subordinated creditor is barred from receiving payments until the superior debt is paid in full." *In re Lantana Motel*, 124 B.R. 252, 255-56 (Bankr. S.D. Ohio 1990).

b. **Debt (claim) subordination v. property interest (lien) subordination**. "Debt subordination should be contrasted to property interest subordination. In a property

[3] Commentators have observed the difficulty in predicting how a Court will interpret provisions in subordination agreements that affect ancillary bankruptcy rights when the drafting is not clear. The choice of law provision in a subordination agreement or intercreditor agreement matters, as different states have different rules of contract interpretation. "For example, Judge Chapman in [*In re Boston Generating, LLC*, 440 B.R. 302, 319 (Bankr. S.D.N.Y. 2010)] was constrained by New York State law that required a restriction on the subordinated lenders to be 'express or intentional.' . . . Judge Jernigan in [*In re Erickson Ret. Cmties., LLC*, 425 B.R. 309, 314 (Bankr. N.D. Tex 2010)] reviewed the applicable subordination agreements under Maryland law where the guiding principle was 'what a reasonable person in the same position would have understood as the meaning of the agreement.'" Berman, *Enforceability*, *supra*, at § I.A.3.

interest subordination, the agreement affects only the relative rights of parties in particular real or personal property. Property interest subordination does not concern any rights the parties may have to receive payments." *Id*. at 256.

c. **Property interest (lien) subordination**. "The most common type of property interest subordination is lien subordination. By executing a lien subordination agreement, the subordinating party agrees to demote the priority of its lien to that of another secured creditor, thereby delaying its recourse to the identified collateral until the other party's secured claim has been satisfied. In a pure lien subordination, the subordinating party's right to receive payments is not limited." *Id*.

d. **Complete v. partial lien subordination**. The majority approach to lien subordination is "partial subordination," which "simply swaps the priorities of the parties to the subordination agreement . . . thus leaving nonparties unaffected by it." *Caterpillar Fin. Servs. Corp. v. Peoples Nat. Bank, N.A.*, 710 F.3d 691, 693-94 (7th Cir. 2013). By contrast, the minority approach to lien subordination is "complete subordination," which "drop[s] the subordinating creditor to the bottom of the priority ladder." *Id*. at 693. Complete subordination may, therefore, benefit a nonparty to the subordination agreement. *See id*.

C. Sample subordination provisions and related rights

1. Debt subordination

a. Subordinated debt, typically unsecured, is often governed by subordination provisions in the debt instrument itself. The following is a sample "agreement to subordinate" provision that could be found in a subordinated note indenture:

> The issuer agrees, and each holder by accepting a note agrees, that the payment of principal of, premium, if any, and interest on, and all other amounts payable in respect of, the notes is subordinated in right of payment, to the extent and in the manner provided in this section/article, to the prior payment when due in cash of all senior indebtedness of the issuer and that the subordination is for the benefit of and enforceable by the holders of such senior indebtedness. The notes shall in all respects rank *pari passu* with any future senior subordinated indebtedness and senior to all existing and future subordinated indebtedness of the issuer, and only senior indebtedness shall rank senior to the notes in accordance with the provisions set forth herein.

b. As demonstrated in this sample provision, a "subordinated" claim can be subordinate with respect to one claim, yet senior to another claim. Subordinated debt claims will typically be *pari passu* with general unsecured claims that are not within the definition of "senior indebtedness" (*e.g.*, trade payables), although this is not always the case. Some Courts have approved the separate classification of subordinated debt claims from other general unsecured debt.

c. Debt subordination provisions generally require the subordinated claim holder to turn over to the senior claim holder all payments received from the borrower until the senior claim holder is paid in full. It is also common for debt subordination provisions to include triggers that stop further payments to subordinated claim holders until the senior claim holder is paid in full. These provisions may lead to subordinated debt holders receiving lower recoveries than other general unsecured claims and may serve as the basis for classifying subordinated debt claims separately from not only senior debt claims but also general unsecured claims.

i. An X-clause may provide a limited exception to the right of senior claim holders to be paid in full, in cash, prior to a distribution to subordinated claim holders, provided that the form of distribution to the subordinated claim holder is subordinated equity or subordinated debt in the reorganized debtor issued pursuant to a plan of reorganization. X-clauses (addressed in more detail below) are strictly construed such that they do not undermine subordination agreements.

2. <u>Lien subordination</u>

a. Lien subordination is typically governed by an intercreditor agreement that, among other things, sets the relative priorities of senior and junior lien holders to common collateral. It does not encompass a general subordination of the claim. While terms of intercreditor agreements vary widely, some variation of the following lien priority language can be found in virtually every intercreditor agreement:

> All junior liens in respect of any collateral are expressly subordinated and made junior in right, priority, operation and effect to any and all senior liens in respect of such collateral, notwithstanding anything contained in this agreement, the term documents, the credit facility documents or any other agreement or instrument to the contrary, and irrespective of the time, order or method of creation, attachment or perfection of such junior liens and senior liens or any defect or deficiency or alleged defect or deficiency in any of the foregoing.

b. Lien subordination differs from debt subordination as to treatment of the underlying claims.

i. The underlying claims of the junior lien holder are not typically junior in priority to the underlying claims of the senior lien holder, and would thus be *pari passu* with respect to any unsecured deficiency claim of the senior lien holder. This may serve as the basis for classifying certain claims of senior and junior lien holders together under a plan of reorganization. If the total amount of senior lien debt exceeds the value of common collateral, the senior lien holders could have unsecured deficiency claims diluted by large unsecured claims of junior lien holders.

ii. The junior lien holder generally is not required to turn over to the senior lien holder all payments received from the obligor until the senior lien holder is paid in full. Instead, the junior lien holder is required to turn over only the proceeds of common collateral it may receive. Junior lien holders also may not be subject to payment stoppage provisions.

iii. Notwithstanding these principles of lien subordination, many intercreditor agreements also contain debt subordination terms. *See* J. Eric Wise and Theodore Sica, *X Clauses: Meaning and Mutations*, BLOOMBERG LAW REPORTS – BANKRUPTCY LAW, Vol. 4, No. 45, Nov. 8, 2010, at 3 [hereinafter Wise, *X Clauses*]; *see also* discussion of *In re 203 N. LaSalle St. L.P.*, 246 B.R. 325 (Bankr. N.D. Ill. 2000) below.

c. Intercreditor agreements often contain extensive limitations on the rights of junior lien holders, including, among other things, giving senior lien holders the exclusive right to all proceeds of common collateral until they have been paid in full and prohibiting junior lien holders from challenging the priority, perfection, validity, or enforcement of the senior lien holders' liens.

i. These provisions may have significant overlap. Because an intercreditor agreement governs priority of recovery from common collateral, what constitutes common collateral is important. Moreover, the arrangement of priorities remains important even if purported collateral is later found to be unencumbered. In *In re Ion Media Networks*, 419 B.R. 585 (Bankr. S.D.N.Y. 2009), a junior lien holder challenged the validity of the senior lien holders' liens on, and the priority of their claims to, certain FCC licenses that were part of the collateral package granted to the senior lien holders, notwithstanding the intercreditor agreement's prohibition on junior lien holders challenging relative priorities to the collateral, including as to any liens "purportedly securing" the secured obligations. *Id*. at 593-94. The junior lien holder argued that if the liens on the FCC licenses were invalid and not part of the collateral package, then all creditors, including the senior and junior lien holders, would share in recoveries from the proceeds or economic value of the unencumbered FCC licenses on a *pari passu* basis. *Id*. at 594 n.10. The Court held that the use of the term "purportedly securing" to describe the universe of liens evidenced the lien holders' intent to establish their rights vis-à-vis each other, regardless of whether the liens were themselves valid. *Id*. at 594. The Court further held that the intercreditor agreement demonstrated that the junior lien holders agreed to be "silent" as to any dispute regarding the validity of the liens and conclusively accepted their relative priorities regardless of whether a lien was ever properly granted in the FCC licenses. *Id*. The Court concluded that under the intercreditor agreement, the lien holders allocated among themselves the economic value of the FCC licenses as "collateral" (regardless of the actual validity of liens in the licenses), so the claims of the senior lien holders were entitled to a higher priority and to the proceeds of the property whether or not a lien could be properly perfected. *Id*. at 595.

d. In addition, intercreditor agreements frequently contain "bankruptcy waivers," pursuant to which the junior lien holder agrees to waive certain rights given to creditors under the Bankruptcy Code. Among other things, junior lien holders may waive their rights to vote in favor of a chapter 11 plan not supported by the senior lien holders or vote against a chapter 11 plan supported by the senior lien holders under all circumstances. Junior lien holders may also assign their plan voting rights to senior lien holders. Courts disagree as to whether these voting-related provisions of intercreditor agreements are enforceable in bankruptcy. Voting-related provisions are discussed more fully below.

II. Classification

Under the Bankruptcy Code, claims may only be classified together if they are "substantially similar." Claims may not be classified together if they are not "substantially similar." Subordination agreements raise various questions when it comes to classifying the claims that are subject to them. Generally, Courts have approved separate classification of senior and subordinated claims based on their different legal rights. For the same reason, Courts have approved separate classification of subordinated claims from general unsecured claims. Some Courts, however, have approved classifying senior and subordinated claims together on the basis that their legal rights as to the debtor are the same, while the subordination agreement governs their legal rights as to each other. If subordinated creditors are bound by a voting rights provision in the subordination agreement, classification of subordinated creditors may become consequential or meaningless.

Later in these materials, we posit some of these scenarios. First, this section discusses certain key classification concepts.

A. Relevant statute

1. Section 1122(a) provides, in relevant part, that "a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class." 11 U.S.C. § 1122(a).

2. Section 1122(a) is mandatory in that *only* substantially similar claims may be classified together. *In re Tribune Co.*, 476 B.R. 843, 854 (Bankr. D. Del. 2012); *Matter of Jersey City Medical Ctr.*, 817 F.2d 1055, 1060 (3d Cir. 1987) (express language of section 1122(a) explicitly forbids a plan from placing dissimilar claims in the same class).

3. Section 1122(a) is permissive in that it does not require that all similar claims be placed together in the same class. *Tribune*, at 854-55 (citations omitted); *In re Drexel Burnham Lambert Group, Inc.*, 138 B.R. 714, 715 (Bankr. S.D.N.Y. 1992) (section 1122(a) does not require that similar classes be grouped together, but merely that any group be homogeneous).

4. Plan proponents and Bankruptcy Courts have considerably broad discretion in deciding how to classify claims. *In re W.R. Grace & Co.*, 475 B.R. 34, 109-10 (D. Del. 2012) (citation omitted); *In re Loop 76, LLC*, 465 B.R. 525, 536 (9th Cir. B.A.P. 2012) ("The court has broad discretion in classifying claims under section 1122(a)."); *In re Charter Commc'ns*, 419 B.R. 221, 264 n.35 (finding that the debtors "enjoy considerable discretion when classifying similar claims in different classes").

5. This discretion is not unlimited, however: "Although the proponent of a plan of reorganization has considerable discretion to classify claims and interests according to the facts and circumstances of the case, this discretion is not unlimited. '[T]here must be some limit on a debtor's power to classify creditors . . . The potential for abuse would be significant otherwise.'" *In re Holywell Corp.*, 913 F.2d 873, 880 (11th Cir. 1990) (quoting *In re U.S. Truck Co., Inc.*, 800 F.2d 581, 586 (6th Cir.1986)).

6. Courts have articulated different principles for limiting separate classification of similar claims, with the primary concern being gerrymandering – separate classification of claims solely to obtain acceptance of a plan by an impaired class to satisfy the requirements of section 1129(a)(10).

a. **No gerrymandering**. "One clear rule . . . emerges from otherwise muddled caselaw on § 1122 claims classification: thou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan." *Matter of Greystone III Joint Venture*, 995 F.2d 1274, 1279 (5th Cir. 1991) ("[I]f § 1122(a) permits classification of 'substantially similar' claims in different classes, such classification may only be undertaken for reasons independent of the debtor's motivation to secure the vote of an impaired accepting class of claims.").

b. **Reasonableness**. "Even though similar claims may be placed in separate classes, plan proponents cannot do so when it would be unreasonable. . . . When the sole purpose and effect of creating multiple classes is to mold the outcome of the voting to effectuate a 'cram down,' each class must represent a voting interest that is sufficiently distinct and weighty to merit a separate voice in determining whether the proposed reorganization should proceed." *In re Coram Healthcare Corp.*, 315 B.R. 321, 349 (citing *In re Route 37 Bus. Park Assocs.*, 987 F.2d 154, 158-59 (3d Cir. 1993)); *In re Boston Post Road Ltd. P'ship*, 21 F.3d 477, 483 (2d Cir. 1994) ("[S]eparate classification of unsecured claims solely to create an impaired assenting class will not be permitted; the debtor must adduce credible proof of a legitimate reason for separate classification of similar claims.").

c. **Business or economic justification**. "[I]f the claims are substantially similar, the plan may place such claims in different classes if the debtor can show a business or economic justification for doing so." *Loop*, 465 B.R. at 536 (citing *In re Barakat*, 99 F.3d 1520, 1526 (9th Cir. 1996)).

d. **"Restrictive" classification**. "[I]t is reasonable for the plan proponent to classify claims separately only if these claims are not 'substantially similar.' . . . If the plan proponent can articulate differences among the claims – that is, if the plan proponent can demonstrate the lack of 'substantial similarity' – then separate classification is proper. . . . The significant aspect of the 'restrictive classification' analysis is that the inquiry focuses objectively upon the claims themselves, not upon the plan proponent's subjective intent." *In re Bloomingdale Partners*, 170 B.R. 984, 997 (Bankr. N.D. Ill. 1994) (citations omitted).[4]

7. In confirmation orders, Courts will generally find a plan classification to be reasonable if it is based on the respective legal rights of each holder of a claim or interest and/or the priorities set forth in the Bankruptcy Code and if the classifications were not proposed to create a consenting impaired class or to manipulate class voting. *See In re Cano Petroleum, Inc.*, 2012 WL 2931107, *5 (Bankr. N.D. Tex. July 18, 2012); *see also In re Station Casinos, Inc.*, 2011 WL 6012089, at ¶ 117 (Bankr. D. Nev. July 28, 2011) (finding that the debtors posited good business reasons for separate classification, certain of the classes had substantially differing legal rights that may require separate classification, there did not appear to be any evidence that the separate classification was intended to effect an economic advantage for the debtors or any group of creditors over another, and there was no evidence of any intent to gerrymander a class for the purpose of creating an impaired accepting class).

8. Naturally, this leads to the question of what is "substantially similar," which is not defined in the Bankruptcy Code. According to the Court in *Loop*, determining whether claims are "substantially similar" is the threshold inquiry in the application of section 1122(a), but many Courts conflate the two-prong classification analysis, "often glossing over the first prong of determining whether the claims are substantially similar, and proceeding to the second prong to determine whether gerrymandering has occurred or whether the plan proponent showed a business or economic justification for separately classifying similar claims." *Loop*, 465 B.R. at 536-37. The *Loop* Court noted the "paucity of case law defining what constitutes either similarity or substantial similarity of claims." *Id.* at 537 (internal quotation marks and citation omitted).

B. Are claims subject to subordination agreements "substantially similar"?

1. Given the "paucity of case law defining what constitutes either similarity or substantial similarity of claims," *Loop*, 465 B.R. at 537, Courts considering the substantial similarity of claims subject to subordination agreements tend to look to general principles of "substantial similarity" that Courts have articulated.

2. "[T]he focus of the classification is the legal character of the claim as it relates to the *assets of the debtor*. . . . It is the 'nature' of their claims being classified that is significant, not the nature of other claims or interests a debtor might have. . . . The existence of a third-party guarantor does not change the nature of a claim vis-à-vis the bankrupt estate and, therefore, is irrelevant to a determination of whether claims are

[4] The *Bloomingdale* Court criticized the "flexible classification" standard, of which it stated *In re ZRM-Oklahoma P'ship*, 156 B.R. 67 (Bankr. W.D. Okla. 1993) represented the most permissive view. *Bloomingdale*, 170 B.R. at 991-94. The *ZRM* Court found that the language of section 1122(a) "prohibits single classification of dissimilar claims. The plain language of this statute does not alone support any other restriction." *ZRM*, 156 B.R. at 70. The *ZRM* Court further found that section 1122(a) "allow[s] a wide range of possible classifications limited by other explicit protection mechanisms in the [Bankruptcy] Code which Congress agreed to in sections 1111, 1123, and 1129." *Id.* at 71. The *ZRM* Court's view of classification appears to represent a minority approach.

'substantially similar' for classification purposes." *In re AOV Indus., Inc.*, 792 F.2d 1140, 1150-51 (D.C. Cir. 1986) (emphasis in original); *see also Coram*, 315 B.R. at 321("A proper determination of whether claims are "substantially similar" focuses on the nature of the claims . . . . The primary analysis centers upon the legal attributes of the claims and not upon the status or circumstances of the claimant. Emphasis is not upon the holder so much as it is upon that which is held.") (internal quotation marks and citations omitted); *but see Loop*, 465 B.R. at 536, 540 ("To determine if claims are 'substantially similar . . . bankruptcy judges must evaluate the nature of each claim, i.e., the kind, species, or category of claims.' . . . [W]hether a claim is substantially similar does not rest entirely on how it relates to 'assets of the debtor.'") (quoting *In re Johnston*, 21 F.3d 323, 327 (9th Cir. 1994)) (internal quotation marks and citation omitted).[5]

3. Courts have generally found that it is proper to classify senior and subordinated claims separately because of the different legal rights of senior and subordinated debt with respect to a debtor's assets.

a. In *In re Reid Park Properties, L.L.C.*, 2012 Bankr. LEXIS 3316 (Bankr. D. Ariz. July 18, 2012), the debtor classified the claims of two notes secured by the same collateral in the same class. Pursuant to the notes, one of them was subordinate to the other, and the noteholders were parties to an intercreditor agreement. The Court found that the claims of the noteholders were separate claims under which each noteholder held a separate note with different payment amounts, despite the fact that they were secured by the same collateral. *Id*. at *4. The Court also found that due to the value of the collateral, the senior noteholder's claim was partially secured, and the subordinated noteholder's claim was completely unsecured. *Id*. at *5. Accordingly, the Court concluded that the claims were not substantially similar and could not be classified together. *Id*.

b. *In re Station Casinos, Inc.*, 2011 WL 6012089, at ¶¶ 115, 117 (Bankr. D. Nev. July 28, 2011) (finding it appropriate to separately classify subordinated note claims from senior note claims due to contractual subordination and because classes had substantially different legal rights that may require separate classification).

c. *In re Easy St. Holding, LLC*, 2010 Bankr. LEXIS 5539, *8 (Bankr. D. Utah July 2, 2010) (finding the separate classification of claim in a certain class to be "valid and

[5] The Court in *Loop* concluded that controlling Ninth Circuit authority (*Johnston*) allows the Bankruptcy Court to consider the existence of a third-party source for payment, including a guarantor, when determining whether unsecured claims are substantially similar under section 1122(a). *Loop*, 465 B.R. at 541. The *Loop* Court stated that *Johnston* rejected a narrow definition of "nature" of the claim (*i.e.*, "an analysis of the legal character or the quality of the claim as it relates to the assets of the debtor") by holding that, at a minimum, a Bankruptcy Court may consider sources outside of the debtor's assets, such as the potential for recovery from a nondebtor or non-estate source. The *Loop* Court, therefore, rejected an undersecured creditor's argument that a third-party guarantor did not render its deficiency claim dissimilar from other unsecured claims. *Id*. at 540 (internal quotation marks and citation omitted). *Loop* articulates the minority position, as "[t]he majority of courts that have considered this issue have held that the existence of a personal guarantee, alone, is not a sufficient basis to find that an unsecured deficiency claim is not substantially similar to other unsecured creditors." *In re 18 RVC, LLC*, 485 B.R. 492, 497 (Bankr. E.D.N.Y. 2012) (citing, *inter alia*, *AOV*, 792 F.2d at 1150-51).

reasonable because the holders of [such] claims executed valid subordination agreements, which expressly subordinated those claims to the claim of" the senior secured creditor).

d. *In re Hawaiian Telecom Commc'ns, Inc.*, 430 B.R. 564, 591 (Bankr. D. Haw. 2009) (finding that senior note claims are not "substantially similar" to subordinated note claims because holders of senior notes claims are entitled to receive payment in full in cash before holders of subordinated notes claims are entitled to receive or retain payment or distribution of any kind or character).

e. *In re Kaiser Aluminum Corp.*, 2006 WL 616243, *13 (Bankr. D. Del. Feb. 6, 2006) (finding that senior subordinated note claims in certain subclass are legally distinct from other claims and interests and are properly classified in separate subclass in light of contractual subordination provisions contained in senior subordinated indenture).

f. *In re American White Cross, Inc.*, 269 B.R. 555, 558-59 (D. Del. 2001) (affirming Bankruptcy Court's denial of creditor's motion to intervene as futile based on Bankruptcy Court's holding that creditor waived its right to enforce a contractual subordination provision by voting to approve a plan that set an equivalent priority (*i.e.*, same classification) for purportedly subordinated claim, because, although section 510(a) provides that subordination provisions will be enforced in bankruptcy, the Bankruptcy Court found that the legislative history of section 510(a) and bankruptcy practice both support its conclusion that subordinated claims are usually addressed in bankruptcy by creating separate classes of creditors or other treatment).

g. *In re Walnut Equip. Leasing Co., Inc.*, 1999 WL 1068448, *1 n.4 (Bankr. E.D. Pa. Nov. 23, 1999) (stating in *dicta* that "I find it rather obvious that holders of subordinated debt do not have claims substantially similar to the holders of senior debt").

h. *In re Envirodyne Indus., Inc.*, 1993 WL 566565, *32 (Bankr. N.D. Ill. Dec. 20, 1993) (finding that the plan placed only substantially similar claims within classes and that the disparate treatment of the various classes of unsecured claims against the debtor appropriately effectuated the subordination provisions of various indentures governing the treatment of those claims and was reasonable and necessary to implement the plan).

i. *In re Richard Buick, Inc.*, 126 B.R. 840, 853 (Bankr. E.D. Pa. 1991) ("many courts have concluded that secured creditors may not be classified together when they . . . possess liens of different priority in the same property, since their respective legal rights are not substantially similar") (collecting cases, including *In re Holthoff*, 58 B.R. 216, 219 (Bankr. E.D. Ark. 1985) (finding certain claims misclassified because classes were defined so that more than one secured creditor with liens on the same property, but with different priorities, were in the same class)).

4. Some Courts, however, have permitted classification of senior and subordinated claims together, such as in a class of general unsecured creditors, finding that an agreement among creditors to subordinate recoveries between themselves does not affect the creditors' status as to the debtor.

a. *In re Union Fin. Servs. Group*, 325 B.R. 816, 821 n.3 (Bankr. E.D. Mo. 2004) (finding that subordinated claim was properly classified, as all claims in class were substantially similar (*i.e.*, unsecured nonpriority) and fact that claim was subordinated to other class members did not change fact that as between creditor and debtor, claim was unsecured nonpriority).

b. *In re Piece Goods Shops Co., L.P.*, 188 B.R. 778, 788 (Bankr. M.D.N.C. 1995) (finding that it did not matter that one creditor agreed to subordinate a portion of its unsecured claim to the unsecured claims of another creditor, as such subordination, among other things, did not place the creditor's claim in a rank or status different from other unsecured claims vis-à-vis the debtors).

5. Courts have also held that classification of subordinated claims separately from other general unsecured claims is proper because other general unsecured claims are not subordinated in full to payment of senior claims.

a. In *In re Coastal Broad. Sys., Inc.*, 2013 WL 3285936, *4 (D. N.J. June 28, 2013), the District Court affirmed the Bankruptcy Court and found that there was nothing unreasonable about placing the claims of appealing creditors, whose claims against the debtor and liens on the assets of the debtor were subordinated to the claims of another creditor pursuant to a subordination and intercreditor agreement, in a separate class from other unsecured creditors, "given that their claims, unlike other unsecured creditors' claims, were uniquely subject to subordination, as well as the agreement's voting rights provision."[6]

b. *In re Greate Bay Hotel & Casino, Inc.*, 251 B.R. 213, 225-26 (Bankr. D. N.J. 2000) (approving separate classification of subordinated noteholders' claims from general unsecured creditors' claims, based on lack of substantial similarity, because subordinated noteholders were subordinated to payment in full of senior noteholders, who were not being satisfied in full by plan).

c. *In re General Homes Corp.*, 134 B.R. 853, 863-64 (Bankr. S.D. Tex. 1991) (finding that subordinated noteholders' claims were subordinated to all other non-subordinated unsecured creditors' claims by unambiguous definition of "senior debt" in indentures).

6. Courts have approved separate classification of claims which the holders voluntarily subordinated for plan purposes, in the absence of a subordination agreement, in order to differentiate them from other claims.

[6] The Court also found that because of the assignment of the appealing creditors' voting rights to the senior creditor, shifting their claims from their own class to the class of general unsecured class would be "merely a change in label," as the senior creditor and the general unsecured class had voted to accept the plan. *Id*.

a. In *In re Nickels Midway Pier, LLC*, 452 B.R. 156, 164-65 (D. N.J. 2011), a non-debtor plan proponent classified itself as the only impaired interest, giving it the sole vote to confirm the plan. The District Court affirmed the separate classification of the proponent in its own class over the debtor's objection that the claim should be classified with all other general unsecured creditors' claims. The plan proponent had consented to subordinate its claim to all other creditors, which the Court found rendered the separate classification reasonable and not arbitrary. *Id*. at 165. Previously, the Bankruptcy Court found that even if the plan proponent had been classified with the other general unsecured creditors and voted to accept the plan, such class would have become an impaired accepting class because the proponent's claim far outweighed the other claims in the class. *In re Nickels Midway Pier, LLC*, 2010 WL 2034542, *8 (Bankr. D. N.J. May 21, 2010).

b. In *In re River Valley Fitness One L.P.*, 2003 Bankr. LEXIS 1252 (Bankr. N.H. Sept. 19, 2003), the proponent of an opposing plan objected to the debtor's separate classification of a bank that had voluntarily subordinated the repayment of its claim to other unsecured creditors. The Court, however, found the separate classification permissible because the "rank, legal character and status" of the bank's claim was different from other unsecured claims. *Id*. at *26-27. As to the gerrymandering argument made by the proponent of the opposing plan, the Court was unable to find an "unlawful purpose" in the act of separately classifying a claim that had essentially subordinated its rights to that of the general unsecured creditors. *Id*. at *27-28. The Court also did not find such classification to be an improper manipulation, as the bank's separate class was not essential to confirmation because the general unsecured creditors' class had also voted for the debtor's plan. *Id*. at *28.

C. Why is classification important?

1. <u>Plan confirmation</u>

a. **<u>Confirmation requirements</u>**. The manner in which claims are classified has a significant impact on confirmation of the plan. Section 1129(a) contains the requirements for plan confirmation, including the requirement that the plan comply with the applicable provisions of the Bankruptcy Code. 11 U.S.C. § 1129(a)(1). This requirement, therefore, incorporates section 510(a), which provides that "[a] subordination agreement is enforceable in a case under [the Bankruptcy Code] to the same extent that such agreement is enforceable under applicable nonbankruptcy law."

b. **<u>Impaired accepting and rejecting classes</u>**. In order for a plan to be confirmed, each impaired class of claims or interests must accept the plan. 11 U.S.C. § 1129(a)(8). In spite of this requirement, as long as one impaired class of claims or interests accepts the plan, 11 U.S.C. § 1129(a)(10), the plan may still be confirmed by "cramming down" the impaired classes of claims or interests that rejected the plan. 11 U.S.C. § 1129(b).

i. Generally, the more impaired classes that are created, the greater the likelihood that there will be a class that rejects the plan. Conversely, the more impaired classes the greater the likelihood that the debtor will be able to satisfy the requirement of there being an impaired accepting class.

ii. Because of the cram down requirement that there must be one impaired accepting class, Courts are particularly sensitive to proper classification, as improper classification may enable a debtor to confirm a plan through cram down that it could not confirm if claims were properly classified. *See, e.g., U.S. Truck,* 800 F.2d at 586 (the debtor is "using its classification powers to segregate dissenting (impaired) creditors from assenting (impaired) creditors (by putting the dissenters into a class or classes by themselves) and, thus, it is assured that at least one class of impaired creditors will vote for the plan and make it eligible for cram down consideration by the court").[7]

c. **<u>Cram down</u>**. Even if there is an impaired accepting class (*e.g.*, senior lien holders), cram down may neutralize the benefits provided by a subordination agreement. While a cram down plan must meet all of the requirements of section 1129(a) except for section 1129(a)(8), that prerequisite is preceded by the words, "[n]otwithstanding section 510(a) of [the Bankruptcy Code]," 11 U.S.C. § 1129(b)(1), which Courts have found may provide a carve out from the requirement that, pursuant to section 1129(a), the plan comply with section 510(a) (*i.e.*, an "applicable provision" of the Bankruptcy Code).[8]

i. The Court in *In re TCI 2 Holdings, LLC,* 428 B.R. 117, 139-41 (Bankr. D. N.J. 2010) overrruled senior lien holders' objection to confirmation of a cram down plan that the senior lien holders' argued violated an intercreditor agreement, causing the plan to be unconfirmable as violative of section 510(a). The Court did not decide if there was a violation of the intercreditor agreement but held that even if there were such a violation, it would not impede confirmation of the plan: "The only logical reading of the term 'notwithstanding' in section 1129(b)(1) seems to be: 'Even though section 510(a) requires the enforceability of subordination agreement in a bankruptcy case to the same extent that the agreement is enforceable under nonbankruptcy law, if a nonconsensual plan meets

[7] A related issue concerns the separate classification of an undersecured creditor's deficiency claim, created under section 1111(b), from other general unsecured creditors' claims which, without such deficiency claim, may constitute an impaired accepting class: "In determining whether a plan may classify an undersecured creditor's deficiency claim separately from other general unsecured claims, the overwhelming majority of courts have not allowed dissimilar treatment or voting distinctions based on separate classification. These courts reject separate classification as an impermissible attempt to 'gerrymander' classes to create an impaired class of claims that will vote in favor of the plan in order to satisfy section 1129(a)(10), which requires at least one impaired accepting class to confirm a plan." *In re SunCruz Casinos, LLC,* 298 B.R. 833, 837 (Bankr. S.D. Fla. 2003) (collecting cases).

[8] In addition, to confirm a cram down plan, the plan must not discriminate unfairly, and it must be fair and equitable with respect to each impaired class of claims or interests that rejected the plan. 11 U.S.C. § 1129(b)(1), (2). These concepts are beyond the scope of these materials, but one Court has responded to the argument that subordinated rights of classes are not enforceable in cram down based on the plain language of 1129(b)(1) by noting that "it is generally understood that such rights are enforceable under the discrimination and fair and equitable concepts of" section 1129(b)(1). *See In re Consul Restaurant Corp.,* 146 B.R. 979, 988 (Bankr. D. Minn. 1992).

all of the § 1129(a) and (b) requirements, the court "shall confirm the plan."' The phrase '[n]otwithstanding section 510(a) of this title' removes section 510(a) from the scope of 1129(a)(1), which requires compliance with 'the applicable provisions of this title.' 11 U.S.C. § 1129(b)(1)." *Id*. at 141.

ii. *In re Tribune Co.*, 472 B.R. 223, 241 (Bankr. D. Del. 2012) (citing *TCI 2*, 428 B.R. at 141, and finding that "the meaning of 'notwithstanding section 510(a) of this title' means that § 1129(b) is applied without prevention or obstruction of any applicable subordination agreements"); *In re Croatan Surf Club, LLC*, 2011 WL 5909199, *2 (Bankr. E.D.N.C. Oct. 25, 2011) (citing *TCI 2* and noting in *dicta* that a Court can confirm a plan which disrupts bargained for priority, and thus is inconsistent with the terms of a subordination agreement, as long as it is fair and equitable and does not discriminate unfairly).[9]

2. Equality of treatment for similarly situated creditors

a. The requirement of only placing claims in a class with substantially similar claims promotes equality of treatment for similarly situated creditors. This requirement, along with the requirement that creditors in the same class be treated the same,[10] seeks to ensure that the debtor cannot treat creditors with similar priorities disparately. *See*, *e.g.*, *Greystone*, 995 F.2d at 1279 ("Each class of creditors will be treated in the debtor's plan of reorganization based upon the similarity of its members' priority status and other legal rights against the debtor's assets. . . . Proper classification is essential to ensure that creditors with claims of similar priority against the debtor's assets are treated similarly.").

3. Uphold integrity of the voting process

a. The requirement of only placing claims in a class with substantially similar claims also upholds the integrity of the voting process by, among other things, seeking to prevent a debtor from stacking a class with creditors likely to support the plan that hold at least two-thirds in amount and more than one-half in number of claims.[11] *See, e.g.*, *Greystone*, 995 F.2d at 1279 ("Classification of claims thus affects the integrity of the voting process, for, if claims could be arbitrarily placed in separate classes, it

[9] The Court in *In re Dura Auto. Sys., Inc.*, 379 B.R. 257, 271 (Bankr. D. Del. 2007) observed that "[a]lthough some commentators have argued in favor of limiting a debtor's ability to discriminate among creditors of the same priority level, they have agreed that discrimination based upon subordination rights is viewed as fair." (citations omitted). The Court made this observation in the context of subordinated noteholders disputing the application of an X-clause. The question regarding unfair discrimination based on priority rights becomes more pertinent where, as in *Tribune*, a *senior* creditor raises it as an objection to its treatment in a cram down plan under section 1129(b)(1).

[10] "A plan shall . . . provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment of such particular claim or interest." 11 U.S.C. § 1123(a)(4).

[11] "A class of claims has accepted a plan if such plan has been accepted by creditors . . . that hold at least two-thirds in amount and more than one-half in number of the allowed claims of such class held by creditors . . . ." 11 U.S.C. § 1126(c).

would almost always be possible for the debtor to manipulate 'acceptance' by artful classification."); *see also Matter of Huckabee Auto. Co.*, 33 B.R. 141, 147-48 (Bankr. Ga. 1983) (Bankr. Ga. 1983) (Section 1122 "insures that classes of claims will have similar interests, and that the votes cast by the class will reflect the joint interests of the class. It thus assures that large claims of a different legal nature are not classed with other claims so as to enable the improperly classed claims to dictate to the other claims." . . . Section 1126(c) "insures that acceptance of a plan will reflect the feelings of a sufficient number of claims of a class of a sufficient monetary amount to make it fair and equitable for all the members of the class.").[12]

D. Impact of classification of claims subject to subordination agreements on voting

1. If a disproportionately large block of senior debt is classified together with a relatively small block of subordinated debt, the subordinated debt holders may find themselves disenfranchised – unable to reject a plan that benefits the senior claim majority but is not in the best interests of the subordinated claim minority. This concern is moot, however, if there is an enforceable voting assignment provision in the subordination agreement, as the senior debt holders would be entitled to vote the subordinated debt holders' claims (the same holds true if the subordinated debt holders are prohibited from voting inconsistently with the senior debt holders).

2. If a disproportionately large block of subordinated debt is classified together with a relatively small block of senior debt, the senior debt holders may find themselves disenfranchised – unable to accept a plan that benefits the senior claim minority but is not in the best interests of the subordinated claim majority. This concern is obviated if there is an enforceable voting assignment provision in the subordination agreement, as the senior debt holders would be entitled to vote the subordinated debt holders' claims (the same holds true if the subordinated debt holders are prohibited from voting inconsistently with the senior debt holders).

3. If senior and subordinated debt is separately classified and the subordinated debt holders are not entitled to retain any property pursuant to the plan because of the subordination agreement, the subordinated debt holders may be not necessarily be deemed to reject the plan under section 1126(g). If there is an enforceable voting assignment provision in the subordination agreement, the senior debt holder may still be entitled to vote the subordinated debt holders' claims.

4. If senior debt and subordinated debt are separately classified and the subordinated debt is impaired and *not* subject to an enforceable voting assignment provision (or other

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[12] In light of section 1126(c), section 1123(a)(4) also plays a role in upholding the integrity of the voting process: "Voting on a plan is by class. Section 1123(a)(4) prevents a plan proponent from rigging the vote of a particular class by providing for more favorable treatment to a claim that by virtue of its amount controls whether or not the class accepts the plan." *In re Rhodes, Inc.*, 382 B.R. 550, 556 (Bankr. N.D. Ga. 2008); *see also Huckabee*, 33 B.R. at 148 ("If [all claims within a class] are treated the same, free unprejudiced voting of their claims is assured on whether their treatment is fair and equitable within the entire scheme of bankruptcy. To permit a plan to treat one claim within a class more favorably than others without the consent of the others, would be for the Court to sanction the engineering of plans which violate the principle of fairness and equity.").

provision prohibiting the subordinated debt holders voting inconsistently with the senior debt holders), then the subordinated debt holders' vote could put the senior debt holders at risk of cram down. This could be the case whether subordinated debt is classified in its own class or with other general unsecured creditors.

5. If subordinated debt were classified with other general unsecured creditors and subject to an enforceable voting assignment provision (or other provision prohibiting the subordinated debt holders voting inconsistently with the senior debt holders), the senior debt holder could influence the vote of the general unsecured creditor class. If the subordinated debt holders held at least two-thirds in amount and more than one-half in number of claims in the class, the senior debt holder could force the acceptance of the plan by that class. Likewise, if the subordinated debt holders held sufficient claims in amount and number to deny the other general unsecured creditors at least two-thirds in amount and more than one-half in number of claims (*i.e.*, a "blocking position"), then the senior debt holder could force the rejection of the plan by that class.

6. If the subordinated debt holders hold claims that are insufficient in amount and number to affect the vote of the class of general unsecured creditors (*i.e.*, less than a blocking position), a Court may find that it does not matter whether subordinated debt holders are classified with the other general unsecured creditors or in their own class.

III. Plan Voting

Intercreditor agreements between junior and senior lien holders often limit the rights of the junior lien holder through "bankruptcy waivers," pursuant to which the junior lien holder agrees to waive certain rights given to creditors under the Bankruptcy Code. Although subordination agreements are generally enforceable in bankruptcy cases pursuant to section 510(a) of the Bankruptcy Code, some Courts have found waivers of rights created by the Bankruptcy Code invalid to the extent they alter a substantive right provided by the Bankruptcy Code. Particularly controversial are voting rights provisions, which involve the junior lien holder waiving its right to vote in favor of a chapter 11 plan not supported by the senior lien holder or to vote against a chapter 11 plan supported by the senior lien lender or which assign the junior lien holder's voting rights to the senior lien holder. The enforceability of voting rights provisions is uncertain, as there is a split in authority on whether such provisions alter or contradict a substantive right provided under the Bankruptcy Code (*i.e.,* violate bankruptcy public policy), and, therefore, are not enforceable.

A. Courts not enforcing assignment of voting rights

1. *In re 203 N. LaSalle St. L.P.*, 246 B.R. 325 (Bankr. N.D. Ill. 2000) is perhaps the leading case refusing to enforce a voting rights provision in light of substantive bankruptcy rights. Another aspect of the decision, however, upheld the payment of postpetition interest to the senior creditor before the subordinated creditor was paid as not being violative of bankruptcy law principles. The dispute as to both provisions of the subordination agreement could only arise in a bankruptcy case, but the Court applied bankruptcy policy differently to both disputes.

a. In *LaSalle*, a bank loaned funds to a limited partnership (LP) which owned part of a commercial office building. The loan was secured by a first mortgage on the property and enforceable only against the property. The LP then obtained a loan from its general partner (GP), which was secured by a second mortgage on the property that was junior and subordinate to the bank's mortgage. The bank and the GP entered into a subordination agreement which provided that, among other things, the bank could vote the GP's claim in any bankruptcy reorganization. *Id.* at 327. The debtor filed for relief under the Bankruptcy Code, and the Bankruptcy Court confirmed the debtor's plan over the bank's objection. The bank appealed the confirmation order, which the Supreme Court reversed, and the Supreme Court remanded the case to the Bankruptcy Court for further proceedings. Subsequently, the bank commenced an adversary proceeding seeking a declaratory judgment that (i) its entire claim, including any deficiency claim, was entitled to payment before any payment to the GP and (ii) it was entitled to vote the GP's claim. *Id*. at 328.

b. **<u>No violation of bankruptcy policy</u>**. The Court, in holding that the bank's claim had priority, rejected the GP's argument that any deficiency claim of the bank should be treated pro rata with its claim. The Court reasoned that the subordination agreement gave senior status to the full amount of principal and interest under the bank's loan, notwithstanding that the loan was nonrecourse (which would likely have resulted in the bank being unable, outside of bankruptcy, to obtain any recovery beyond the value of its collateral). *Id*. at 329-30. The Court also rejected the GP's argument that in order for the bank's deficiency claim to be senior, the subordination agreement had to explicitly accord senior status to it, finding that there was no requirement under the Bankruptcy Code mandating any special degree of explicitness to accord senior status to a deficiency claim. *Id*. at 330. The Court held that the payment of an unsecured deficiency claim violated no policy of bankruptcy law, and there was no reason why an explicit provision should have been required to obtain its enforcement in a subordination agreement. The Court noted that a subordination provision that violates no principle of bankruptcy law must be enforced as it would be under nonbankruptcy law. *Id*.[13]

[13] The Court offered this explanation because the GP cited the "Rule of Explicitness," which provides that, if the parties to a subordination agreement are going to vary the general bankruptcy rule that interest stops on the petition date and instead require the payment of postpetition interest to the senior creditor from the subordinated creditor's recovery, then the agreement must explicitly state as much. *Id*. at 330. The Court noted that it was doubtful whether the Rule of Explicitness continued to be viable, including as to postpetition interest, in light of section 510(a) and cited *In re Southeast Banking Corp.*, 156 F.3d 1114, 1120-24 (11th Cir. 1998) for its holding that section 510 obviated the bankruptcy-based requirement of explicitness and that any remaining need for special explicitness depended on applicable state law. *Id*. The *Southeast Banking* Court had certified a question to the New York Court of Appeals as to whether New York had a Rule of Explicitness for postpetition interest. In the absence of any rules of interpretation that applied specifically to subordination agreements, the Court of Appeals looked to New York's general law of contracts and found that, in accordance with the Rule of Explicitness, New York law would require specific language in a subordination agreement to alert a junior creditor to its assumption of the risk and burden of allowing the payment of a senior creditor's postpetition interest demand. *In re Bank of New Engl. Corp.*, 364 F.3d 355, 364-65 (1st Cir. 2004) (citing *Chem. Bank v. First Trust of N.Y.* (*In re Southeast Banking Corp.*), 93 N.Y.2d 178, 688 N.Y.S.2d 484, 710 N.E.2d 1083, 1084–88 (1999)) (internal quotation marks omitted). The First Circuit in *Bank of New Engl.*, however, disagreed with the Eleventh Circuit in *Southeast Banking*, as the First Circuit found that the Eleventh Circuit had invited the Court of Appeals to craft a bankruptcy-only canon of contract

c. **Violation of bankruptcy policy**. In contrast, the Court refused to enforce the GP's assignment of its voting rights under the subordination agreement, holding that the Bankruptcy Code, not the subordination agreement, governed the determination of voting rights. *Id*. at 330-31. Section 1126(a) allows the "holder of a claim" to vote to accept or reject a plan, and, as the parties acknowledged that the GP held its claim, there was no reason for deviating from the plain language of section 1126(a) and not allowing the GP to vote. *Id*. at 331. The Court provided three reasons for its holding. First, the Court held that prebankruptcy agreements do not override contrary provisions of the Bankruptcy Code. *Id*. Second, section 510(a), in directing enforcement of subordination agreements, does not allow for waiver of voting rights under section 1126(a). The Court quoted the Black's Law Dictionary definition of subordination as "[t]he act or process by which a person's rights or claims are ranked below those of others," and found that "subordination thus affects the order of priority of payment of claims in bankruptcy, but not the transfer of voting rights." *Id*. Third, the Court held that Bankruptcy Rule 3018(c) does not allow the voting of a subordinated creditor's claim by the senior creditor. Because the bank was not acting at the direction of the GP (the bank would be acting in its own interests and possibly contrary to those of the GP), the bank could not be seen as the GP's agent (as required by the Bankruptcy Rule 3018(c)). *Id*. at 331-32. Lastly, the Court found that the plain language of section 1126(a) is consistent with reasonable bankruptcy policy, as even though a creditor's claim is subordinated, it may have substantial interest in the manner in which its claim is treated. "Subordination affects only the priority of payment, not the right to payment," so if the assets in the estate were sufficient, the subordinated creditor would have the potential for receiving a distribution. The Court concluded that Congress may have decided to protect that potential by allowing the subordinated claim to vote, which assures that the holder of a subordinated claim has a potential role in the negotiation and confirmation of a plan, a role that would be eliminated by enforcing contractual transfers of voting rights. *Id*. at 332.

2. The *LaSalle* Court quoted approvingly from *In re Hart Ski Mfg. Co.*, 5 B.R. 734, 736 (Bankr. D. Minn. 1980), where the Court, in a dispute involving a subordinated creditor's right to seek adequate protection or lifting the stay, held that "the intent of section 510(a) (subordination) is to allow the consensual and contractual priority of payment to be maintained between creditors among themselves in a bankruptcy proceedings [sic]. There is no indication that Congress intended to allow creditors to alter, by a subordination agreement, the bankruptcy laws unrelated to distribution of assets." *Id*. at 736. The Court noted that the Bankruptcy Code guarantees each secured creditor certain rights, including the right to participate in voting for confirmation or rejection of any plan of reorganization. The Court found that this right and "others not related to contract priority of distribution pursuant to section 510(a) cannot be affected by the actions of the parties

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interpretation. This misapprehended the reach and breadth of section 510(a), which, by virtue of its reference to "nonbankruptcy law," does not vest in states any power to make bankruptcy-specific rules (the *Bank of New Engl.* Court found that there was no reason to believe that the New York Courts would apply the Rule of Explicitness outside the bankruptcy context). *Id*. at 363, 366.

prior to the commencement of a bankruptcy case when such rights did not even exist." *Id*.

3. Other Courts have followed the reasoning of *LaSalle* and *Hart* and declined to enforce voting rights assignments. *See, e.g.*, *In re SW Boston Hotel Venture, LLC*, 460 B.R. 38, 52, (Bankr. D. Mass. 2011), *vacated and remanded on other grounds*, 2012 WL 4513869 (1st Cir. B.A.P. Oct. 1, 2012) (adopting the reasoning of *LaSalle* and *Hart* and finding the assignment of voting rights in a subordination agreement unenforceable, as the provision purported to alter a substantive right under the Bankruptcy Code); *In re Croatan Surf Club, LLC*, 2011 WL 5909199, at *2-3 (Bankr. E.D.N.C. Oct. 25, 2011) (finding, like *LaSalle*, that section 1126(a) dictates who may vote on a plan and that subordination does not change the existence of a debt or claim or its holder; it merely provides for a different order of payment).

B. Courts enforcing assignment of voting rights

1. The Court in *In re Aerosol Packaging, LLC*, 362 B.R. 43, 46–47 (Bankr. N.D. Ga. 2006) looked at the same provisions of the Bankruptcy Code and Bankruptcy Rules as the *LaSalle* Court and came to the opposite conclusion.

a. The Court was called upon to decide which ballot was valid: the ballot cast by a subordinated lender rejecting the debtor's plan or the ballot cast by a senior lender in the subordinated lender's name accepting the plan. Prior to the debtor's bankruptcy, the debtor and the subordinated lender executed a subordination agreement in favor of the senior lender in connection with the senior lender's loan to the debtor. The Court noted that, as the debtor was a party to, and beneficiary of, the subordination agreement, it, like the senior lender, should be entitled to rely on its enforcement. *Id*. at 45. In addition to subordinating its claims against the debtor and liens on the assets of the debtor in all respects to the claims and liens of the senior lender, the subordinated lender authorized the senior lender to take certain actions in its own name and the name of the subordinated lender, to the detriment of the subordinated lender. This broad grant of authority affected significant substantive rights otherwise possessed by the subordinated lender, including, among other things, the right to vote the subordinated lender's claims in any bankruptcy of the debtor. *Id*. Nevertheless, after both the senior and subordinated lenders cast a ballot for the subordinated lender's claim, the subordinated lender urged the Court to declare that it was entitled to vote its own claim. The subordinated lender relied heavily on *LaSalle*, and the debtor and the senior lender argued that *LaSalle* was wrongly decided. *Id*. at 44-46.

b. Unlike *LaSalle*, the Court found that section 1126(a) grants a right to vote to a holder of a claim, but it does not expressly or implicitly prevent that right from being delegated or bargained away by such holder. *Id*. at 47. The Court found that the subordination agreement appeared to be enforceable under Georgia law, thus enabling its enforcement under section 510(a). *Id*. Like *LaSalle*, the court noted that Bankruptcy Rule 3018 (and 9010) permits agents and other representatives to take actions, including voting on behalf of parties. Contrary to *LaSalle*, however, the court held that the senior lender was acting as a duly authorized agent for the subordinated lender, reasoning that its actions were "similar to the actions of a real estate lender acting as the agent for the borrower in executing a deed under power of sale in Georgia to convey title to foreclosed property at a foreclosure sale (*i.e.*, as an agent having a power coupled with an interest). In both instances, the agent acts in its own interests, and not in those of the purported principal." *Id*. The Court concluded that the express terms of the subordination agreement provided for the assignment of the subordinated lender's right to vote its claim to the senior lender, with the result being that the senior lender would vote such claim and take other actions in support of its own interests and potentially contrary to the wishes and immediate interests of the subordinated creditor. *Id*. The Court, therefore, recognized the validity of the senior lender's ballot for the subordinated lender's claim and disregarded the subordinated lender's ballot. *Id*.

2. The District Court in *In re Coastal Broad. Sys., Inc.*, 2013 WL 3285936, *5 (D. N.J. June 28, 2013) reached the same conclusion as the *Aerosol* Court, albeit in *dicta*, as the subordinated creditors waived their argument as to the Bankruptcy Code's purported prohibition on voting rights assignments by not making that argument in the Bankruptcy Court. *Id*. The *Coastal* Court first rejected the argument that section 510(a) applies exclusively to priority and not to voting rights, holding that by its plain terms, section 510(a) provides for the enforcement of subordination agreements as a whole, without distinguishing between individual components of such agreements. *Id*. The *Coastal* Court next agreed with the *Aerosol* Court that section 1126(a) does nothing to foreclose the assignment of a claim holder's voting rights to another (and disagreed with *LaSalle* and *Hart* on the same point). *Id*. Third, the *Coastal* Court refused to find that a voting rights assignment violated public policy, instead finding that creditor rights, including their attendant voting rights, can be freely traded in the ordinary course. The Court observed that it would make little sense that a creditor could be free to sell its rights in full but be barred from selling a portion. *Id*.[14] Finally, the Court rejected the argument that the subordination agreement conflicted with Bankruptcy Rule 3018, holding that the senior creditor sat in the shoes of the subordinated creditors for all intents and purposes and that it would improperly elevate form over substance to view the senior creditor as anything other than a "creditor" for voting purposes. *Id*. at *6. The Court also held, in contradistinction to *LaSalle*, that the use of the term "authorized agent" in the Bankruptcy Rules merely contemplates an entity authorized to act on another's behalf and does not require any deeper inquiry into interests, motivation, or control. Because the subordination agreement authorized the senior creditor to vote on the subordinated creditors' behalf, it was an "authorized agent" under Bankruptcy Rule 3018. *Id*.

3. Other Courts have enforced assignment of voting rights, and, in doing so, denied voting-related arguments that implicitly rely on the unenforceability or disregard of such provisions. *See In re Inter Urban Broad. of Cincinnati, Inc.*, 1994 WL 646176, *2 (E.D. La. Nov. 16, 1994) (finding that senior creditor's vote of subordinated creditor's claim

[14] Commentators have also made the same observation: "Since a lender can assign its entire bundle of rights related to a claim, there doesn't seem to be a cogent reason, certainly no public policy reason, why the lender should be prevented from giving up only a portion of its bundle of rights." Berman, *Enforceability*, *supra* p. 3-4, at § II.B.

pursuant to subordination agreement was proper and in accord with law and rejecting debtor's argument that subordinated creditor was deemed to reject a plan under section 1126(g) because it would receive nothing under the plan based on the subordination agreement); *In re Curtis Ctr. L.P.*, 192 B.R. 648, 660 (Bankr. E.D. Pa. 1996) (refusing to allow debtor to rely on class with subordinated creditor as accepting impaired class for purposes of section 1129(a)(10) where subordinated creditor had assigned vote to senior creditor and senior creditor would not vote to accept plan).

4. **Subrogation**. In *In re Avondale Gateway Ctr. Entitlement*, LLC, 2011 WL 1376997 (D. Ariz. Apr. 12, 2011), a senior creditor cast two votes to reject the debtor's plan, one vote on behalf of itself and the other vote on behalf of a subordinated creditor with whom it was party to a subordination agreement. The subordinated creditor independently voted to accept the plan. *Id*. at *1. The Bankruptcy Court denied the debtor's challenge to the vote cast by the senior creditor on the subordinated creditor's behalf, holding that a subrogation clause in the subordination agreement authorized the senior creditor to vote on the subordinated creditor's behalf. The debtor appealed. *Id*. The District Court found that, notwithstanding the absence of an express assignment of voting rights in the subordination agreement, the subrogation clause meant that the senior creditor stepped into the shoes of the subordinated creditor with respect to the claim against the debtor and acquired all of the subordinated creditor's rights with respect to the claim, including the right to vote the claim in bankruptcy. *Id*. at *2-3. The Court found *LaSalle* and *Hart* inapposite because those cases relied on subordination rather than subrogation, where the subrogee steps into the shoes of the subrogor and succeeds to the latter's rights. *Id*. at *4. While under Arizona law a subrogation agreement is not enforceable as to non-assignable rights, the Court found cases, including *Aerosol*, to be persuasive as to the assignability of plan voting rights. Thus, the District Court concluded that the subrogation clause was effective in the Bankruptcy Court. *Id*.

C. Vote disqualification

1. In *In re Sentry Operating Co. of Texas, Inc.*, 264 B.R. 850, 857-58 (Bankr. S.D. Tex. 2001), the plan proponents (debtors and secured creditor) moved to disqualify the votes of subordinated creditors, alleging that the applicable provision of subordinated notes prohibited the subordinated creditors from voting against any plan so long as the senior indebtedness was not paid. The provision required that senior indebtedness be paid in full prior to payment of any funds to the subordinated creditors and that the subordinated creditors may not act in any way to prevent the senior indebtedness from being paid. The subordination agreement prohibited the subordinated creditors from voting their claims in any manner inconsistent with the subordination agreement, but it also provided that the claims of the subordinated creditors were not subordinated to other unsecured claims. Because the plan provided for greater payment to trade creditors than to the subordinated creditors, which violated the subordination agreement, the Court concluded that the subordinated creditors' vote against the plan was in accordance with the subordination agreement, not violative of it. *Id*. at 858.

IV. "X-Clause" Coverage

While plan voting is one important consequence of classification, another important consequence of classification is treatment – in other words, what a creditor will receive under the plan. Treatment is a broad category of inquiry, but in general the rule under subordination agreements is that senior creditors or lien holders must be paid in full in cash on account of their claims against the debtor or from the proceeds of common collateral before subordinated creditors or lien holders may receive any distributions or retain and property on account of their claims or liens. Thus, subordinated creditors are generally required to turn over to senior creditors any securities they receive under a plan. An X-clause, however, provides a limited exception to this rule.

A. What is an X-clause?

1. "The X clause usually permits the junior creditors to receive and retain 'permitted junior securities' [under a plan] even though the senior debt has not been paid in full in cash. These permitted junior securities are typically defined as equity or debt securities that are junior to any securities received by the senior creditors in the restructuring to at least the same extent as provided in the intercreditor terms governing the junior and senior debt." Wise, *X Clauses*, *supra* p. 7, at 1.

2. The Seventh Circuit has explained the purpose behind X-clauses: "[X-clauses] 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." *Matter of Envirodyne Indus., Inc.*, 29 F.3d 301, 306 (7th Cir. 1994).[15]

[15] *See also In re Metromedia Fiber Network, Inc.*, 416 F.3d 136, 139-140 (2d Cir. 2005): "Helpful guidance is found in the American Bar Foundation's *Commentaries on Model Debenture Indenture Provisions* (1971) [hereinafter *Commentaries*]. In a nutshell, when subordinated and senior note holders are given securities under a plan of reorganization, an X–Clause allows the subordinated note holder to retain its securities only if the securities given to the senior note holder have higher priority to future distributions and dividends (up to the full amount of the senior notes). This provides for full payment of the senior notes before any payment of the subordinated notes is made. In such a case, the senior note holder enjoys unimpaired the priority to payment that it had under its notes, *i.e.*, payments on the subordinated note holder's securities are 'subordinate ... to the payment of all Senior Indebtedness.' *See Commentaries, supra,* § 14–5, at 570 (X–Clause is triggered where 'mortgage bonds, preferred stock or similar higher class security' are provided to senior note holders and 'common stock' is provided to subordinated note holders because 'this kind of distribution gives practical effect to the subordination and therefore turnover is not required'); Ad Hoc Committee for Revision of the 1983 Model Simplified Indenture, *Revised Model Simplified Indenture*, 55 Bus. Law. 1115, 1221 (2000) ('If Senior Debt were to receive preferred stock and the subordinated debt were to receive common stock, for example, where the preferred stock precluded distributions to common stockholders until the preferred stock was redeemed, the X–Clause would permit that distribution.'). This approach assures that the junior creditor remains fully subordinated without requiring it to yield assets that are not

B. What are the consequences of X-clauses in bankruptcy?

1. Courts that have considered X-clauses, including at the Circuit Court level, have been consistent in their approach: they are unwilling to construe X-clauses so as to subvert the purpose of a subordination agreement. Courts have rejected formalistic arguments that pull X-clauses out of the context of subordination agreements and attempt to characterize certain X-clause provisions as an exception to the subordination agreements rather than as a convenience mechanism. The following cases demonstrate some of the arguments used by subordinated creditors to try to get around the purposes of X-clauses and Courts' responses to such attempts.

2. Three Circuit Courts have considered X-clauses.

a. **Seventh Circuit** (*Matter of Envirodyne Indus., Inc*., 29 F.3d 301, 305-06 (7th Cir. 1994)). Senior and subordinated noteholders were both issued common stock pursuant to the debtor's plan of reorganization instead of new notes. The subordinated noteholders, who were issued proportionately less stock than the senior noteholders as compared to their debt, objected to this treatment on the basis that the payment subordination provision in an X-clause only applied to the distribution of new "securities" but not new stock. The Court rejected this argument, finding that the purpose of X-clauses (as quoted above) bore no relation to the subordinated noteholders' interpretation of this poorly drafted X-clause, which would make the senior noteholders' priority entirely dependent on the form of the distribution. *Id*. at 306. The Court observed that it could not understand why the form in which rights in the assets of the reorganized firm were allocated among the creditors should determine the creditors' priority – specifically why a distribution in the form of stock should erase the priority of a senior class of creditors: "To make priority depend on the form of distribution in this way would, moreover, give senior creditors an incentive to press for liquidation, contrary to the purpose of Chapter 11, since then there would be no distribution of stock and hence no chance for the junior creditors to achieve parity with the seniors." *Id*.

b. **Third Circuit** (*In re PWS Holding Corp.*, 228 F.3d 224, 244-45 (3d Cir. 2000)). An out-of-the-money subordinated noteholder argued that under an X-clause, it was entitled to receive securities in the reorganized entity that were subordinated to the senior creditors' interests to the same extent that they had an interest in the old entity. The Court found the X-clause inapplicable, where the senior creditors were not being paid in full, as the X-clause simply waived subordinated noteholders' general obligation to turn over distributions to the senior creditors as long as any new securities issued to the subordinated creditors were subordinated "to the same extent as" the existing subordinated debt. *Id*. at 244. The Court agreed with *Envirodyne* that the X-clause was a convenience mechanism and concluded that the clause was not a requirement that the debtors distribute subordinated securities to subordinated

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required for full payment of the senior creditor and that would therefore make a round-trip to the senior creditor and back, with the attendant delay, friction, and transaction cost."

noteholders in proportion to any securities distributed to the senior creditors. *Id*. at 244-45 (citing *Envirodyne*, 29 F.3d at 306).

c. **<u>Second Circuit</u>** (*In re Metromedia Fiber Network, Inc.*, 416 F.3d 136, 139-41 (2d Cir. 2005)). Under the debtor's plan, subordinated noteholders were to receive cash, common stock, and warrants to purchase additional stock, all of which would be reallocated to the senior creditors (which received the same form of distribution). The subordinated noteholders conceded that the plan properly reallocated the cash and stock to the senior creditors but argued that the X-clause allowed them to keep the warrants. The Court cited *Envirodyne* as construing a nearly identical X-clause to exempt from subordination securities allocated to junior creditors that "are subordinated to the claims of the senior creditors," and which, therefore, do not "erase the priority" of the senior class. *Id*. at 140 (quoting *Envirodyne*, 29 F.3d at 303, 306 and citing *PWS*, 228 F.3d at 244-45). The Court, however, found that allowing the subordinated noteholders to retain the warrants would impair the senior creditors' priority. The senior creditors were not being paid in full, and, if the subordinated creditors kept the warrants, they would be able buy the same class of common stock allocated to the senior creditors, which would give the subordinated noteholders and the senior creditors equal priority to any future distribution. *Id*. at 140-41.

3. Judge Carey of the Delaware Bankruptcy Court has considered X-clauses in two cases.

a. *In re Dura Auto. Sys., Inc.*, 379 B.R. 257, 264-70 (Bankr. D. Del. 2007). Subordinated noteholders made a similar argument to that advanced in *Envriodyne*: the X-clause excepted "permitted junior securities" from the subordination provisions of a subordinated notes indenture, and the grammatical structure of the definition of "permitted junior securities" included equity securities without qualification (debt securities were required to be subordinated to the same extent as under the subordinated notes indenture). Thus, the subordinated noteholders were required to share in the distribution of common stock and participate in a rights offering on a *pari passu* basis with senior creditors. The Court rejected this reading of the definition of "permitted junior securities" based on its reading the indenture as a whole: "When read as a whole, the Subordinated Note Indenture clearly manifests the intent to assure payment in full of the Senior Notes before permitting payment (in whatever form) to the Subordinated Noteholders. The Plaintiffs argue, in counterpoint, that the purpose of an x-clause is to carve out certain distributions from the otherwise applicable subordination provisions. Therefore, the X–Clause should be read generously in favor of those who are its intended beneficiaries so as to give the fullest effect to this intention. This argument must fail because an x-clause, as a general proposition, creates only limited exceptions to the otherwise applicable subordination provisions and, therefore, must be read narrowly, and in harmony, with the entire contract. This principle applies equally to the X–Clause at issue here." *Id*. at 269. The Court concluded, therefore, that to interpret the X-clause to include new common stock and a rights offering in the definition of "permitted junior securities" without the subordination qualification applicable to debt securities would "eviscerate" the purpose of the subordination provisions in the subordinated notes indenture and expand the limited X-clause carve out beyond its intended scope. *Id*. at 270.

b. *In re Spansion, Inc.*, 426 B.R. 114, 149-51 (Bankr. D. Del. 2010). The indenture trustee for subordinated noteholders argued that the plain language defining "permitted junior security" in the subordinated indenture specified that "capital stock" (such as new common stock issued pursuant to the plan) was exempt from the subordination provisions of the subordinated indenture. Similar to *Dura*, the Court found that "capital stock" was modified by the concluding language "subordinated in right of payment" in the definition of "permitted junior securities." *Id*. at 151. The Court found that the X-clause must not be considered on its grammatical structure alone but also within the context of the entire agreement, which was more reflective of the parties' intent that, except in limited circumstances, no payment could be made to holders of the subordinated notes until the senior noteholders were paid in full or consented. *Id*. Accordingly, the Court concluded that the new common stock issued pursuant to the plan was not a "permitted junior security" and not exempt from the subordination provisions of the subordinated indenture. *Id*.