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Subordination Agreement Provisions Shifting Chapter 11 Voting Rights: Can the Seniors Disenfranchise the Juniors?

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SUBORDINATION AGREEMENT PROVISIONS SHIFTING CHAPTER 11 VOTING RIGHTS: CAN THE SENIORS DISENFRANCHISE THE JUNIORS?

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In this article, Prof. Resnick examines how courts have dealt with voting rights provisions found in subordination agreements.

Subordination agreements among creditors are common in financial transactions. When a company seeks additional credit, the new lender may insist on an agreement with existing creditors which provides that their right to payment will be subordinated to the full payment of the new loan. The existing creditors may be willing to sign such an agreement for the purpose of encouraging the new lender to provide the borrower with liquidity needed to continue the business as a profitable venture, thereby increasing the likelihood that the borrower will meet all future financial obligations. In addition, contractual subordination is used frequently in connection with the issuance of debt securities. The level of priority of the

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debt securities, whether senior or junior, will directly affect their interest rate and market price.

In general, contractual subordination will be respected in the event the borrower becomes a debtor in a bankruptcy case. Section 510(a) of the Bankruptcy Code provides that "[a] subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law."[1] Unless a bankruptcy court rearranges priorities based on equitable principles, known as equitable subordination, or the class of senior creditors effectively waives the benefits of the subordination agreement by voting to accept a chapter 11 plan in which they give up their rights to junior creditors,[2] the subordination agreement controls the ranking of prebankruptcy claims against the bankruptcy estate.[3]

In addition to using subordination agreements to achieve priority over other creditors with respect to the payment of their claims, senior creditors also use them to obtain other rights from junior creditors. In particular, subordination agreements have included provisions that give the senior creditor the right to cast the junior creditor's vote to either accept or reject a plan of reorganization in the event the borrower is in chapter 11. These provisions effectively give a senior creditor two votes; it may vote with respect to its own claim and may vote again with respect to the subordinated claim. Senior creditors have argued that these provisions should be enforceable as a matter of contract, but junior creditors, wishing to vote on a chapter 11 plan despite the contractual provision, have argued that the enforcement of these provisions would be inconsistent with the provisions of the Bankruptcy Code granting voting rights only to the holders of claims. This article will examine how courts have dealt with these voting rights provisions found in subordination agreements.

VOTING RIGHTS IN CHAPTER 11: WHY THEY ARE IMPORTANT

The Bankruptcy Code requires that every chapter 11 plan designate classes of claims and interests, except for certain priority claims.[4] The claims included in a particular class must be "substantially similar" to the other claims in the class.[5] Frequently, senior claims and junior claims are placed in separate classes and given different treatment under a chapter 11 plan.[6] The Code also requires that the plan describe the treatment that each class will receive and designate whether the class is "impaired" or "unimpaired" by the plan.[7] There are two ways in which a class of claims is left unimpaired by the plan. First, the plan leaves a class unimpaired if it does not alter the legal, equitable, or contractual rights of the holders of the claims in that class.[8] Second, despite prior defaults, a plan may leave a class unimpaired if all defaults are cured (other than defaults based on the debtor's bankruptcy or insolvency or certain other nonmonetary defaults), the original maturity dates that existed before the default and acceleration are reinstated, the creditors are compensated for damages resulting from their reasonable reliance on contractual provisions or applicable law that gives them the right to accelerate payment, and the rights of the creditors in that class are not otherwise altered.[9]

If a class of claims remains unimpaired by the plan, the class, including each creditor holding a claim in that class, is conclusively presumed to have accepted the plan and, therefore, such creditors are not entitled to vote on the plan.[10] But if the class is impaired, the holders of claims in the class have a right to vote to accept or reject the plan.[11] The plan proponent solicits votes from impaired creditors by distributing ballots, certain required notices, and a court-approved disclosure statement.[12]

Confirmation of a chapter 11 plan depends on its acceptance by classes of claims and interests. There are two basic methods for confirming a plan. The most common method is by obtaining the acceptance of each and every impaired class, and by satisfying certain other requirements set forth in the Bankruptcy Code.[13] However, in the event that one or more impaired classes do not accept the plan, the court may confirm the plan nonetheless under the so-called "cram down" provisions of chapter 11, but only if at least one class, not counting the votes of insiders, has accepted the plan and certain other requirements are met.[14]

In order to obtain the acceptance of a class of claims, it is necessary to receive a sufficient number of acceptances based on a required percentage of creditors of that class who actually vote. The plan will be deemed accepted by a class if the creditors who hold at least two-thirds in dollar amount and more than one-half in number of the total allowed claims of the class who actually vote accept the plan. Only the claims held by those creditors who vote to accept or reject the plan are counted for this purpose. For example, suppose there are 100 creditors holding claims totalling $10 million in the same class. Assume further that only 30 of those creditors, holding a total of $1 million in claims, vote on the plan. For the class to accept the plan, it must be accepted by at least 16 creditors (more than one-half of those that vote) who hold at least $666,667 in allowed claims (two-thirds in amount of the allowed claims held by those who voted).[15]

The importance of voting rights of creditors in chapter 11 cases is best discussed in the context of an illustration. Suppose that an insolvent corporate debtor in chapter 11 proposes a plan that has two classes of unsecured claims and one class of shareholders. Class A includes senior unsecured claims and Class B includes junior unsecured claims held by creditors who contractually agreed to be subordinated to Class A creditors. The plan provides that (a) Class A senior creditors will receive deferred cash payments equal to the full amount of their claims, (b) Class B junior creditors will receive payment of only ten percent of the amount of their claims, and (c) shareholders will continue to own their shares without any dilution. Both Class A and Class B are impaired and entitled to vote on the plan. In this situation, it is likely that Class B junior creditors would vote to reject the plan, thus forcing the debtor to obtain confirmation under the cram down provisions of the Code. If so, the plan could not be confirmed because it is does not satisfy the "fair and equitable" requirement under section 1129(b).[16] A plan is not fair and equitable with respect to the nonaccepting class of junior creditors unless it gives each holder of a Class B claim property equal to the allowed amount of its claim or, in the alternative, the plan provides that shareholders shall not receive or retain any property on account of their equity interests.[17] This is the so-called "absolute priority rule" applicable in chapter 11. That is, the plan may not be crammed down the junior creditors unless they are paid in full with some form of property or the shareholders lose their shares entirely. In contrast, if Class B accepts this plan, it may be confirmed without satisfying the fair and equitable requirement. Therefore, Class B's right to vote against the plan is an important safeguard against shareholders maintaining their equity interests while paying Class B creditors only a small fraction of their claims.

Now suppose that the subordination agreement contains a provision that gives the senior creditors the right to cast votes on the plan on behalf of the junior creditors. If enforceable, that contractual provision would enable the senior creditors to control Class B's vote, thereby depriving Class B junior creditors the opportunity to vote to reject the plan. In this situation, Class A senior creditors would vote to accept the plan on behalf of Class B, as well as Class A, causing the court to confirm the plan as accepted by all impaired classes. The junior creditors would be bound to accept payment of only ten percent of their claims while equity holders continue to own the entire company. The result deprives the junior creditors of the protection of the absolute priority rule. This scenario is not unrealistic because the senior creditors, who would be receiving full payment of their claims, would be eager to have the plan confirmed and would have no incentive to bargain for a greater distribution for the disenfranchised junior creditors.

DECISIONS ENFORCING VOTE TRANSFER PROVISIONS

In general, advocates have offered two main reasons why provisions transferring voting rights to senior creditors under a subordination agreement should be enforceable. The first reason is based on traditional contract law principles. As discussed above, section 510(a) of the Bankruptcy Code expressly provides that subordination agreements are enforceable to the same extent that they are enforceable under nonbankruptcy law. From a policy perspective, parties are expected to bargain rationally. If a party voluntarily enters into a subordination agreement containing a vote transfer provision, it can be assumed that the subordinated creditor received a benefit in exchange and expects the agreement to be enforced. The senior creditor also can be expected to have relied on the vote transfer provision as an inducement for granting credit or for giving some other form of consideration. In essence, the traditional contract argument is that the agreement should be enforced consistent with the parties' intent.

The second reason advanced for enforcing vote transfer provisions is that a subordinated creditor has no interest in its claim until the senior creditor is paid in full. Based on this "no interest" rationale, it would be inequitable for the junior creditor to be allowed to vote on a plan that affects the senior creditor. In essence, the senior creditor has a superior interest in the junior creditor's claim and should be considered the holder of the claim for voting purposes.

The Curtis Center Limited Partnership Case

Several courts have enforced vote transfer provisions based on one or both of these arguments. For example, a bankruptcy court recognized the enforceability of such a provision in *In re Curtis Center Limited Partnership,*[18] a real estate chapter 11 case. Sumitomo Trust and Banking Co., Ltd., which was the holder of an undersecured first mortgage, entered into a subordination agreement in which Mellon Bank, a junior mortgagee owed approximately $25 million, agreed to subordinate its entire indebtedness — including any distributions to be made to Mellon under any plan of reorganization or from any other source — to the approximately $84 million debt owed to Sumitomo. When Sumitomo filed a motion for relief from the automatic stay, it made several arguments in support of its motion, including that the debtor would not be able to obtain confirmation of any chapter 11 plan because it would never be able to obtain the affirmative vote of any impaired class of claims, excluding the votes of insiders, as required under section 1129(a)(10) of the Bankruptcy Code.[19] The debtor argued that it would be able to satisfy the requirements under section 1129(a)(10) because its plan placed Mellon Bank in a separate class and provided for the payment of $1.3 million to Mellon.[20] The debtor argued that Mellon would likely vote in favor of this plan, thereby satisfying the requirements under section 1129(a)(10).

Sumitomo countered the debtor's argument by relying on the language of the subordination agreement that expressly granted to Sumitomo the authority to perform certain acts on behalf of Mellon in the event of the borrower's bankruptcy. In particular, the subordination agreement specifically stated that Sumitomo was authorized on behalf of Mellon to "'vote or consent in any proceedings with respect to any and all claims of [Mellon] relating to [Mellon's] debt, in each case as Sumitomo may deem advisable, in its sole discretion.'"[21] Sumitomo had repeatedly stressed its right to vote Mellon's claim and "has stated matter of factly that it will vote on Mellon's behalf to reject the Debtor's plan."[22] The court found Sumitomo's argument persuasive, finding that there was no hope that the debtor would be able to obtain an acceptance with respect to the Mellon claim because it would be Sumitomo, rather than Mellon, casting the vote. Therefore, the class consisting solely of the Mellon claim should be disregarded for purposes of evaluating the prospect of the debtor satisfying section 1129(a)(10). "The language of the subordination agreement is plain and unambiguous. The terms of this prepetition agreement are fully enforceable in this Bankruptcy case pursuant to 11 U.S.C. § 510(a)."[23]

The Inter Urban Broadcasting Case

Another decision upholding the vote transfer provisions of a subordination agreement was rendered in *In re Inter Urban Broadcasting*.[24] A company that was indebted to Firstmark Credit Corporation borrowed funds from Barclays Business Credit, Inc., in part to pay a portion of the earlier debt. As a condition precedent to extending credit, Firstmark, Barclays, and the borrower signed a subordination agreement which provided that Firstmark assigned and subordinated to Barclays all of its claims, collateral, interests and rights against the borrower until Barclays was paid in full. The agreement gave Barclays the right to vote Firstmark's claim in connection with any plan of reorganization. Later, when the borrower was in chapter 11, Barclays filed a creditor's plan of reorganization providing for the sale of the debtor's assets, payment of only a portion of Barclays' claim, and no payment to Firstmark. Barclays voted both its own and Firstmark's claims to accept the plan. When the debtor objected to Barclays' plan and moved to disqualify Barclays' votes, the bankruptcy court denied the motion and confirmed Barclays' plan.

On appeal to the district court, the debtor argued that Firstmark must be deemed to have rejected the plan because it would not receive any distribution on its claim. Under section 1126(g) of the Bankruptcy Code, a class is deemed to have rejected a plan if the holders of claims in that class are not entitled to receive anything under the plan.[25] The district court noted that the debtor did not provide any authority regarding the application of section 1126(g) when a class consisting of a junior creditor will receive no distribution under the plan, but the junior creditor subordinated its claim and transferred its voting rights to a senior creditor who then votes to accept the plan. Although that argument was not raised in the bankruptcy court, that court found that, under the subordination agreement, Barclays was granted the right to vote Firstmark's claim. It also found that Firstmark had been given notice of the bankruptcy proceeding, had appeared through counsel of record, and did not object to Barclays' voting of Firstmark's claim.

The district court found that Firstmark had benefited from Barclays' loans to the debtor and, in exchange for that benefit, assigned and subordinated its claims and rights to Barclays. In addition, the district court found that "Firstmark held no claim or interest and could not do so unless and until Barclays was paid in full."[26] Therefore, the only way for the debtors to prevail on the voting issue was to persuade the court that the subordination agreement should not be enforced. Noting that the Bankruptcy Code provides that a subordination agreement is enforceable in a bankruptcy case to the same extent that it is enforceable under applicable nonbankruptcy law,[27] and that the debtors did not attack the agreement as unenforceable under nonbankruptcy law, the district court upheld the subordination agreement, including the vote transfer provision, and held that Barclays' vote of Firstmark's claim was proper.

The Davis Broadcasting Case

Similarly, in *In re Davis Broadcasting, Inc.,*[28] a lender, Broadcast Capital, Inc., filed a motion to reopen a chapter 11 case and to modify the order confirming the plan of reorganization. Before the chapter 11 case commenced, Broadcast signed a subordination agreement with AmeriTrust, another creditor, in which Broadcast agreed to subordinate its claim to that of AmeriTrust's lien and to give AmeriTrust, in addition to other rights, the right to vote on behalf of Broadcast in a bankruptcy proceeding. AmeriTrust subsequently voted, on its own behalf and on behalf of Broadcast, to accept the debtor's plan of reorganization. Broadcast neither objected to confirmation nor appealed the confirmation order. The plan was substantially consummated, but eight months later, Broadcast filed its motion to reopen the case to correct an error in the plan. Although the court did not expressly rule on the validity of the subordination agreement provision transferring Broadcast's voting rights to AmeriTrust, it stated, in dicta, that it "must keep in mind that Broadcast was not forced to loan money to the Debtor and enter into the Subordination Agreement .... In essence Broadcast is saying that it should not suffer any ill effects from AmeriTrust's not protecting its interests as it would have preferred, although Broadcast freely entered into the Subordination Agreement that put it into this situation."[29] The court criticized Broadcast for not wanting to "be held responsible for its own actions."[30] Without ruling on the issue, the court appeared to have recognized the enforceability of the vote transfer provision of the subordination agreement.

The Pre-Code Decision in the Itemlab Case

Perhaps the most far-reaching decision giving a senior creditor the right to vote the claim of a subordinated creditor was *Matter of Itemlab, Inc.*,[31] a case decided under the former Bankruptcy Act. After Blanmill Realty Corp. signed an agreement in which it agreed to subordinate its claim to the claim of Dutch-American Mercantile Corp. until it was paid in full, the debtor filed a petition under Chapter XI of the former Bankruptcy Act. The plan of arrangement provided for payment of 25 percent of the creditors' claims, thereby enabling Dutch-American, the senior creditor, to receive payment equal to 25 percent of its claim and 25 percent of Blanmill's claim. Dutch-American was against the plan and wanted to vote its claim and Blanmill's claims to defeat the plan. The bankruptcy referee held that the answer to the question as to who had the right to cast the vote representing the Blanmill claim depended on the terms and effect of the subordination agreement executed by the debtor, Blanmill, and Dutch-American.

Blanmill argued unsuccessfully that it is a creditor, notwithstanding the subordination agreement, and should have been permitted to vote on the plan. Although the agreement was silent as to voting rights, the court interpreted the agreement as a "complete subordination agreement"[32] which entitled Dutch-American to have "complete control over the claim."[33] Before the Bankruptcy Code's enactment in 1978 and section 510(a)'s express recognition of the enforceability of subordination agreements,[34] courts relied on several equitable theories to uphold and enforce subordination agreements. Courts found, alternatively, that a senior creditor obtains an equitable lien on the junior claim,[35] or that subordination results in an equitable assignment of the claim.[36] Other courts have held that subordination results in a constructive trust whereby the junior creditor continues to hold its claim as a constructive trustee for the benefit of the senior creditor.[37] The court in Itemlab stated that, regardless of these equitable approaches, "it is quite obvious that in each case substance and not form prevailed and that the intent of the parties is paramount."[38] Although there was no legal assignment of the claim, nor any equitable assignment until a determination that Itemlab was insolvent and had insufficient assets to pay Dutch-American's claim in full, the court found that "according to the terms of the contract it was the clear intention of the parties, upon the occurrence of insolvency and insufficiency of assets for Dutch's claim out of the dividends of both claims, to make an immediate transfer of Branmill's claim to Dutch."[39]

The *Itemlab* court found that because the subordination agreement was signed by the debtor, the junior creditor, and the senior creditor, it was the clear intent of all three parties that the debtor would pay the senior creditor the junior creditor's claims in the event of insolvency.[40] Although the agreement was silent regarding the right to vote the claim of the junior creditor, the court concluded, in a classic application of the "no interest" rationale, that only the senior creditor should have the right to vote the claim:

> "Since the vote attached to the claim is the only means of determining how and when the claim shall be enforced and the terms of payment, it would follow that the person entitled to collect the claim should be the person entitled to vote the claim; otherwise the result would be anomalous and would repose in the inferior creditor the power to use his vote to determine how the superior creditor shall collect a claim in which the inferior creditor no longer has an interest."[41]

VOTE TRANSFER PROVISIONS HELD UNENFORCEABLE

Departing from those judicial decisions that upheld the enforceability of vote transfer provisions in subordination agreements, the Bankruptcy Court for the Northern District of Illinois refused to enforce such a provision in *In* *re 203 North LaSalle Street Partnership.*[42]

The debtor, 203 North LaSalle Street Partnership, owned fifteen floors of a commercial office building on which there was a first mortgage in favor of Bank of America to secure a loan obtained in 1987. In 1988, the debtor obtained a second mortgage loan from its general partner, North LaSalle Street Limited Partnership. The second mortgage explicitly provided that it was subordinated to the bank's first mortgage. At the time the second mortgage loan was given, North LaSalle and the bank also entered into an intercreditor agreement providing that North LaSalle's loan was subordinate to the bank's loan. Four years later, North LaSalle and the bank entered into a "Consent and Subordination Agreement" in consideration for the bank's waiver of certain rights under the original loan documents. This agreement included a comprehensive subordination provision and, for the first time, provided that the bank could vote North LaSalle's claim in any reorganization case.[43]

Unable to pay the first mortgage loan, the debtor filed a chapter 11 petition in 1995, when the outstanding balance owed to Bank of America was approximately $93 million and the balance owed to North LaSalle on the junior mortgage loan was approximately $11 million. A plan of reorganization was confirmed by the bankruptcy court, but the confirmation order was reversed by the Supreme Court for reasons unrelated to the subordination provisions.[44] After the case was remanded, Bank of America filed a complaint commencing an adversary proceeding seeking a declaration that, among other things,[45] it was entitled to vote the claim of North LaSalle in anticipated confirmation proceedings. North LaSalle contended that it had the right to vote its own claim with respect to any chapter 11 plan, notwithstanding the subordination agreement.

The bankruptcy court began its analysis by focusing on section 1126(a) of the Bankruptcy Code, which provides that "[t]he holder of a claim ... may accept or reject a plan."[46] Since the parties acknowledged that North LaSalle is the holder of the claim under the second mortgage loan, North LaSalle should be the only party with the ability to vote that claim with respect to any plan of reorganization, unless there is some basis for deviating from the plain language of section 1126(a). Bank of America offered several reasons for deviating from this statutory language, but the bankruptcy court rejected each one.

First, the bank argued that it had the right to vote North LaSalle's claim because of the clear language of the subordination agreement. The court rejected that argument, noting that "[i]t is generally understood that pre-bankruptcy agreements do not override contrary provisions of the Bankruptcy Code.... Indeed, since 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."[47] The court was referring to numerous decisions in which courts have refused to enforce prebankruptcy agreements that had the effect of depriving a party of the benefits of bankruptcy.[48] Therefore, the "fact that North LaSalle agreed that the Bank could vote its claim as part of a subordination agreement does not provide a basis for disregarding § 1126(a)."[49]

The bank's second argument was based on section 510(a) of the Bankruptcy Code, which expressly recognizes the enforceability of subordination agreements to the same extent they are enforceable under nonbankruptcy law. But the court construed section 510(a) narrowly, rejecting the argument that voting provisions contained in subordination agreements are within the scope of the Code's express recognition of the enforceability of subordination agreements. Black's Law Dictionary defines "subordination" as "[t]he act or process by which a person's rights or claims are ranked below those of others."[50] The court reasoned that this definition supports the view that subordination "affects the order of priority of payment of claims in bankruptcy, but not the transfer of voting rights."[51] As further support for its position, the court cited *In re Hart Ski Mfg. Co.*,[52] where the bankruptcy court held that a subordinated secured creditor was entitled to adequate protection of its claim.

> "The intent of §510(a) ... 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."[53]

The court in *Hart Ski* went beyond the adequate protection issue when, in dicta, it stated that the Code "guarantees each secured creditor certain rights, regardless of subordination ... includ[ing] the right ... to participate in the voting for confirmation or rejection of any plan of reorganization."[54]

The third argument rejected by the court was that Bank of America had the right to vote North LaSalle's claim because of Rule 3018(c) of the Federal Rules of Bankruptcy Procedure, which requires that an acceptance or rejection of a plan be signed by the creditor or equity security holder "or an authorized agent."[55] The bank argued that, by virtue of the subordination agreement, it was an "authorized agent" of the subordinated creditor for the purpose of voting. However, an agent is "commonly understood to act at the direction of a principal."[56] The court reasoned that the "test of agency is the existence of the right to control the method or manner of accomplishing a task by the alleged agent."[57] The court commented that the bank would not be voting at the direction or under the control of North LaSalle and, in fact, the bank would be voting in its own interests which may be contrary to the interests of North LaSalle. Therefore, the court held that the bank could not be viewed as the agent for North LaSalle under Rule 3018(c).[58]

The court then considered policy arguments regarding section 1126(a) of the Code. The court found that the plain language of the section, which gives the "holder" of a claim the right to vote, is "completely consistent with reasonable bankruptcy policy."[59] Despite subordination, a junior creditor may have an interest in how the claim is treated in a chapter 11 plan. "Subordination affects only the priority of payment, not the right of payment."[60] A subordinated creditor may have the potential to receive a distribution if the assets of the estate are sufficient, "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 transfers of Chapter 11 voting rights."[61]

WHEN THE SENIOR CREDITOR HAS A SECURITY INTEREST IN THE JUNIOR CLAIM

The court's reasoning in *203 North LaSalle Street* is persuasive. An entity's right to vote on a chapter 11 plan depends on its status as a "holder" of the claim, and subordination alone should not affect the junior creditor's status as the holder. A provision in the subordination agreement expressly giving the senior creditor the right to vote the junior claim should not, by itself, override the absolute priority rule, which is a key protection afforded creditors under the Bankruptcy Code.

Suppose, however, that the subordinated creditor expressly grants to the senior creditor a present, enforceable security interest in the junior claim to secure the debtor's payment obligation on the senior debt. Does the security interest affect the enforceability of the separate provision of the agreement that gives the senior creditor the right to vote the junior claim? The court in *203 North LaSalle Street* did not address this issue, but earlier decisions, such as *In re Inter Urban Broadcasting,*[62] upheld vote transfer provisions where a junior creditor assigned its claim to a senior creditor under the subordination agreement.[663]

In general, a person with a security interest in a claim against the debtor has the right to vote the claim in the debtor's bankruptcy case according to the relative interests of the parties.[64] Rule 3001(e) of the Federal Rules of Bankruptcy Procedure, which governs transfers of claims other than those based on publicly traded debt securities, specifically addresses voting rights when claims are transferred for security. Whether a claim is transferred for security before or after a proof of claim has been filed in the bankruptcy case, "[i]f the transferor or transferee does not file an agreement regarding its relative rights respecting voting of the claim, payment of dividends thereon, or participation in the administration of the estate, on motion by a party in interest and after notice and a hearing, the court shall enter such orders respecting these matters as may be appropriate."[65] The Advisory Committee Note to Rule 3001 explains the basis for this rule. "An assignee for security has been recognized as a rightful claimant in bankruptcy."[66]

Rule 3001(e) recognizes that it is common practice for a creditor holding a claim against the debtor, and a third party with a security interest in the claim, to enter into an agreement regarding voting rights in the event the debtor is in chapter 11. The rule merely requires that the agreement be filed in the court for it to be effective. Otherwise, on request of either party, the court determines the relative voting rights, apparently based on the parties' respective interests in the claim.

The recognition of agreements regarding the voting rights of entities with security interests in claims against the debtor, together with the unwillingness of some courts to enforce vote transfer provisions in subordination agreements, raises the question of whether the granting of a security interest as part of the subordination agreement should always enable senior creditors to obtain voting rights, thereby depriving a class of junior claims of the absolute priority rule. Would courts that follow *203 North LaSalle Street* allow a senior creditor to vote a subordinated claim over the objection of the junior creditor where the senior creditor is granted a security interest in the subordinated claim? Although a secured creditor may be the holder of the claim for limited purposes, and therefore a proper party to vote the claim, it also could be argued that the policy of affording all classes the protection of the absolute priority rule, or the right to waive it, outweighs the policy of giving secured creditors the right to vote in the context of a subordination agreement. The answer to this question will have to await further judicial development. In any event, unless and until courts resolve this issue, it is likely that more senior lenders will attempt to obtain security interests in junior claims to increase the likelihood that contractual shifting of voting rights in chapter 11 cases will be enforced.

CONCLUSION

In view of the recent decision of the bankruptcy court in *203 North LaSalle Street,* senior lenders should not rely on the enforceability of vote transfer provisions in subordination agreements. The Bankruptcy Code limits the right to vote to the holder of the claim and subordination alone does not make the senior creditor the holder. Moreover, shifting voting rights to senior creditors could have the effect of depriving the holders of junior claims of the absolute priority rule embodied in chapter 11.

However, when a creditor grants to a third party a security interest in its claim, the Bankruptcy Rules and judicial decisions recognize the validity and enforceability of agreements allocating voting rights between the parties and, in the absence of a voting rights agreement, the court may allocate such rights. It remains to be seen whether those courts that would otherwise refuse to enforce vote transfer provisions of subordination agreements, such as the 203 North LaSalle Street court, will enforce vote transfer provisions in the context of a subordination agreement coupled with the grant of a security interest in the junior claims.

NOTES

[1] 11 U.S.C. §510(a). Before the enactment of the Bankruptcy Code in 1978, there were no statutory provisions recognizing or giving effect to subordination agreements in bankruptcy cases. The former Bankruptcy Act, which was in effect from 1898 until the effective date of the 1978 Bankruptcy Code, was silent on contractual subordination. Nonetheless, although subordination agreements by their terms modified the statutory scheme of priorities under the old Bankruptcy Act, bankruptcy courts relied on their equitable powers to give effect to such agreements. As the Court of Appeals for the Second Circuit reasoned, "[e]quitable considerations ... require that the concept of equal distribution be applied only to creditors of equal rank, i.e., creditors who are similarly situated. Creditors who expressly agree to subordinate their claims against a debtor and the creditors for whose benefit the agreement to subordinate is executed are not similarly situated." *In re Credit Indus. Corp.*, 366 F.2d 402, 408 (2d Cir. 1966). *See also In re W.T. Grant Co.*, 75 B.R. 163 (S.D.N.Y. 1987). *See generally*, Heather J.VanMeter, *How Explicit Do You Need to Be? An Analysis of the Rule of Explicitness after Southeast Banking*, 105 Commercial L.J. 35, 41-44 (2000). Reliance on equitable powers to enforce subordination agreements is no longer necessary because the Bankruptcy Code, in section 510(a), expressly provides for their enforcement.

[2] The legislative history to the Bankruptcy Reform Act of 1978, referring to Section 510(a), recognizes that a bankruptcy court is required to enforce subordination agreements, but that "[a] subordination agreement will not be enforced, however, in a reorganization case in which the class that is the beneficiary of the agreement has accepted, as specified in 11 U.S.C. § 1126, a plan that waives rights under the agreement. Otherwise, the agreement would prevent just what chapter 11 contemplates: that seniors may give up rights to juniors in the interest of confirmation of a plan and rehabilitation of the debtor." H.R. Rep. No. 595, 359 (1978), reprinted in 1978 U.S.C.C.A.N. 5963, 6339.

[3] Although a subordination agreement usually is enforced as written, courts often require a clear and unambiguous statement in the agreement if the senior creditor seeks to obtain postpetition interest from distributions that otherwise would be paid to junior creditors. *See, e.g.,* Alan N. Resnick and Brad Eric Scheler, "The Right of a Senior Creditor to Receive Post-Petition Interest from a Subordinated Creditor's

Distributions: Did the Rule of Explicitness Survive the Enactment of the Bankruptcy Code," 32 U.C.C. L.J. 466 (2000).

[4] 11 U.S.C. § 1123(a)(1). Claims that are not placed in classes are administrative expense claims, claims that arise between the filing of an involuntary petition and the order for relief, and priority tax claims.

[5] 11 U.S.C. § 1122(a).

[6] For a discussion on whether senior and junior claims may be placed in the same class, see Daniel C. Cohn, "Subordinated Claims: Their Classification and Voting Under Chapter 11 of the Bankruptcy Code," 56 Am. Bankr. L. J. 293, 304-307 (1982).

[7] 11 U.S.C. § 1123(a)(2) and (a)(3).

[8] 11 U.S.C. § 1124(1).

[9] 11 U.S.C. § 1124(2).

[10] 11 U.S.C. § 1126(f).

[11] 11 U.S.C. § 1126(a).

[12] 11 U.S.C. § 1125. *See also* Fed.R. Bankr. P. 3017(d).

[13] *See* 11 U.S.C. § 1129(a).

[14] *See* 11 U.S.C. § 1129(b). To confirm a plan under the cram down method, the requirements of section 1129(a), other than the requirement that every class accepts the plan, must be satisfied, and the plan must be fair and equitable and may not discriminate unfairly, with respect to all nonaccepting classes. *See* 11 U.S.C. § 1129(b).

[15] 11 U.S.C. §1126(c). The percentage of votes required for a class of equity interests to accept a plan is governed by section 1126(d).

Despite the number of acceptances, however, the court has the power to disqualify the vote of any creditor or equity interest holder whose acceptance or rejection was not cast in good faith, is not solicited or procured in good faith, or was in violation of any provision of the Bankruptcy Code. *See* 11 U.S.C. §1126(e).

[16] 11 U.S.C. § 1129(b).

[17] *See* 11 U.S.C. § 1129(b)(2)(B).

[18] 192 B.R. 648 (Bankr. E.D.Pa. 1996).

[19] *See* 11 U.S.C. § 1129(a)(10), which provides that:

"(a) The court shall confirm a plan only if all of the following requirements are met:

* * *

> (10) If a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan has accepted the plan, determined without including any acceptance of the plan by any insider."

[20] The court indicated that these funds would be directly or indirectly derived from a source other than the debtor "in a manner that would permit Mellon to retain said

funds notwithstanding any subordination agreement between Mellon and Sumitomo." 192 B.R. at 659.

[21] 192 B.R. at 660.

[22] *Id.*

[23] *Id.*

[24] 1994 WL 646176 (E.D. La. 1994).

[25] 11 U.S.C. §1126(g).

[26] 1994 WL 646176 (E.D. La. 1994), at *2.

[27] 11 U.S.C. §510(a).

[28] 169 B.R. 229 (Bankr. M.D. Ga. 1994), *rev'd. on other grounds,* 176 B.R. 290 (M.D. Ga. 1994).

[29] *Id.* at 234.

[30] *Id.*

[31] 197 F.Supp. 194 (E.D.N.Y. 1961).

[32] 197 F.Supp. at 197.

[33] 197 F.Supp. at 197.

[34] 11 U.S.C. § 510(a).

[35] *See, e.g., In re Geo. P. Schinzel & Co., Inc.,* 16 F.2d 289 (S.D.N.Y. 1926); *Searle v. Mechanics' Loan & Trust Co.,* 249 F. 942 (9th Cir. 1918).

[36] *See, e.g., In re Handy-Andy Community Stores, Inc.,* 2 F.Supp. 97 (W.D. La. 1932).

[37] *See, e.g., In re Dodge-Freedman Poultry Co.,* 148 F.Supp. 647 (D.N.H. 1956), aff'd 244 F.2d 314 (1st Cir. 1957).

[38] 197 F.Supp. at 197.

[39] *Id.* at 197-198.

[40] *Id.* at 197.

[41] *Id.* at 198. The *Itemlab* court's reliance on the "no interest" theory is further evidenced by its reference to *Meinhard, Greff & Co. v. Brown.* 199 F.2d 70 (4th Cir. 1952), another pre-Code case which did not involve a subordination agreement, as authority for its ruling. In *Meinhard,* a bond issued by a corporation was pledged by the bond owner to secure payment of another debt of the corporation. The face amount of the bond was much larger than the balance of the debt for which the bond was pledged. The court in *Meinhard* held that the creditor pledgee was entitled to vote the claim represented by the bond in the corporation's reorganization proceeding to the extent of the amount secured by the pledge, with the bond owner entitled to vote the remainder of the claim. The court reasoned that, despite the absence of any statutory provisions dealing with the issue, it may rely on equitable powers to reach a result based on the interest of each party with respect to the bond . "We have no doubt as to the power of the court, under such circumstances, to apportion the vote of the bond in accordance with the interest of the owner and

pledgee respectively." *Id.* at 75.

[42] 246 B.R. 325 (Bankr. N.D. Ill. 2000).

[43] The "Consent and Subordination Agreement" contained the following provision:

> "[North LaSalle] further agrees that in the event of any dissolution, winding up, liquidation, readjustment, reorganization or other similar proceeding relating to ... the [debtor] ..., whether in bankruptcy, insolvency, or receivorship ..., [liabilities owed to the bank] shall first be paid in full before [North LaSalle] shall be entitled to receive and to retain any payment or distribution in respect of the liabilities [of the debtor under the second mortgage], and in order to implement the foregoing, (a) all payments and distributions of any kind or character in respect of the [debt owed to North LaSalle] ... shall be made directly to [Bank of America] ... and (c) [North LaSalle] hereby irrevocably agrees that [Bank of America] may, at its sole discretion, in the name of [North LaSalle] or otherwise, demand, sue for, collect, receive and receipt for any and all such payments or distributions and file, prove, and vote or consent in any such proceedings with respect to, any and all claims of [North LaSalle] relating to the [debts owed to North LaSalle]."

246 B.R. at 327-328.

[44] The Supreme Court reversed the confirmation order because the plan did not meet the "fair and equitable" requirement for confirmation over the objection of a class of creditors that did not accept the plan. *See* 11 U.S.C. § 1129(b). *Bank of America Nat'l Trust and Savings Ass'n v. 203 N. LaSalle St. Partnership,* 526 U.S. 434, 119 S.Ct. 1411, 143 L.Ed. 607 (1999).

[45] The bank also asked for a declaration that its entire claim, including any portion in excess of the value of the property, must be paid before North LaSalle receives any payment from the debtor on account of its subordinated claim. North LaSalle argued that the bank was entitled to payment only up to the value of the property because the obligation owed to the bank was nonrecourse. The bankruptcy court rejected North LaSalle's argument and held that any unsecured deficiency portion of the bank's claim is entitled to senior status over North LaSalle's claim. The court held that the agreement was unambiguous and clearly showed the parties' intent to subordinate North LaSalle's claim to the bank's entire claim, including any deficiency claim. 246 B.R. at 328-330.

[46] 11 U.S.C. § 1126(a).

[47] 246 B.R. at 331.

[48] The court cited *In re Cole,* 226 B.R. 647, 652 n.7 (9th Cir. BAP 1998), where the bankruptcy appellate panel collected decisions refusing to enforce prepetition waivers of bankruptcy benefits other than discharge of indebtedness.

[49] 246 B.R. at 331.

[50] *Id.*, citing Joseph R. Nolan and Jacqueline M. Nolan-Haley, Black's Law Dictionary 1426 (6th ed. 1990).
[51] 246 B.R. at 331.
[52] 5 B.R. 734 (Bankr. D. Minn. 1980).
[53] 5 B.R. at 736.
[54] *Id.*
[55] Fed.R.Bankr.P. 3018(c).
[56] 246 B.R. at 331.
[57] *Id.*, quoting from *Brunswick Leasing Corp. v. Wisconsin Central Ltd.*, 136 F.2d 521, 526 (7th Cir. 1998), which quoted from *Wargel v. First Nat'l Bank of Harrisburg*, 121 Ill.App.3d. 730, 736 (1984).
[58] For another decision narrowly construing the phrase "authorized agent" with respect to the right to vote on a chapter 11 plan, *see In re Southland Corp.*, 124 B.R. 211 (Bankr. N.D. Tex. 1991) (beneficial holders, rather than record holders, of debt securities could vote on a chapter 11 plan; the record holders were not authorized agents of the beneficial holders).
[59] 246 B.R. at 332.
[60] *Id.*
[61] *Id. See also,* Daniel C. Cohn, *Subordinated Claims: Their Classification and Voting Under Chapter 11 of the Bankruptcy Code,* 56 Amer. Bankr. L.J. 293, 316 (1982) ("Unrestricted voting of subordinated claims by senior creditors robs the subordinated claimants of the opportunity to decline to assent, without providing any other protection for their interests. An unrestricted voting provision in a subordination agreement should not be enforced, and agreements that do not provide for unrestricted voting should not be interpreted to require it."); James L. Lopes, *Contractual Subordinations and Bankruptcy,* 97 Banking L.J. 204, 217 (1980) ("A negotiated plan of arrangement could never be reached if the subordinated creditors did not have the power to block confirmation if they were not satisfied with the arrangement.").
[62] 1994 WL 646176 (E.D.La. 1994) (discussed *supra*).
[63] *See also Matter of Heller-Sperry, Inc.*, 154 F. Supp. 359 (D.R.I. 1957), where creditors, including a holder of a debenture, signed an agreement subordinating their claims to certain bank loans, assigning their claims to the banks as security for the bank loans, granting the banks the right to vote the subordinated claims in a reorganization case, and granting the banks' agent the right to file proofs of claim to enforce such subordinated claims. When the debtor filed a bankruptcy petition, the banks' agent had possession of the debenture. Although the banks' right to vote the debenture claim was not at issue, the district court held that the banks' agent was the only person entitled to file a proof of claim and that a proof of claim filed by the

debenture holder had to be expunged. Based on the court's reasoning, the court probably would have permitted the banks to vote the debenture claim in the bankruptcy case.

[64] *See* note 41 *supra* for a discussion of *Meinhard, Greff & Co. v. Brown,* 199 F.2d 70 (4th Cir. 1952), where the court held that a pledgee of a bond that had a face amount greater than the debt for which it was pledged was entitled to vote the claim represented by the bond in the issuer's reorganization case under the former Bankruptcy Act, but only to the extent of the amount secured by the bond.

[65] Fed. R. Bankr. P. 3001(e)(3) and (4).

[66] Advisory Committee Note, F. R. Bank. P. 3001. The Advisory Committee Note cites *Feder v. John Engelhorn & Sons,* 202 F.2d 411 (2d Cir. 1953) as authority for this statement.