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From the Bankruptcy Courts

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?

Subordination agreements among creditors who would otherwise be entitled to share equally in a company's bankruptcy estate are common in financial transactions. For example, a company may obtain financing by issuing debentures that are subordinated to other debt securities or other types of indebtedness. The level of priority, whether senior or junior, will directly affect the credit risk, interest rate, and market with respect to particular debt securities. Subordination agreements may arise in other contexts as well, such as when a debtor experiencing financial difficulties seeks an additional loan. The new lender may insist on an agree-

ment 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 debtor with needed capital. Regardless of the context, however, parties often rely on the enforceability of subordination agreements when entering into financial transactions.

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

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subordinate their claims against a debtor and the creditors for whose benefit the agreement to subordinate is executed are not similarly situated.”¹ 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.

The Right to Post-Petition Interest in Bankruptcy Cases

Another rule that is fundamental to bankruptcy law—both under the former Act and under today’s Code—is that interest on unsecured or undersecured claims stops accruing when a bankruptcy petition is filed by an insolvent debtor.² This rule, which recognizes that the debtor’s delay in repayment during the bankruptcy case results from operation of law, prevents creditors from profiting or suffering a loss in relation to each other because of the delay.³ The only creditors entitled to recover post-petition interest from an insolvent debtor’s estate are those whose claims are oversecured by collateral of a value that exceeds the allowed amount of their claims.⁴ The inability to recover post-petition interest from a debtor’s estate could be significant when a debtor’s Chapter 11 case lasts for several years

before confirmation of a plan of reorganization.

It is not surprising that senior creditors—armed with an enforceable agreement that subordinates the rights of junior creditors to the full payment of senior claims—have attempted to recover post-petition interest from distributions that otherwise would be made to junior creditors.⁵ That is, senior creditors have argued that, although they were not entitled to recover post-petition interest from the bankruptcy estate or the debtor, they were entitled to receive it from junior creditors. They have argued that such recovery is consistent with the junior creditors’ agreement to subordinate their right to repayment until the senior debt had been paid in full, and full payment of senior debt includes the payment of post-petition interest.

The Development of the Rule of Explicitness

This argument by senior creditors was addressed by the Court of Appeals for the Third Circuit in *In re Time Sales Finance Corp.*⁶ in 1974, four years before the enactment of the Bankruptcy Code. The court held that a junior creditor could agree to subordinate its claim to a senior creditor’s demands for post-petition

¹ *In re Credit Indus. Corp.*, 366 F.2d 402, 408 (2d Cir. 1966).

² 11 U.S.C. § 502(b)(2).

³ See *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 163 (1946).

⁴ See 11 U.S.C. § 506(b).

⁵ See, e.g., *Matter of Time Sales Finance Corp.*, 491 F.2d 841 (3rd Cir. 1974); *In re Kingsboro Mortgage Corp.*, 514 F.2d 400 (2d Cir. 1975); *Matter of King Resources Co.*, 528 F.2d 789, 791 (10th Cir. 1976).

⁶ *In re Time Sales Fin. Corp.*, 491 F.2d 841 (3rd Cir. 1974).

interest, but that such agreement is enforceable only if the subordination agreement is explicit on that issue.

If a creditor desires to establish a right to post-petition interest and a concomitant reduction in the dividends due to subordinate creditors, the agreement should clearly show that the general rule that interest stops on the date of the filing of the petition is to be suspended, at least vis-a-vis these parties.⁷

The Third Circuit then focused on the subordination agreement before it, and concluded that its language requiring that senior debt must be "paid in full" before payment to junior creditors—without any specific mention of post-petition interest—was not sufficient to alert junior creditors that they had agreed to subordinate their rights to the post-petition interest claims of senior creditors. Accordingly, the court affirmed the district court's holding that the senior creditors were not entitled to receive post-petition interest from distributions that would otherwise go to subordinated creditors. Other courts in pre-Code cases adopted the Third Circuit's approach, which became known as the "Rule of Explicitness."⁸

An interesting question that has surfaced is whether the Rule of Explicitness—a judge-made federal

common law doctrine—survived the enactment of the 1978 Bankruptcy Code. As previously noted, unlike the former Bankruptcy Act, the Bankruptcy Code provides express statutory authority for the recognition and effectiveness of subordination agreements in bankruptcy cases. In particular, section 510(a) of the 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."⁹ But the Code is silent regarding the right of a senior creditor to receive post-petition interest from distributions that would otherwise go to junior creditors.

The issue as to whether or not the Rule of Explicitness has remained in effect after the enactment of the Bankruptcy Code was recently examined in a series of three decisions—two by the Court of Appeals for the Eleventh Circuit and one by the Court of Appeals of the State of New York—in *In re Southeast Banking Corporation*.¹⁰ In this dispute between senior and junior creditors, both the bankruptcy court¹¹ and the district court¹² ruled in favor of the junior creditors applying the traditional Rule of Explicitness.

⁹ 11 U.S.C. § 510(a).

¹⁰ See *In re Southeast Banking Corp.*, 156 F.3d 1114 (11th Cir. 1998) ("Southeast I"); *In re Southeast Banking Corp.*, 93 N.Y. 2d 178 (N.Y. 1999) ("Southeast II"); *In re Southeast Banking Corp.*, 179 F.3d 1307 (11th Cir. 1999) ("Southeast III").

¹¹ 188 B.R. 452 (Bankr. S.D. Fla. 1995).

¹² 212 B.R. 682 (Bankr. S.D. Fla. 1997).

⁷ 491 F.2d at 844.

⁸ See *In re King Resources Co.*, 385 F. Supp. 1269 (D.Col. 1974), *aff'd* 528 F.2d 789 (10th Cir. 1976); *In re Kingsboro Mortgage Corp.*, 379 F. Supp. 227, 231 (S.D.N.Y. 1974), *aff'd* 514 F.2d. 400 (2d Cir. 1975).

The Facts

Southeast Banking Corporation ("Southeast") issued \$ 60 million in principal amount of unsecured notes (the "Senior Notes"). The Chase Manhattan Bank ("Chase"), is the indenture trustee under the Senior Indenture and Gabriel Capital, L.P. ("Gabriel") is the holder of a substantial portion of the Senior Notes. In addition, under five indentures (the "Subordinated Indentures"), Southeast issued in excess of \$ 300 million in principal amount of subordinated notes ("the Subordinated Notes"). Each of the Subordinated Indentures contains language that subordinates collection of the Subordinated Notes to the prior payment "in full" of the Senior Notes.¹³ The Subordinated Indentures made no specific mention of post-petition interest that may accrue on the Senior Notes, or of the indenture trustee's fees and costs for collecting such post-petition interest.

¹³ The five Subordinated Indentures contain similar language. Four indentures provide, in relevant part, that in the event of any liquidation or bankruptcy of Southeast, "all obligations of [Southeast] to Holders of Senior Indebtedness of [Southeast], shall be entitled to be paid in full before any payment shall be made on account of the principal of or interest on the [Subordinated] Notes." One Subordinated Indenture provides, in relevant part, that "upon ... payment or distribution of assets of [Southeast] ... in bankruptcy, all principal, premium, if any, and interest due or to become due upon all Senior Indebtedness shall first be paid in full ... before any payment is made on account of the principal or, premium, if any, or interest on Debentures...." 212 B.R. at 690-691.

When Southeast filed a voluntary bankruptcy petition under Chapter 7 of the Bankruptcy Code in 1991, both Chase and the trustee for the Subordinated Notes filed proofs of claims as unsecured nonpriority claims on behalf of the noteholders. Because Southeast was insolvent, any claims for post-petition interest asserted by unsecured creditors would not be allowable in the bankruptcy case. However, Chase and Gabriel ("Senior Creditors"), relying on the subordination provisions of the Subordinated Indentures, commenced a proceeding to compel the payment of post-petition interest on the Senior Notes, as well as reimbursement for Chase's fees and costs in connection with the action, from distributions otherwise payable to the holders of the Subordinated Notes ("Junior Creditors") with respect to their claims for principal and pre-petition interest.

The bankruptcy court, ruling on motions for summary judgment, held that the Senior Creditors were not entitled to recover post-petition interest, or costs incurred in attempting to collect post-petition interest, from any distributions otherwise payable to the Junior Creditors with respect to their claims for principal and pre-petition interest on the Subordinated Notes.¹⁴ The district court affirmed.¹⁵ Both the bankruptcy court and the district court based their holdings on the Rule of Explicitness and a finding that the language

¹⁴ 188 B.R. 452 (Bankr. S.D. Fla. 1995).

¹⁵ 212 B.R. 682 (Bankr. S.D. Fla. 1997).

of the indentures was not sufficiently explicit to make it clear that the Junior Creditors' claims would be subordinated to the Senior Creditors' claims for post-petition interest. These courts rejected the argument made by the Senior Creditors that the enactment of section 510(a) of the Bankruptcy Code abrogated the Rule of Explicitness.

Eleventh Circuit Rejects District Court's Reasoning: Southeast I

In the first of two opinions ("Southeast I"), the Court of Appeals for the Eleventh Circuit disagreed with the district court's analysis. Although it agreed with the finding below that the language in the indenture agreements requiring "payment in full" to Senior Creditors without any specific reference to post-petition interest is not sufficiently precise to satisfy the Rule of Explicitness,¹⁶ the Eleventh Circuit held that the Rule of Explicitness did not survive the enactment of section 510(a) of the Bankruptcy Code.¹⁷ That section provides that a subordination agreement is enforceable "to the same extent that such agreement is enforceable under applicable nonbankruptcy law."

The Eleventh Circuit construed the phrase "applicable nonbankruptcy law" in section 510(a) to mean "any

relevant federal or state law."¹⁸ The court noted the absence of any independent federal statute that might guide the interpretation of subordination agreements, as well as the parties' failure to refer to any nonbankruptcy federal common law on the subject. This absence of federal authority did not surprise the court because usually the interpretation of private contracts is a state law matter.

The Eleventh Circuit also noted that the Rule of Explicitness was a creature of the broad equitable powers enjoyed by bankruptcy courts before the Code's enactment. It also pointed out the contrast between section 510(a), which requires enforcement of subordination agreements to the extent provided in nonbankruptcy law, and section 510(c), which gives the court the power to subordinate claims based on the doctrine of equitable subordination.

The language of section 510(c) expressly invokes the bankruptcy courts' historical exercise of their equitable powers to subordinate the claims of creditors who engaged in inequitable conduct in favor of the claims of those creditors who came to court with clean hands. Section 510(c), therefore, powerfully demonstrates that Congress was aware of the bankruptcy courts' exercise of their equitable powers in the context of subordination, and that Congress knew how to preserve those powers to the extent it chose to do so. In sharp contrast to section 510(c), however, section 510(a) includes no such ex-

¹⁶ 156 F.3d at 1120.

¹⁷ 156 F.3d at 1127. Senior Circuit Judge Fay dissented and supported the view that section 510(a) did not abolish the Rule of Explicitness.

¹⁸ 156 F.3d at 1121, quoting *Patterson v. Shumate*, 504 U.S. 753, 757-759 (1992).

press grant of authority that would permit the bankruptcy courts to continue enforcing and interpreting subordination agreements in equity. When compared with Congress' decision to permit the bankruptcy courts to retain their powers of equitable subordination in section 510(c), section 510(a)'s command to enforce subordination agreements according to the applicable nonbankruptcy law can only be read as a clear and contemplated break with prior practice. Accordingly, the plain language of the text, as well as the provision's structure, supports our conclusion that Congress, by designating state law to govern the interpretation and enforcement of subordination agreements, withdrew the foundation of equitable authority under with the bankruptcy courts had developed the Rule of Explicitness.¹⁹

As a result, because the Rule of Explicitness no longer has its support in federal judge-made equitable principles, the rule, if it is to continue to exist and be relied upon, must find its source of authority in state law. The Eleventh Circuit turned to the choice of law provisions in the Subordinated Indentures which provided that New York law governs the enforcement and interpretation of the contracts.²⁰ The court noted that New York courts have never considered the question of whether explicit language is required to subordinate a junior creditor's claim to a senior creditor's claim for post-petition interest. This absence of state law authority is not

surprising because this issue arises only in bankruptcy cases and, until the Eleventh Circuit decision, federal judge-made equitable principles were available to invoke the Rule of Explicitness. Rather than attempting to predict how New York courts would resolve this issue, the Eleventh Circuit certified the following question to the New York State Court of Appeals:²¹

What, if any, language does New York law require in a subordination agreement to alert a junior creditor to its assumption of the risk and burden of the senior creditor's post-petition interest?

Before sending the issue to the New York Court of Appeals, however, the Eleventh Circuit offered a few observations, apparently for the benefit of the New York court. First, it noted that the "paid in full" language in the Subordinated Indentures may sound in absolute terms and that "Chase's characterization of the phrase as requiring the payment of interest until the final repayment of the underlying obligation is a straightforward one."²² However, the court commented that the phrase

²¹ The Eleventh Circuit certified this question to the New York Court of Appeals based on N.Y. Rules of Court § 500.17(a) (McKinney 1997), which provides: "Whenever it appears to ... any United States Court of Appeals ... that determinative questions of New York law are involved in a cause pending before it for which there is no controlling precedent of the [New York] Court of Appeals, such court may certify the dispositive questions of law to the [New York] Court of Appeals."

²² 156 F.3d at 1124.

¹⁹ 156 F.3d at 1122-1123.

²⁰ *Id.* at 1125.

"paid in full" is ambiguous in the bankruptcy context where "the law has long been clear that even a senior creditor often has no claim for post-petition interest from the debtor and, therefore, a junior creditor may reasonably expect to recover some repayment from the debtor without being held hostage to an often sizeable claim for the senior creditor's post-petition interest."²³

As a final message to the New York Court of Appeals, the Eleventh Circuit volunteered that "we wonder" whether the New York courts would "disturb" the uniform treatment of federal courts on this issue, particularly in view of evidence that the capital markets appear to have adjusted to the Rule of Explicitness.²⁴ The court noted that the American Bar Association's "Model Simplified Indenture,"²⁵ in response to the Rule of Explicitness, includes language that clearly and explicitly alerts a junior creditor that subordination applies to the senior creditor's post-petition interest. In an apparent attempt to influence the New York Court of Appeals, the Eleventh Circuit offered the following advice:

Given New York's role as the nation's financial capital and our intuition that a sizeable proportion of outstanding

indenture agreements include clauses that invoke New York law, as well as the importance of standardization in indenture agreements generally, we suspect that the courts of New York, as a practical matter, would be loath to depart from prior practice and thus radically reduce the current value of debt held subject to the condition of subordination until the senior creditor receives 'payment in full.'²⁶

New York Court of Appeals Adopts the Rule of Explicitness as Its Own: Southeast II

In response to the question certified by the Eleventh Circuit, the New York Court of Appeals²⁷ adopted the Rule of Explicitness as a principle of interpretation of contracts under New York law. In particular, the court held that "[i]n 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 post-petition interest demand."²⁸

The New York Court of Appeals began its analysis by recognizing the widespread effect that its decision would have on financial agreements.

[W]e are acutely cognizant of the practical effect that our answer to the certified question will have on a vast sea of subordination agreements not before us now in live cases or contro-

²³ *Id.*

²⁴ *Id.* at 1124.

²⁵ See American Bar Association, Model Simplified Indenture, 38 Bus. Law. 741, 769 (1983). See also, *In re Ionosphere Clubs, Inc.*, 134 B.R. 528, 535 n. 14 (Bankr. S.D.N.Y. 1991), quoting an indenture with similarly explicit language to satisfy the Rule of Explicitness.

²⁶ *Id.* at 1125.

²⁷ *In re Southeast Banking Corporation*, 93 N.Y.2d 178 (N.Y. 1999) ("Southeast II").

²⁸ *Id.* at 186.

versies, nor even within the framework of this Eleventh Circuit litigation, involving enormous sums of outstanding public debt. Indeed, while it is not our forum's role to rule ultimately on the subordination agreements at issue in this case, we recognize that they and many others were drafted and entered into before the Rule of Explicitness was called into question by the ruling of the Eleventh Circuit in the instant case.²⁹

The Court of Appeals did not treat the practical effect of a decision on this question lightly. Noting that parties in subordination agreements undoubtedly relied on the Rule of Explicitness—"their lawyers would have been quite remiss had they not"³⁰—the New York Court of Appeals wrote that the practical policy consequence is a matter of legitimate concern in the development of common law with respect to commercial matters, where "reliance, definiteness, and predictability are such important goals of the law itself."³¹

The practical realities aside, the Court of Appeals also found the Rule of Explicitness to be grounded on sound and relevant policies. Focusing on the mischief that the rule was designed to remedy, the court noted that it evolved as an equitable principle to rectify the perceived inequity that resulted when a junior creditor's potential distributions from a bankruptcy estate were taken to pay a senior creditor's post-petition interest. "If a senior creditor is

allowed to recover post-petition interest from a subordinated creditor, a senior creditor could end up receiving more recovery than it would have been entitled to against the debtor, while the subordinated creditor's recovery is proportionately diminished."³² Such a result should not be permitted in the absence of clear, explicit language providing for it in the subordination agreement. This policy basis for the Rule of Explicitness did not change in 1978 because the general rule requiring disallowance of post-petition interest in bankruptcy cases continued under the Code.³³

Finally, the New York Court of Appeals reasoned that the adoption of the Rule of Explicitness as state common law would be consistent with its ruling in another case where it held that, as a general rule, a creditor is not entitled to interest that accrues following an assignment for the benefit of creditors under the New York Debtor and Creditor Law. In *Matter of Pavone Textile Corp. v. Bloom*,³⁴ the Court of Appeals held that "the general rule as to post-assignment interest prevails in the absence of any statute expressly providing for such interest."³⁵ In *Southeast Banking*, the New York Court of Appeals referred to its decision in *Pavone Textile* and commented that "the Rule of

²⁹ *Id.* at 183-184.

³⁰ *Id.* at 184.

³¹ *Id.* at 184.

³² *Id.* at 185.

³³ See 11 U.S.C. § 502(b)(2).

³⁴ 302 N.Y. 206, *aff'd*: 342 U.S. 912 (1951).

³⁵ *Id.* at 213.

Explicitness safeguards reliance by parties on the analogous general rule that creditors are not entitled to post-petition interest in bankruptcy proceedings absent express language to that effect in subordination agreements ordering priorities among the contracting parties."³⁶

Back to the Eleventh Circuit: Southeast III

Based on the law of the State of New York as enunciated in the opinion of the New York Court of Appeals, the Eleventh Circuit applied the Rule of Explicitness in upholding the district court's decision denying the request of the Senior Creditors to receive post-petition interest from distributions otherwise payable to Junior Creditors.³⁷ But the Eleventh Circuit further clarified its decision by noting in a footnote that

[T]he district court opinion was incorrect in concluding that under bankruptcy law, the Rule of Explicitness survives the enactment of section 510(a) of the Bankruptcy Code. Rather, we must look to the "applicable nonbankruptcy" law to determine the extent to which a subordination agreement is enforce-

able. In this case, we determined that the applicable nonbankruptcy law is the law of New York.... We apply the Rule of Explicitness here because New York law, not the Bankruptcy Code, requires us to do so.³⁸

Conclusion

The series of decisions in *South-east Banking* is instructive for senior and junior creditors and their lawyers. Parties can no longer rely on the Rule of Explicitness unless it is adopted as state law. Fortunately, many indentures and other financing agreements with subordination provisions contain choice of law clauses providing that they shall be governed by New York law. For those, the Rule of Explicitness will continue to govern questions regarding the subordination of junior claims to post-petition interest claims of senior claims, and general language providing for payment in full of senior claims before junior claims receive any payment will not be sufficient for that purpose.

For subordination agreements not governed by New York law, whether the Rule of Explicitness will apply will depend on the development and application of state law.

³⁶ 93 N.Y.2d at 186.

³⁷ 179 F.3d 1307 (11th Cir. 1999).

³⁸ *Id.* at 1311 n.2.