Pratt's Journal of Bankruptcy Law

VOLUME 8 NUMBER 6 SEPTEMBER 2012

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ISSN 1931-6992

Does a Subordinated Debt Holder's Assignment of Its Right to Vote on a Bankruptcy Plan Effectively Sacrifice All of the Subordinated Debt Holder's Rights in a Chapter 11 Case?

ALAN J. LIPKIN

In this article, the author analyzes a recent court decision that highlights the perils to subordinated debt holders from agreeing to a subordination agreement provision assigning the right to vote their subordinated claims in a subsequent bankruptcy case of the debt issuer.

A little-noticed "Not for Publication" opinion by the United States Bankruptcy Court for the District of New Jersey highlights the perils to subordinated debt holders from agreeing to a subordination agreement provision assigning the right to vote their subordinated claims in a subsequent bankruptcy case of the debt issuer.[1] In *Coastal Broadcasting*, the court held that "the voting assignment provision is enforceable" and, therefore, the subordinated debt holders' rights were overridden by the debtor's Chapter 11 plan that the senior bank lender had stated it would vote to accept.[2] In particular,

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Published by A.S. Pratt in the September 2012 issue of *Pratt's Journal of Bankruptcy Law*.
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the plan "totally extinguish[ed] any and all rights [the subordinated debt holders] would otherwise have enjoyed under the express terms of the Subordination Agreement," including "any right [the subordinated debt holders] might have to payment, once the Bank is paid in full."[3] Thus, the subordinated debt holders lost any ability to recover on their claims, *even if the senior bank lender was paid in full* (as was provided for in the plan).

ENFORCEABILITY OF PLAN VOTE ASSIGNMENT PROVISION IN A SUBORDINATION AGREEMENT

Accordingly, once a subordinated debt holder agrees to a subordination agreement assigning the right to vote its claim in a bankruptcy case, the subordinated debt holder has limited protections in a subsequent Chapter 11 case of the issuer. As a threshold matter, the subordinated debt holder may argue such a vote assignment provision is unenforceable in a bankruptcy case. Lower courts have split on the enforceability issue and there is no circuit court opinion on point.[4]

Notably, the fate of the *Coastal Broadcasting* subordinated debt holders underlies one of the arguments against broad enforcement of all provisions in a subordination agreement. Specifically, there is a policy argument that preserving a creditor's right to vote its subordinated claim is the only way to ensure the subordinated creditor has a role in the plan process sufficient to protect the creditor's potential for receiving a plan distribution.[5] Meanwhile, the remaining arguments on enforceability of a voting assignment concern Bankruptcy Code or rule interpretation.

First, courts debate whether the language of Section 1126(a) providing that "[t]he holder of a claim . . . may accept or reject a plan" precludes assignment of a voting right because the language of Section 1126(a) signifies the subordinated claim holder must always control its vote.[6]

Second, courts debate whether the language of Section 510(a) providing 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" encompasses all provisions of a subordination

agreement or merely the subordination clause(s) concerning the priority and flow of distributions.[7]

Third, courts debate whether the language of Federal Rule of Bankruptcy Procedure 3018(c) requiring that a plan vote "be signed by the creditor or . . . an authorized agent" means that plan voting rights are nonassignable unless the authorized agent is controlled by the subordinated creditor.

LIMITED ALTERNATIVES: PLAN CONFIRMATION OBJECTIONS

If all aspects of a subordination agreement, including a vote assignment, are enforceable, then a subordinated debt holder would have limited alternative arguments. The senior creditor's vote *to accept* a Chapter 11 plan on behalf of the subordinated claim should preclude a subordinated debt holder's challenge to plan confirmation based on the best interests test and the cramdown protections of Sections 1129(a)(7) and 1129(b) of the Bankruptcy Code, respectively. That is because those challenges require: (a) a vote *to reject* a plan by the individual creditor (for the best interests test, which requires the dissenting creditor to receive at least as much under the Chapter 11 plan as the creditor would receive in a Chapter 7 case); or (b) *rejection* by the class of subordinated creditors (for the cramdown test, which requires that the plan not discriminate unfairly against, and be fair and equitable respecting, the class of subordinated claims).[8] Nonetheless, one argument not addressed in *Coastal Broadcasting* or the other vote assignment cases is that the senior creditor's acceptance of the plan on behalf of the subordinated claim holder is overridden by the subordinated claim class's deemed rejection of the plan under Section 1126(g) of the Bankruptcy Code. In effect, if, as in *Coastal Broadcasting*, the plan provides for *no distributions* for the subordinated claims class, then Section 1126(g) provides that the plan shall be deemed rejected by that class.[9]

Another potential confirmation objection would exist if there is a meaningful prospect for recovery by a subordinated debt holder that would be extinguished by a plan and the applicable subordination agreement does not preclude all plan-related actions by the subordinated

creditor. Then perhaps the subordinated debt holder could argue the plan is not "proposed in good faith" as required by Section 1129(a)(3) of the Bankruptcy Code. Also, if the senior creditor's good faith were in question, then the subordinated creditor might seek to have the senior creditor's vote of the subordinated claim invalidated under Section 1126(e). Section 1126(e) provides that "the court may designate any entity whose acceptance or rejection of such plan was not in good faith...."[10] Even if permissible, however, such good faith objections typically would have limited prospects for success.[11]

OTHER POTENTIAL STRATEGIES

Alternatively, the subordinated creditor could seek leverage through ownership of other claims or otherwise seek to promote a plan that would cramdown the senior creditor and override the applicable subordination agreement. Significantly, Section 1129(b), which would control the senior creditor's rights in such a cramdown scenario, begins with the phrase "notwithstanding section 510(a) of this title...."[12] Presumably, therefore, such a cramdown plan could provide a subordinated claim with rights that otherwise would be precluded under an applicable subordination agreement. Additionally, the subordinated debt holder could pay the senior debt in full if the situation warranted such a payment. Indeed, that option is a rationale expressed by certain bankruptcy courts for enforcing all terms of a subordination agreement, no matter how harsh.[13]

CONCLUSION

Consequently, the threshold issue of whether a plan voting assignment provision is enforceable will likely control the treatment of subordinated claims in a Chapter 11 case and courts are split on resolution of that issue. Thus, subordinated and senior lenders that anticipate the enforceability of an assignment of a subordinated creditor's right to vote on a plan will be a significant issue should pay careful attention to the likely venue of a potential Chapter 11 case for the issuer.

Correspondingly, all such parties should conduct negotiations and should strategize with the understanding that all provisions of a subordination agreement might not be enforceable and with the recognition of the consequences if all such provisions are enforceable.

NOTES

[1] *See In re Coastal Broadcasting Systems, Inc.*, Case No. 11-10596 (GMB) (Bankr. D.N.J. July 6, 2012).
[2] *Id.* at 12.
[3] *Id.* at 8-9.
[4] Cases supporting enforcement in a bankruptcy case of all provisions of a subordination agreement, including the assignment of the right to vote on a plan, include: *In re Avondale Gateway Center Entitlement, LLC*, 2011 U.S. Dist. LEXIS 41450, at *11-12 (D. Ariz. April 11, 2011); *In re Erickson Retirement Communities, LLC*, 425 B.R. 309, 315-16 (Bankr. N.D. Tex. 2010); *In re Aerosol Packaging, LLC*, 362 B.R. 43, 47 (Bankr. N.D. Ga. 2006); *In re Curtis Center Ltd. Partnership*, 192 B.R. 648, 660 (Bankr. E.D. Pa. 1996). Cases supporting denial of enforcement of subordination agreement provisions beyond those governing priority of payment of claims include: *In re SW Boston Hotel Venture, LLC*, 460 B.R. 38, 52 (Bankr. D. Mass. 2011); *In re Croatan Surf Club, LLC*, 2011 WL 5909199, at *3 (Bankr. E.D.N.C. Oct. 25, 2011); *In re 203 N. LaSalle St. P'shp.*, 246 B.R. 325, 331-32 (Bankr. N.D. Ill. 2000); *In re Hart Ski Mfg. Co., Inc.*, 5 B.R. 734, 736 (Bankr. D. MN. 1980).
[5] *See In re Croatan Surf Club, LLC*, 2011 WL 5909199 *3 (citing *In re 203 N. LaSalle St. P'shp.*, 246 B.R. at 332).
[6] 11 U.S.C. § 1126(a).
[7] 11 U.S.C. § 510(a).
[8] Otherwise, the fair and equitable standard would preclude the holder of claim or equity interest junior to the subordinated claim's class from receiving or retaining under the plan property on account of such junior claim or interest unless the subordinated debt claims were paid in full under the plan. *See* 11 U.S.C. § 1129(b)(2)(B).
[9] *See* 11 U.S.C. § 1126(g) ("a class is deemed not to have accepted a plan if such plan provides that claims or interests of such class do not entitle the holders of such claims or interests to receive or retain any property under the plan on account of such claims or interests").

[10] 11 U.S.C. § 1126(e).
[11] *See In re DBSD North America, Inc.*, 634 F.3d 79, 101-02 (2d Cir. 2011) ("Bankruptcy courts should employ § 1126(e) designation sparingly as the 'exception not the rule.'").
[12] 11 U.S.C. § 510(a).
[13] *See, e.g.*, *In re Aerosol Packaging, LLC*, 362 B.R. at 47.