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Intercreditor Agreements in Bankruptcy

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Chapter 3A

Intercreditor Agreements—Drafting Considerations with Bankruptcy in Mind—Presentation Slides

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INTERCREDITOR AGREEMENTS – DRAFTING CONSIDERATIONS WITH BANKRUPTCY IN MIND

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INTRODUCTION

This presentation assumes that:

- (a) the Intercreditor Agreement ("IA") is between a first lien lender ("1st Lien") and a second lien lender ("2d Lien"), both having liens on the same collateral with each obligor granting a lien (a "Grantor") also a party to the IA
- (b) the IA provides only for a lien (and not a debt) subordination;
- (c) 1st Lien is a working capital lender and 2d Lien is a term lender or indenture trustee;
- (d) 1st Lien and 2d Lien debt and liens are separately documented, with separate lien grants; and



2

- (e) all of the IA provisions are enforceable in a bankruptcy ("BK") case of each Grantor

Outcome of the negotiations will depend, in part, upon a variety of factors, including relative size of the 1st Lien and 2d Lien debt, the willingness of either to replace the other in the borrower's capital structure if IA negotiations break down, and the past experiences of the parties with one another

Whether you represent the 1st Lien, 2d Lien, Grantor (Debtor), or a third party creditor, it is important that you understand how the words on the pages of an IA can impact the progress and outcome of a BK case.



3

GENERAL BANKRUPTCY PROVISIONS

1. No Challenge to Liens

Both 1st Lien and 2d Lien agree not to challenge each other's liens

Note: When each party has its own priority in a so-called "split-collateral" deal, each may wish to reserve right to challenge whether certain collateral falls into the other's priority category

2. Stay Relief

(a) 2d Lien will not seek stay relief unless sought by 1st Lien

(b) 2d Lien will not oppose stay relief sought by 1st Lien



4

3. Avoidance and Reinstatement

- (a) If a payment to 1st Lien or 2d Lien is avoided, the debt intended to be paid is reinstated, and
- (b) If IA has been terminated, IA is also reinstated



5

CONDITIONAL AND ABSOLUTE SUBORDINATIONS

1. Issue: What is the result in BK if 1st Lien is avoided or equitably subordinated?

E.g. – 1st Lien owed \$500K
– 2d Lien owed \$1 mil.
– Collateral = \$1 mil.

2. If IA Silent

- 1st Lien avoided and preserved under §551 for benefit of estate, with result that estate receives \$500K from collateral
- 2d Lien gets \$500K (\$1 mil. collateral minus preserved 1st Lien)

Note: 2d Lien not hurt, but receives no windfall



6

3. Conditional Subordination

- (a) If subordination by 2d Lien is conditioned upon 1st Lien not being avoided or equitably subordinated, 2d Lien argues subordination is ineffective if those events occur, 2d Lien assumes first priority position (receiving \$1 mil. in collateral proceeds) and BK trustee takes nothing from collateral
- (b) 2d Lien might have problems if 1st Lien was a "natural first" (i.e., perfected first), as BK trustee may argue contractual subordination was superfluous, conditional subordination not relevant, and avoidance and preservation of 1st Lien under §551 is unaffected by IA

Note: 2d Lien may press for language in IA that priorities are automatically reversed at any time 1st Lien is unperfected or if 1st Lien is avoided or equitably subordinated



7

4. Absolute Subordination

- (a) If IA provides 2d Lien's subordination is absolute, irrespective of avoidance or equitable subordination of 1st Lien, 2d Lien may suffer

E.g.— BK trustee avoids 1st Lien and gets 1st Lien's first \$500K;
– 2d Lien gets next \$500K, but must turn over to 1st Lien per IA;
– 2d Lien's claim deemed paid, *vis-à-vis* debtor, by \$500K;
– 2d Lien subrogated to 1st Lien's unsecured claim

- (b) If 1st Lien debt is also equitably subordinated, 2d Lien is worse off than if it had been a general unsecured creditor, as it would be subrogated to an equitably subordinated 1st Lien claim

5. Effect of Equitable Subordination

- (a) If 1st Lien is equitably subordinated only to certain unsecured creditors harmed by 1st Lien's inequitable conduct, there should be carved out of



8

1st Lien's collateral any losses suffered by those creditors (not to exceed 1st Lien debt) -- 2d Lien unharmed

- (b) If 1st Lien is disallowed as a secured claim due to equitable subordination, 1st Lien is "void" under § 506(d) but is preserved for estate under §551



9

FURTHER SUBORDINATION OF 1ST LIEN

1. Issue: What if 1st Lien contractually subordinates to a third party's lien that is junior to 2d Lien? What impact on 2d Lien in a liquidation of the collateral?
2. Examples of Third Party Lienors:
 - landlords
 - custom brokers
 - carriers
 - processors
 - factors
 - equipment vendors/lessors
 - sureties on bonded jobs
 - inventory or equipment vendors



10

3. Options:

(a) If IA is silent and if:

- 1st Lien = \$100K
- 2d Lien = \$200K
- 3d Lien = \$500K
- Collateral = \$700K

A few courts hold:

- 3d Lien (elevated to first position) gets \$500K
- 1st Lien gets \$100K
- 2d Lien gets \$100K (50% of claim)

Note: 2d Lien bears brunt of 1st Lien's subordination



11

Better reasoned cases hold:

- 3d Lien gets \$100K
(out of 1st Lien's first position)
- 2d Lien gets \$200K
(unaffected by 1st Lien's election to subordinate)
- 3d Lien gets \$400K
(balance owed to it)
- 1st Lien takes nothing

Note: 1st Lien bears brunt of its subordination

(b) If IA requires 2d Lien also to subordinate to 3d Lien or provides that 1st Lien remains prior to 2d Lien despite 1st Lien's subordination to 3d Lien:

- 3d Lien elevated to first position and gets \$500K
- 1st Lien gets \$100K
- 2d Lien gets \$100K (50% of claim)



12

4. Unintentional Subordination by 1st Lien

E.g.— 1st Lien = \$500K

– 2d Lien = \$500K

– Collateral value = \$1 mil.

– Federal tax lien = \$100K

– Per IRC 45-day rule, assume tax lien trumps \$50K of future advances by 1st Lien

IRS gets \$50K

1st Lien gets \$450K (\$50K loss)

2d Lien gets \$500K (full recovery)

Note: 2d Lien should remain unaffected



13

CAPPED 1ST LIEN DEBT

1. Two Approaches:

- (a) Dollar cap; and/or
- (b) Borrowing base (“BB”) cap

2. Consequences of Exceeding Cap. IA should spell out consequences of exceeding the cap, including:

- (a) If IA contains a covenant by 1st Lien not to exceed cap, 2d Lien may assert breach of IA and seek to recover damages suffered or to enjoy 1st Lien's enforcement rights
- (b) Waterfall changes –1st Lien debt in excess of cap paid to 1st Lien only after 2d Lien debt is fully paid; and/or



14

- (c) 2d Lien's purchase option is triggered

Note: Important to spell out when exceeding the cap is tested and effect of later reduction of 1st Lien debt to an amount within the cap

Note: 1st Lien may seek to cap amount of 2d Lien debt in waterfall

3. Dollar Cap

- (a) Both overall cap and separate subcaps for revolver, term loan and banking relationship debt
- (b) Make provision for line of credit ("LOC") growth (and possibility of DIP financing)
- (c) Take into account any "accordion" feature in LOC
- (d) For term loans, cap may reduce by (i) payments actually made (with no authority to reload) or (ii) payments required to be made (Note: clause (ii) can be dangerous for 1st Lien)



15

- (e) Make sure cap is inclusive not only of (i) principal amount of debt (loans and letters of credit), but also (ii) add-on's (without a cap):

- (1) interest (including post-petition accruals)
- (2) lender and LC issuer fees
- (3) enforcement expenses
- (4) indemnities
- (5) protective advances

- (f) Make provision for banking relationship debt (e.g., cash management, credit cards, ACH transactions, hedges), which sometimes is the subject of a subcap

4. Borrowing Base Cap

- (a) Revolver (principal only) limited by lesser of (i) the LOC (with a growth or emergency cushion) or (ii) a BB cap



16

- (b) BB cap should allow for some level of overadvances or post-default "Agent Advances" (e.g., the greater of a percentage of the BB or a dollar amount)
- (c) 1st Lien will want the right to rely upon BB certificates and to be able to test BB at the time of each credit extension, without regard to future changes in BB (i.e., no "backed in" overadvance)

Note: 2d Lien may have concerns over Grantor's post-default cessation of provision of BB certificates by Grantor or reduced frequency of reporting

- (d) 1st Lien may attempt to exclude from revolver cap any revolver loans that would otherwise cause cap to be exceeded if loan proceeds are used to pay 2d Lien debt or add-on's with respect to 1st Lien debt within the cap

5. Combined Cap

- (a) Lesser of dollar or BB cap
- (b) Greater of dollar or BB cap (e.g., where there is suppressed availability)



17

CASH COLLATERAL/DIP FINANCING

1. 2d Lien's Consent to Use of Cash Collateral

- (a) 2d Lien will consent to the extent 1st Lien consents, provided
- (b) 2d Lien is granted a replacement lien, as adequate protection, on post-petition assets, but junior in priority to pre-petition and post-petition liens in favor of 1st Lien ("2d Adequate Protection Liens")

2. 2d Lien's Consent to DIP Financing

- (a) 2d Lien won't oppose, will be deemed to have consented to (and at a hearing will consent to) any priming DIP financing consented to or provided by 1st Lien, subject to 2d Lien being provided 2d Adequate Protection Liens
- (b) 2d Lien may seek to condition consent upon aggregate of pre-petition 1st Lien debt and DIP financing not exceeding any dollar or BB cap in IA



18

- (c) 2d Lien may seek to reserve objection rights to economic terms of DIP financing that are not "market" or otherwise reasonable (e.g., interest rate, fees, lending limits, term of commitment)
- (d) 2d Lien may seek to reserve objection rights to "case management provisions" in DIP financing (e.g., required 363 sale, plan provisions and milestones)

3. Some Hotly Negotiated Topics

- (a) 2d Lien's right to request adequate protection payments (e.g., post-petition interest and/or periodic principal payments, and reimbursement for post-petition professional expenses, such as expenses of attorneys, accountants and other consultants)
- (b) 2d Lien's reservation of right to object to DIP financing on any basis that an unsecured creditor could object
- (c) Priming DIP financing must also prime 1st Lien's pre-petition liens



19

Note: If 1st Lien provides DIP financing, this may impede 1st Lien's ability to "roll over" 1st Lien debt over time from collections of pre-petition collateral or "roll up" 1st Lien debt into DIP financing on day one

- (d) 2d Lien's subordination to professional expense "carve-out" in DIP financing order to the extent consented to by 1st Lien
 - 2d Lien may insist that 1st Lien reserve carve-out against BB
 - 1st Lien may insist upon an allocation of the carve-out in a split-collateral deal (whether based on the ratable amount of their outstanding loans or relative value of their respective priority collateral)
- (e) 2d Lien's pre-consent to DIP financing under IA not a bar to 1st Lien's seeking approval of DIP financing on any other terms (even if less favorable to 2d Lien)



20

- (f) 2d Lien providing its own DIP financing, including with a priming lien on its own primary collateral (in a split-collateral deal) and on all other collateral

Note: Lien priority provisions in IA may not preclude 2d Lien from doing so, unless "lien" is broadly defined to include any statutory, judicial or contractual lien, whether created or arising before or during BK case. 1st Lien on occasion (and reluctantly) may consent to 2d Lien priming DIP with respect to specified types of collateral or if 1st Lien declines to provide DIP financing in amount sufficient to meet borrower's needs in BK case



21

SALE OF COLLATERAL

1. 2d Lien's Consent

- (a) 2d Lien asked to consent to any 363 sale (or plan sale) that is consented to by 1st Lien (and *vice versa* in split-collateral deals)
- (b) 2d Lien's acknowledgment of and consent to 1st Lien's credit bid rights (and *vice versa* in split-collateral deals)
- (c) Usually agreed to where 2d Lien has its own primary collateral, but more difficult negotiation when 2d Lien is junior on all of collateral

2. Typical Consent Conditions:

- (a) 2d Lien attaches to proceeds with same priority
- (b) Excess over cap distributed per IA's waterfall provisions
- (c) Proceeds permanently reduce 1st Lien debt



22

Note: May be problematical if 1st Lien provides ongoing DIP financing post-sale or elects (or is obligated) to fund a carve-out

(d) 2d Lien's option to purchase 1st Lien debt triggered in 363 sale context

(e) 2d Lien preserves credit bid rights

Note: This could present problems if sale is free of all liens unless 1st Lien debt is required to be satisfied, in cash, at time of sale

(f) 2d Lien reserves right to object, on the same basis an unsecured creditor could object, to fairness of bid procedures, timing and process for conducting sale, and amount and method of payment of purchase price

Note: If 2d Lien debt will not be paid in full from sale and 1st Lien and 2d Lien encumber substantially all of the BK estate's assets, objections to sale will usually be lodged by creditors committee in any event



23

ALLOCATION OF SPLIT-COLLATERAL PROCEEDS

1. Split-Collateral Structure: In a split-collateral deal, 1st Lien is usually first on working capital assets (accounts, inventory, and customer lists, and certain related intangibles) and 2d Lien is usually first on fixed assets, IP assets, and/or equity interests in each Grantor

2. If IA is Silent on Allocation

(a) Parties risk that allocation in the purchase agreement may be adopted by a court in an allocation contest

- Of course, a party may always withhold consent to a sale or other disposition of its priority collateral
- However, in some federal circuits, a BK court may force a sale of collateral under §363 for a price equal to what the court determines the value of the collateral to be

(b) The BK court may determine allocation in a contested hearing based on valuation evidence



24

- (c) If orderly liquidation values are used, 1st Lien's inventory may have inconsequential value divorced from IP (such as trademarks or tradenames) unless IA authorizes 1st Lien's use of IP
- (d) How is the "going concern" premium to be allocated?

3. Some Allocation Options

- (a) 1st Lien and 2d Lien agree to attempt to agree. In the absence of agreement, 1st Lien and 2d Lien agree to be bound by determination of a mutually agreed upon valuation expert
- (b) 1st Lien receives as deemed proceeds attributable to its priority collateral consisting of
 - (i) accounts, the book or face value thereof,
 - (ii) inventory, the book value thereof (or the higher of book value and last appraised value), and
 - (iii) all other 1st Lien priority collateral, the book value thereof (or value determined by a mutually agreed upon valuation expert or a court, in each case taking into account the methodology of sale (orderly liquidation vs. going concern sale)), with deposit account balances included in the sale to be shared in accordance with the tracing/priority rules established elsewhere in the IA; and



25

2d Lien receives any excess (which 2d Lien risks may be less than the value of its priority collateral, but may be lion's share of going concern premium in a going concern sale)

Note: Pegging the value of accounts at face amount may be risky for the 2d Lien, as some accounts (especially in a sale that is not a going concern sale) may be subject to offsets, counterclaims, significant deductions or write offs. 2d Lien will likely bargain for book value, after giving allowance for historical dilution and write offs.

Note: Limiting "accounts" to those items of 1st Lien priority collateral that are rights to payment for good or services may unintentionally overlook other payment rights in the form of promissory notes, chattel paper, supporting obligations, and general intangibles. Accordingly, the term "payment rights" might be a better term as its definition in the IA may incorporate not only accounts but also rights to payment that are evidenced by or consist of instruments, chattel paper or payment intangibles

Note: Be careful in use of "book value" as a valuation reference for items of collateral that may be assigned an unrealistically high value (such as intercompany claims) or



26

no assigned value on the Grantor's books (such as a customer list)

- (c) 2d Lien receives as deemed proceeds attributable to its priority collateral consisting of fixed assets their value per most recent MAI appraisal and 1st Lien receives any excess (which may be all, or lion's share, of going concern premium)
- (d) The IA should provide that a sale of equity interests in a Grantor is deemed to be a sale of the assets of the Grantor and the proceeds realized from any such sale are to be allocated in the manner that would apply if there had been a sale of those underlying assets
- (e) Much of the formulation will depend upon the specific nature of the items of priority collateral involved, the importance of those items to the overall business, and whether such items have assigned to them any "book value"

E.g. — Working capital lender provides a revolving credit facility to co-borrowers engaged in trucking business



27

- Each co-borrower grants working capital lender a security interest in rolling stock and accounts receivable
- Term lender's loan to co-borrowers is secured by intellectual property (assume nominally valued trade name and website) and real estate of one co-borrower
- Co-borrowers file for BK and one without real estate sells all of its assets, as a going concern, for \$20 million
- Accounts receivable, at face value, total \$5 million and rolling stock has fair market value of \$12 million
- Under some allocation formulations in an IA, the working capital lender would receive only \$17 million of total purchase proceeds (face amount of accounts plus appraised value of rolling stock), with the remaining \$3 million representing the "going concern premium" allocated to nominally valued priority collateral of term lender



28

FULL PAYMENT OF 1ST LIEN DEBT

1. Full Payment Condition

Full payment of 1st Lien debt is typically a condition to 2d Lien's exercise of certain post-default rights and remedies

2. Definitions

"Full payment" should be defined and usually includes:

- payment of all 1st Lien loans;
- termination of the LOC;
- cash collateralization of (or supporting letter of credit for) certain contingent obligations in liquidated amounts (e.g., letters of credit and guaranties);



29

- cash collateralization of (or supporting letter of credit for) outstanding hedges (up to any cap on senior 1st Lien debt);
- termination (or acceptable credit support for ongoing provision) of depository relationship and other cash management products;
- cash collateralization of (or lien retention for) pending or overtly threatened claims (or until deadline for challenging liens or claims under DIP financing order passes without a challenge);
- execution of full release of known and unknown claims against 1st lien by borrower

Note: 2d Lien may object to “full release” requirement as likely unavailable in BK case

- ### 3. Full payment requirement can be helpful to 1st lien in BK case when litigation is threatened or ongoing



30

2D LIEN'S PURCHASE OPTION

1. Reasons for Purchase Option

- (a) Allows 2d Lien to “control its own destiny” when differing views exist between 1st Lien and 2d Lien on direction of BK case (e.g., liquidation vs. reorganization)
- (b) Prevent 1st Lien’s exercise of credit bid rights in 363 sale
- (c) 2d Lien “loan-to-own” strategy

2. Certain Drafting Issues

- (a) What events trigger option?
 - (i) Acceleration of 1st Lien debt
 - (ii) Filing of BK case
 - (iii) Sale of assets with mandatory release
 - (iv) 1st Lien’s foreclosure



31

- (b) How long does option remain open?

Note: 1st Lien wants a narrow window (say, 10 to 15 days) to exercise and will require in IA that option exercise is irrevocable

- (c) Who can exercise option?

Note: This is crucial where 2d Lien debt is held by multiple parties. Is option exercisable by 2d Lien agent for all or by any 2d Lien party (and, if so, first to act)?

- (d) What is to be purchased?

Note: Is all 1st Lien debt to be purchased? Only the portion below the cap? 1st Lien should make sure 2d Lien is not allowed to purchase all 1st Lien debt, including excess over the cap, for a price equal to the capped amount; and DIP financing must be purchased as well, particularly if DIP loans do not prime 1st Lien's pre-petition position

- (e) What is the price?

Note: Is price "par" or "market" and does it include prepayment or termination charges? LIBOR fees?



32

- (f) When is the closing?

Note: Important to 1st Lien that there be a short window to close (say, 10 days)

- (g) What are closing mechanics and terms of sale?

Note: Should address form of closing documents; and sale should be for cash and without recourse except for breach of limited warranties (e.g., ownership and authority to sell)

Other Issues

- (a) Authority of 1st Lien to sell loans to others prior to 2d Lien's exercise of option
- (b) Right of 1st Lien to terminate cash management post-sale and resign from any agency relationship in syndicated deal



33

- (c) 1st Lien's right to "roll over" or "roll up" in DIP financing (which may eliminate purchase option)
- (d) Non-assignability of purchase option by 2d Lien
- (e) Failure or refusal of any 1st Lien lender in a syndicated deal to cooperate (obligations of 1st Lien lenders to sell should be several and not joint)
- (f) 2d Lien's assumption of 1st Lien's funding obligations under credit documentation and indemnification of 1st Lien for breaches
- (g) Borrower's pre-consent in credit documents to purchase option exercise (i.e., 2d Lien is an "Eligible Assignee")
- (h) 1st Lien's authority post-default to cease lending or to exercise remedies despite exercise of option

Note: Often limited to "exigent circumstances"



34

CHAPTER 11 PLAN ISSUES

1. Voting

- (a) 1st Lien's authority to vote 2d Lien claim
- (b) 2d Lien's agreement to support plan supported by 1st Lien

2. Non-Support of Certain Plans

3. Reorganization Securities (the "X" Clause)

- (a) Authority of 2d Lien to receive equity securities under plan
- (b) Authority of 2d Lien to receive debt securities under plan



Chapter 3B

Intercreditor Agreements in Bankruptcy: A Compendium

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Contents

I.	The Universe of Intercreditor Agreements	3B-1
II.	Jurisdiction, Bankruptcy Code §510(a), and State Law	3B-1
III.	The Courts' Approaches: Intercreditor Agreements and the Administration of Bankruptcy Cases	3B-3
	A. Subordinated Creditor's Right to Seek Adequate Protection	3B-4
	B. Subordinated Creditor's Right to Object to Postpetition Financing	3B-5
	C. Subordinated Creditor's Right to Object to Section 363 Sales.	3B-5
	D. Standstill Provisions/Subordinated Creditor's Right to Appointment of Examiner	3B-7
	E. Subordination Provisions Affecting Chapter 11 Plan Confirmation	3B-8
IV.	Conclusion	3B-13

I. The Universe of Intercreditor Agreements

Intercreditor agreements are used in a variety of financing transactions to establish the respective rights and remedies of two or more creditors in credit facilities provided to a common borrower. Intercreditor agreements are not standardized and their scope varies widely. In secured financing transactions, the intercreditor agreement typically governs the relative rights and priorities of each creditor's liens in the borrower's assets. Intercreditor agreements may also include payment subordination provisions, payment standstill terms, and other creditor rights and remedies that do not directly involve collateral. "Report of the Model First Lien/Second Lien Intercreditor Agreement Task Force established by the Commercial Finance Committee of the Business Law Section of the American Bar Association," 65 *The Business Lawyer* 809 (May 2010) at p. 809. Following its introductory remarks, the ABA Task Force's Report presents the text of a "First Lien/Second Lien Intercreditor Agreement" (the "Model Agreement"), which contains provisions, including alternate provisions, that address issues on which first and second lien creditors typically hold different views. The Report and Model Agreement are also available at <http://www.abanet.org/dch/committee.cfm?com=CL190029>.

Intercreditor agreements and agreements among lenders purport to alter the rights of junior-lien creditors or subordinated creditors in the bankruptcy of their common debtors. While there is no limit to the number of terms that can be placed in an intercreditor agreement, there are many provisions that frequently arise in the bankruptcy context. Such agreements include waivers of the right to object to bankruptcy sales, voting restrictions on plans of reorganization, and waivers of rights to object to debtor-in-possession financing and the debtor's use of cash collateral. *See*, Section 6 of the Model Agreement.

The effect of intercreditor agreements in bankruptcy—chiefly in Chapter 11 cases—can be substantial, because such agreements can subject debtor borrowers to competing claims over estate assets. This is particularly true in the case of subordination agreements, which typically govern two or more lenders' priority of repayments from a common debtor or recovery from common collateral. Regardless of whether or not the debtor is a party to the intercreditor agreement, the Chapter 11 debtor will become a central participant in the process as the party responsible for confirming a plan of reorganization or liquidation under the Bankruptcy Code. It is fundamental that such plans are the primary means of lender repayment and recovery under Chapter 11, so plan-related decisions made by the debtor are necessarily affected by, and have a direct impact on, the contract rights of creditors and the disputes that affect them.

II. Jurisdiction, Bankruptcy Code §510(a) and State Law

Bankruptcy courts have assumed jurisdiction over the interpretation of disputed intercreditor agreements based on their conclusion that bankruptcy cases cannot be finally administered without a resolution of the intercreditor dispute. For example, in *In re Best Products, Co.*, 168 B.R. 35 (Bankr. S.D.N.Y. 1994), the court concluded that "enforcement of a contractual subordination agreement clearly involves the adjustment of the debtor-creditor relationship, determinations of the priority of liens, and administration of the estate and so falls within the ambit of 28 U.S.C. §157(b)(2)(A), (K), and (O)...[Accordingly,] the resolution of the contractual subordination dispute is core." *Id.* at 66-7. For similar recent "core" jurisdictional

analyses, *see In re Energy Future Holdings Corp.*, 546 B.R. 566, 569-70 (Bankr. D. Del. 2016); *Delaware Trust Co. v. Wilmington Trust, N.A.*, 534 B.R. 500, 511-18 (S.D.N.Y. 2015).

A bankruptcy court derives its specific authority to interpret intercreditor agreements from §510(a) of the Bankruptcy Code, which provides that a “subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable non-bankruptcy law.” Courts have routinely confirmed that intercreditor agreements are subordination agreements for purposes of §510(a). *See, e.g., In re Ion Media Networks, Inc.*, 419 B.R. 585, 595 (Bankr. S.D.N.Y. 2009) (an intercreditor agreement is an enforceable contract under section §510(a)). To avoid any threshold question as to whether or not an intercreditor agreement qualifies as a subordination agreement, Section 6.11 of the Model Act suggests including a provision in the agreement specifically stating that the “Parties acknowledge that this Agreement is a ‘subordination agreement’ under section 510(a) of the Bankruptcy Code, which will be effective before, during, and after the commencement of an Insolvency Proceeding.”

State laws in general plainly acknowledge the validity of subordination agreements. For example, Article 9 of the Uniform Commercial Code specifically states that “this Article does not preclude subordination by agreement by a person entitled to priority.” RCW 62A.9A-339; ORS 79.0339. Accordingly, bankruptcy courts look to state contract law to determine the enforceability of subordination agreements. *See, e.g., Best Products Co.*, 168 B.R. at 69 (“The applicable non-bankruptcy law to which Section 510(a) refers is that of contracts.”).

Consistent with this principle, in *In re Howland*, 545 B.R. 653 (Bankr. D. Or. 2015), Judge Dunn acknowledged that “[a] contractual subordination agreement is simply a contractual arrangement whereby one creditor agrees to subordinate its claim against the debtor in favor of the claim of another...A subordination agreement does not need to be in any particular form, or in writing [and]...A creditor can agree with the debtor to subordinate its interests to the interests of other creditors.” *Id.* at 659. Judge Dunn continued his opinion by stating that as a threshold basis for interpreting the subordination issue before him, “Oregon follow[s] the Restatement (Second) of Contracts which generally defines a contract as ‘a promise or a set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty.’” *Id.*

In Washington, courts generally enforce subordination agreements in accordance with their terms, sometimes even enforcing oral subordination agreements. *See, e.g., Skeel v. Christensen*, 17 Wash. 649, 50 Pac. 466 (1897). Also, if multiple instruments contain adequate statements about the intended order of priority among parties, that ordering can be enforced. *See, Bank of Gresham v. Johnson*, 143 Wash. 24, 254 Pac. 464 (1927). Significantly, Washington courts have asserted that a subordination agreement will be construed in favor of the subordinated creditor and the senior creditor’s “priority rights under a subordination agreement are strictly limited to the express terms and conditions of the agreement.” *Campanella v. Rainier National Bank*, 26 Wash. App. 418, 420, 612 P.2d 460 (1980); *Ban-Co Investment Co. v. Loveless*, 22 Wash. App. 122, 134, 587 P.2d 567 (1978). *See, also, U.S. Through Farmers Home Admin., U.S. Dept. of Agriculture v. Haas Fruit Co., Inc.*, 812 F.Supp. 173 (E.D. Wash. 1993) (Integrated subordination agreement did not subordinate creditor’s security interest in farm equipment to security interest of Farmers Home Administration (FmHA) in that equipment; agreement did not mention creditor’s lien on equipment and there was no separate agreement

pursuant to which creditor released or subordinated its interest.); *but see White & Bollard, Inc. v. Goodenow*, 58 Wash. 2d 180, 185, 361 P.2d 571 (1961) (court enforced an agreement by seller to subordinate to future financing obtained by the buyer even where the subordination agreement contained no material detail about the terms of the future financing).

Despite, however, the Code’s declaration that a subordination agreement is enforceable in a bankruptcy case “to the same extent that such agreement is enforceable under applicable non-bankruptcy law,” state law and state court decisions are typically of limited usefulness to the bankruptcy process, particularly in the interpretation of terms that go beyond the establishment of priorities:

[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. 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, Nov. 2011, at §1.A.3.

In addition, to the extent a state court sought 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).

III. The Courts’ Approaches: Intercreditor Agreements and the Administration of Bankruptcy Cases

Intercreditor agreements and subordination agreements routinely seek to alter the rights of junior-lien creditors or subordinated creditors in a bankruptcy of their common debtors. Accordingly, intercreditor agreements frequently contain not only payment/collateral priority provisions but also waivers of rights that all creditors would normally hold in bankruptcy cases: for example, the right to object to bankruptcy sales; the right to vote on plans of reorganization; and the right to object to debtor-in-possession financing and/or the use of cash collateral. Although Bankruptcy Code §510 provides that “subordination agreements” are enforceable in bankruptcy to the same extent such agreements are enforceable under applicable nonbankruptcy law, the courts’ approaches to the treatment of creditor disputes arising from such bankruptcy waiver provisions has not been uniform. To help remedy this lack of uniformity, the drafters of

the Model Agreement (Sections 6.1-6.10) proposed language addressing a number of these subordination issues: use of cash collateral and DIP financing (6.1); sale of collateral (6.2); relief from the automatic stay (6.3); adequate protection (6.4); first lien objections to second lien actions (6.5); claim avoidance/reinstatement of obligations (6.6); the right to receive reorganization securities (6.7); the right of the first- and second-lienholders to assert postpetition claims against each other (6.8); waivers of second lienholder claims (6.9); and plan classifications of first- and second-position creditor claims (6.10). Over time, bankruptcy courts have addressed these and related intercreditor subordination issues in a variety of ways. The central theme of the courts' decisions, however, has been to determine the extent of the enforceability of waivers of bankruptcy rights that are included in intercreditor agreements.

A. Subordinated Creditor's Right to Seek Adequate Protection. Following enactment of the Bankruptcy Code, the first reported decision to address a subordination agreement was *In re Hart Ski Manufacturing Co., Inc.*, 5 B.R. 734 (Bankr. D. Minn. 1980). In *Hart Ski*, two creditors had liens on the same collateral. During the course of the case, the subordinated creditor (Beatrice) filed a motion for adequate protection or relief from stay. The subordination agreement at issue in *Hart Ski* contained a broad provision prohibiting the subordinated creditor, without the written consent of Aetna (the senior creditor), from taking any action to “assert, collect or release the indebtedness or any part thereof or realize on any collateral securing the indebtedness or enforce any security agreements, real estate mortgages, lien instruments, or other encumbrances securing said indebtedness.” Based on the agreement, the senior creditor objected to Beatrice's motion, asserting that Beatrice had waived its right to seek adequate protection or file a motion for stay relief. In its brief opinion, the court rejected Aetna's objection:

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.

Id. at 736.

Hart Ski reflects a judicial attitude that is opposed to allowing parties to a bankruptcy case to bargain around—and thereby agree to obviate or waive—the balanced components of the reorganization process that the Bankruptcy Code establishes. More recent decisions, by contrast, have taken a less restrictive approach to intercreditor agreements. In *Aurelius Capital Master v.*

Tousa, 2009 WL 6453077 (S.D. Fla. Feb. 6, 2009), for example, the subordinated secured creditor (Wells Fargo as agent for the Second Lien Lenders) objected to the court’s approval of a cash collateral order, because the order did not prohibit the use of cash collateral to finance the estate’s potential causes of action against Wells. The bankruptcy court approved the cash collateral order, which the senior creditors (the First Lien Lenders) had approved, and Wells appealed, asking the district court to remand the issue to the bankruptcy court for a determination whether Wells was adequately protected against the estate’s use of cash collateral to pursue claims against Wells. The intercreditor agreement at issue in the case contained a provision providing that the Second Lien Lenders would be deemed to consent to any cash collateral order approved by the First Lien Lenders and further providing that the Second Lien Lenders “will not request or accept any form of adequate protection or any other relief in connection with the use of such cash.” *5. Based on this language, the court rejected Wells’ request for adequate protection, concluding that the intercreditor agreement barred Wells from seeking adequate protection and that “[p]ut differently, Wells Fargo had bargained away its right to object by entering into the Intercreditor Agreement.” *8.

B. Subordinated Creditor’s Right to Object to Postpetition Financing. In *In re MPM Silicones*, 518 B.R. 740 (Bankr. S.D.N.Y. 2014) (“*Momentive*”), the intercreditor agreement at issue contained a provision stating that “[n]o Second-Priority Party will contest or support any other person contesting (a) any request by the Senior Lenders for adequate protection, or (b) any objection by the Senior Lenders to any motion based on the Senior Lenders’ claiming a lack of adequate protection.” The issue before the court in *Momentive* was dismissal of several causes of action asserted by the senior creditors for alleged breach of the intercreditor agreement by the subordinated creditors, including a claim that the subordinated creditors had breached the agreement by supporting a debtor-in-possession financing proposal that primed the senior creditors without their consent. In dismissing the senior creditors’ claim, the court concluded that the senior creditors’ claim failed to state what specific actions the subordinated creditors took to support the approval of such a priming lien. The court also concluded that the senior creditors’ failure to identify the particular section of the intercreditor agreement allegedly breached was significant because, based on the court’s analysis, the intercreditor agreement “nowhere prohibits junior lien holders from supporting a priming lien financing, and counsel have not identified one. In fact, it appears that the only prohibition in the [intercreditor agreement] relating to priming liens bars objections to such liens that are *supported* by the senior lien holders.” *Id.* at 748.

C. Subordinated Creditor’s Right to Object to Section 363 Sales. In *In re Boston Generating, LLC*, 440 B.R. 302 (Bankr. S.D.N.Y. 2010), the debtor filed a motion seeking approval of a sale of all its assets. As presented, the anticipated proceeds of the sale would be sufficient to pay 98% of the first-position secured lenders’ claims (the “First Lien Lenders”) but would generate no dividend for junior secured creditors (the “Second Lien Lenders”) or unsecured creditors. The Second Lien Lenders objected to the sale.

Section 3.1(b)(i) of the Intercreditor Agreement before the *Boston* court provided that

[u]ntil the Discharge of First Lien Obligations has occurred,
whether or not any Insolvency or Liquidation Proceeding has been
commenced...the First Lien Collateral Agent, at the written

direction of [the First Lien Lenders holding a majority of the First Lien Debt], shall have the exclusive right to enforce rights, exercise remedies...and make determinations regarding the release, sale, disposition or restrictions with respect to the Collateral without any consultation with or the consent of the Second Lien Collateral Agent or any Second Lien Secured Party...provided that the Lien securing the Second Lien Obligations shall remain on the proceeds of such Collateral released or disposed of subject to the relative priorities described in Section 2.1.

Section 3.1(c) of the Intercreditor Agreement further stated:

Without limiting the generality of the foregoing, unless and until the Discharge of First Lien Obligations has occurred, except as expressly provided in Sections 3.1(a)(i), 3.1(g) and 6.3(b) and this Section 3.1(c), the *sole right* of the Second Lien Collateral Agent, the Second Lien Administrative Agent, and any other Second Lien Secured Party with respect to the Collateral is to hold a Lien on the Collateral pursuant to the Second Lien Collateral Documents for the period and to the extent granted therein and to receive a share of the proceeds thereof, if any, after the Discharge of First Lien Obligations has occurred. [Emphasis added].

Section 3.1(g) permitted the Second Lien Agent to “file any pleadings, objections, motions or agreements which assert rights or interests available to unsecured creditors of the Loan Parties arising under any Insolvency or Liquidation Proceeding or Applicable non-Bankruptcy Law, in each case not inconsistent with the terms of this Agreement....”

In their opposition to the Second Lien Lenders’ objection to the sale, the First Lien Lenders asserted that Section 3.1(b)(i) made two points: first, that decisions as to whether the Collateral should be sold free and clear of liens were the exclusive province of the First Lien Agent; second, that the Second Lien Lenders’ protection came not from overruling determinations by the First Lien Agent, but from the attachment of their liens to the proceeds of the sale. The First Lien Agent also noted that the Intercreditor Agreement gave the First Lien Agent “the exclusive right to enforce rights, exercise remedies...and make determinations regarding the release, sale, disposition or restrictions with respect to the Collateral.”

In response, the Second Lien Lenders argued that Section 3.1(b)(i) on its face did not prohibit the Second Lien Agent and the Second Lien Lenders from taking action on their own, including objecting to a §363 Sale; and that “in light of the absence of an explicit prohibition against filing a §363 sale objection under the Intercreditor Agreement and the fact that general unsecured creditors could object to the Sale Transaction, the conferral under Section 3.1(g) of the Intercreditor Agreement to the Second Lien Agent and the Second Lien Lenders of rights of unsecured creditors must be viewed as granting such parties authorization to file the Objection.”

In its ruling, the court acknowledged that although

it goes against the spirit of the subordination scheme in the Intercreditor Agreement to allow the Second Lien Lenders to be heard and to attempt to block the disposition of the Collateral supported by the First Lien Agent, I am now constrained by the language of the Intercreditor Agreement. After extensive briefing and oral argument as well as detailed review of the Intercreditor Agreement, the Court finds no provision which can be read to reflect a waiver of the Second Lien Agent's right to object to a §363 sale motion, either in its capacity as a Secured Party or in its capacity as an unsecured creditor. Here, the perfect storm of a poorly drafted agreement, the ill-defined scope of section 3.1(g)'s retained right to object as an unsecured creditor, and the fact that, pursuant to the Secured Parties' own stipulation, there is "no exercise of remedies" leads me to conclude that the Second Lien Agent and Second Lien Lenders have standing to object to the §363 sale.

Id. at

As the court's comments make plain, *Boston Generating* is noteworthy for its requirement of specific clarity in the language of subordination agreements.

D. Standstill Provisions/Subordinated Creditor's Right to Appointment of Examiner. Standstill provisions typically require a subordinated creditor to forego enforcement action against the common collateral of the senior and subordinated creditors until some specified time after the declaration of a default. Such provisions also purport to stay subordinated creditors from exercising their remedies until after the senior creditor has exercised its own collection remedies.

In *In re Erickson Retirement Communities, LLC*, 425 B.R. 309 (Bankr. N.D. Tex. 2010), the court addressed two subordination agreements. In each of the subordination agreements, the subordinated creditors (the Michigan Retirement System Entities) agreed, among other things, not just to subordinate their right to payment until the senior lenders were paid in full, but also not to "exercise any rights or remedies or take any action or proceeding to collect or enforce any of the Subordination Obligations" without "the prior written consent of the Agent until the senior secured lenders had been "fully satisfied." Each subordination agreement also provided that the subordinated creditors "waive, for the benefit of the Agent and the Lenders...any principles or provisions of law, statutory or otherwise, which are or might be in conflict with the terms of this Agreement and any legal or equitable discharge of [the Subordinated Creditor's] obligations hereunder." Each of the subordination agreements also provided for an assignment to the senior lenders by the subordinated creditors of their interests in the subordinated creditors' loan documents and also provided that in the event the subordinated creditors did not comply with the assignment, the senior lenders would be appointed attorney-in-fact of the subordinated creditors.

Despite these subordination provisions, the subordinated creditors in *Erickson* filed a motion for the appointment of an examiner pursuant to §1104(c) of the Bankruptcy Code. In their objection, the senior lenders argued that the provisions of the subordination agreements collectively prohibited the subordinated lenders from pursuing their motion and that by operation of these agreements, the subordinated creditors lacked standing and/or had waived their right to pursue the motion because they had essentially agreed to stand still, be “silent seconds,” and yield in all respects to the senior secured lenders until the senior secured lenders were paid in full.

The *Erickson* court agreed with the senior creditors’ argument and, applying general contract principles, ruled that a reasonable person in the shoes of the subordinated party would have understood that they must not take action, but must “stand still” until the senior secured lenders were paid in full. *Id.* at 315. The *Erickson* court also noted that the subordinated creditors were “sophisticated commercial entities who knowingly waived all legal and statutory rights that would be in conflict with their obligation to ‘standstill’ until the [senior lenders] had been paid in full.” *Id.* at 316.

See, also, In re American Roads LLC, 496 B.R. 727 (Bankr. S.D.N.Y. 2013) (court enforced the standstill provision and similarly noted that the subordinated creditors were “sophisticated parties fully aware of the implications of such a waiver”).

E. Subordination Provisions Affecting Chapter 11 Plan Confirmation.

Intercreditor agreements frequently contain provisions affecting the ability of subordinated creditors to participate in the plan confirmation process.

1.) Claim Classification. Bankruptcy Code 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.” Plan proponents and bankruptcy courts have considerably broad discretion in deciding how to classify claims. *See, e.g., 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).”). How should a plan classify a subordinated creditor?

Courts have usually found it 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. *See, e.g., In re Station Casinos, Inc.*, 2010 WL 11492265, at * 22 (Bankr. D. Nev., August 17, 2010) (“due to the contractual subordination of the Subordinated Note Claims, it is not appropriate under the distribution mechanisms of the Plan to classify those claims in the same Class as the Senior Note Claims”), citing *In re Hawaiian Telecom Communications, Inc.*, 430 B.R. 564, 591 (Bankr. D. Haw. 2009) (“senior note claims and subordinated note claims are different and thus may be classified separately”); *In re Grete 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 a 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).

2.) Right to Vote on Plan. Intercreditor agreements frequently purport to limit the rights of the subordinated creditor to vote in favor of a Chapter 11 plan that the senior creditor does not support; or to vote against confirmation of a Chapter 11 plan that the senior lender does support; or purport to effect an assignment of the subordinated creditor's plan voting rights to the senior creditor. The courts have treated these plan voting provisions in different ways.

In *In re 203 North LaSalle Street L.P.*, 246 B.R. 325 (Bankr. N.D. Ill. 2000), the court addressed a subordination agreement executed by Bank of America and North LaSalle Street LP. The agreement on its face subordinated North LaSalle's creditor rights to the creditor rights of Bank of America and, in particular, contained a provision giving Bank of America, in the event of a bankruptcy filing, the right to "file, prove, and vote or consent in any such proceedings with respect to any and all claims of North LaSalle." *Id.* at 328. Following remand of the case from the U.S. Supreme Court, Bank of America filed an adversary complaint seeking, among other things, a declaration that the Bank was authorized to vote the claim of North LaSalle in the pending confirmation proceeding.

Despite the plain language of the subordination agreement, Judge Wedoff concluded that the Bank did not have the right to vote North LaSalle's creditor claim:

While the language of the subordination agreements governs the outcome of the Bank's right to repayment of any deficiency claim, the language of the Bankruptcy Code governs the determination of voting rights in this case. Section 1126(a) of the Code provides that [t]he holder of a claim may vote to accept or reject a plan under Chapter 11, and the parties acknowledge that North LaSalle is the holder of the claim arising under its loan. Unless there is some basis for deviating from the plain language of §1126(a), North LaSalle should therefore be allowed to vote its claim in the confirmation process. . . . None of the arguments given by the Bank justifies any deviation from the plain language of §1126(a).

First, 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). It is generally understood that pre-bankruptcy agreements do not override contrary provisions of the Bankruptcy Code. Thus, in *Klingman v. Levinson*, 831 F.2d 1292, 1296 n. 3 (7th Cir.1987), the court noted that the Bankruptcy Code generally provides for the discharge of an individual's debts, and that it would be contrary to public policy to allow a debtor to contract away the right to a discharge. *See, also, In re Cole*, 226 B.R. 647, 652 n. 7 (9th Cir. BAP 1998) (collecting decisions refusing to enforce prepetition waivers of bankruptcy benefits other than discharge). 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.

Second, §510(a), in directing enforcement of subordination agreements, does not allow for waiver of voting rights under §1126(a). Subordination, though not defined by the Code, has a common understanding in the law, reflected in Black's Law Dictionary, which defines subordination as: The act or process by which a person's rights or claims are ranked below those of others. Joseph R. Nolan and Jacqueline M. Nolan-Haley, Black's Law Dictionary 1426 (6th ed.1990). Subordination thus affects the order of priority of payment of claims in bankruptcy, but not the transfer of voting rights. One of the decisions cited by North LaSalle, *Beatrice Foods Co. v. Hart Ski Mfg. Co. (In re Hart Ski Mfg. Co.)*, 5 B.R. 734, 736 (Bankr.D.Minn.1980), made this point emphatically in the course of deciding that a subordinated 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 proceedings. There is no indication that Congress intended to allow creditors to alter, by a subordination agreement, the bankruptcy laws unrelated to distribution of assets.

Hart Ski went on to address the very issue involved here, stating in dicta that the Code guarantees each secured creditor certain rights, regardless of subordination...including the right...to participate in the voting for confirmation or rejection of any plan of reorganization.

Third, Fed.R.Bankr.P. 3018(c) does not allow the voting of a subordinated creditor's claim by the senior creditor. The rule provides that an acceptance or rejection of a Chapter 11 plan must be signed by the creditor or equity security holder or an authorized agent...The Bank in this case would not be acting at the direction of North LaSalle in voting its claim; it would be acting in its own interests, quite possibly contrary to those of North LaSalle. Accordingly, the Bank cannot be seen as the agent of North LaSalle under Rule 3018.

Finally, far from producing any results at odds with the intent of Congress, the plain language of §1126(a) is completely consistent with reasonable bankruptcy policy. Although a creditor's claim is subordinated, it may very well have a substantial interest in the manner in which its claim is treated.

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 transfers of Chapter 11 voting rights.

Id. at 331-2.

Other courts following the reasoning of *LaSalle* and *Hart Ski* 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 *2-3 (Bankr. E.D.N.C. Oct. 25, 2011).

By contrast, a number of courts have enforced the assignment of plan voting rights. In *In re Aerosol Packaging, LLC*, 362 B.R. 43 (Bankr. N.D. Ga. 2006), the court considered the same provisions of the Bankruptcy Code and Bankruptcy Rules as the *LaSalle* Court and came to the opposite conclusion. In *Aerosol*, the subordinated creditor had executed an agreement 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 creditor. The subordination agreement also authorized the senior creditor to take certain actions in its own name and the name of the subordinated lender, including the right to vote the subordinated creditor's claims in any bankruptcy of the debtor. Regardless of the agreement, both the senior and subordinated creditors cast ballots for the subordinated creditor's claim, with the subordinated creditor basing its legal argument on *LaSalle*.

The *Aerosol* court rejected the *LaSalle* conclusion, asserting that §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. The court found that the subordination agreement appeared to be enforceable under Georgia law and thus was enforceable under §510(a). As in *LaSalle*, the court noted that Bankruptcy Rule 3018 (and 9010) permits agents and other representatives to take actions such as voting on behalf of other parties. But the *Aerosol* court concluded that the senior creditor before it was acting as a duly authorized agent for the subordinated creditor and 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.* at 47. 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 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.

For a case reaching the same conclusion as *Aerosol*, see, *In re Coastal Broadcasting Systems, Inc.*, 2013 WL 3285936, *5 (D. N.J. June 28, 2013).

3.) Objections to Plan Confirmation. Courts have been willing to enforce the terms of intercreditor agreements when they are appropriately drafted to cover the adverse conduct of the subordinated creditor. In *Ion Media Networks v. Cyrus Select Opportunities Master Fund Ltd. (In re Ion Media Networks)*, 419 B.R. 585 (Bankr. S.D.N.Y. 2009), appeal dismissed, 480 B.R. 494 (S.D.N.Y. 2012), the purchaser of second-lien claims that were subject to an intercreditor agreement objected to confirmation of a plan supported by the first-lien creditors, primarily on the basis that the debtors’ Federal Communications Commission licenses were not part of the collateral on which the senior creditors had a perfected security interest and that the value of those licenses should therefore be shared pro rata among all general unsecured creditors. The intercreditor agreement between the creditors explicitly recognized the priority of the senior lenders’ interests, stating:

Each of the Secured Parties acknowledges and agrees (x) to the relative priorities as to the Collateral (and the application of the proceeds therefrom) as provided in the Security Agreement ... and acknowledges and agrees that such priorities (and the application of proceeds from the Collateral) shall not be affected or impaired in any manner whatsoever including, without limitation, on account of ... (iii) any nonperfection of any lien *purportedly securing* any of the Secured Obligations (including, without limitation, whether any such Lien is now perfected, hereafter ceases to be perfected, is avoidable by any bankruptcy trustee or otherwise is set aside, invalidated, or lapses). [Emphasis added.]

Id. at 594. Moreover, the intercreditor agreement included language prohibiting challenges to this priority scheme, stating:

[U]pon the commencement of a case under the Bankruptcy Code by or against any Grantor...(b) each secured party agrees not to take any action or vote in any way inconsistent with this Agreement so as to contest (1) the validity or enforcement of any of the Security Documents...(2) the validity, priority, or enforceability of the Liens, mortgages, assignments, and security interests granted pursuant to the Security Documents...or (3) the relative rights and duties of the holders of the first Priority Secured Obligations

Id. at 597.

Focusing on the use of the words “purportedly securing” in the intercreditor agreement, the court determined that the subordinated creditor had “agreed to grant an indisputable first lien interest ...[in] ‘purported’ Collateral,” and that the FCC broadcasting licenses constituted such “purported” collateral, regardless of whether a lien on the FCC licenses was ever properly granted. Accordingly, the court denied the subordinated creditor’s objection to plan confirmation, noting that the intercreditor agreement contained “plain and purposeful” language requiring the second lien lender to remain silent in the event of a Chapter 11 case and concluding that the subordinated creditor therefore lacked standing to object. *Id.* at 597-8. Commenting that the subordinated creditor’s tactics “have caused a material increase in administrative expenses in these cases,” the court further suggested that the subordinated creditor could be liable for damages as a result of what the court characterized as violations of the intercreditor agreement. *Id.* at 590, n. 4.

4.) Cram Down. In the case of cram down plan confirmations, Bankruptcy Code §1129(b)(1) provides:

(b)(1) *Notwithstanding section 510(a) of this title*, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirement of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan. [Emphasis added.]

In order for a Chapter 11 plan to be confirmed under §1129(a), each impaired class of claims or interests must accept the plan. 11 U.S.C. §1129(a)(8). If all creditor classes do not accept the plan, the plan may still be confirmed under §1129(b) by “cramming down” the impaired classes of claims or interests that rejected the plan, as long as at least one impaired class of claims or interests has accepted the plan. But what is the effect of the phrase “[n]otwithstanding section 510(a) of this title” in §1129(b)(1)?

In *In re TCI 2 Holdings, LLC*, 428 B.R. 117 (Bankr. D. N.J. 2010), the court overruled the senior creditors’ objection to confirmation of a cram down plan on the grounds that the plan violated an intercreditor agreement, causing the plan to be unconfirmable as violative of §510(a), an “applicable provision” of the Code under §1129(a)(1). In its ruling, the *TCI* 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 a cram down confirmation of the plan. In an opinion (apparently) of first impression, the court concluded that

[t]he only logical reading of the term ‘notwithstanding’ in section 1129(b)(1) seems to be: ‘Even though section 510(a) requires the enforceability of a subordination agreement in a bankruptcy case to the same extent that the agreement is enforceable under nonbankruptcy law, if a nonconsensual plan meets 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.

IV. Conclusion

Case law makes it clear that bankruptcy courts will normally enforce the provisions of intercreditor/subordination agreements when those provisions merely establish the priority of claims, payments, and rights in collateral. Case law is less clear on the extent to which courts will enforce bankruptcy waiver provisions in intercreditor agreements that go beyond establishing claim/payment priority. As reflected in *Hart Ski* and *203 North LaSalle*, the courts’

initial impulse was to conclude that §510(a) did not extend to approval of such bankruptcy waiver provisions. More recent opinions, however, have demonstrated the courts' increasing willingness to enforce bankruptcy waivers embedded in intercreditor/subordination agreements, particularly when the parties are commercially sophisticated (*Erickson*) and—most importantly—the language of the waiver provisions is absolutely clear and unambiguous (*Momentive; Boston Generating*). This requirement is consistent with Washington case law holdings that “priority rights under a subordination agreement are strictly limited to the express terms and conditions of the agreement” (*Campanella; Ban-Co Investment Co.*). Evaluating facts on a case by case basis, courts may also be inclined to enforce bankruptcy waivers in cases where the subordinated creditor uses an intercreditor agreement as a basis to engage in obstructionist behavior or unwarranted aggressive litigation tactics (*Ion Media*).

