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REVIEW

Viewpoint: Chapter 11 Voting Rights Under a Subordination Agreement

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The Bankruptcy Code provides in § 510(a) that subordination agreements are enforceable in a bankruptcy case to the same extent that they are enforceable under nonbankruptcy law. This seems simple enough, and for the most part-at least as it relates to debt- and lien-subordination provisions-it is. If a senior lender and a subordinated lender enter into a debt- and/or lien-subordination agreement prior to bankruptcy, then absent some unusual circumstances (such as equitable subordination), the agreement regarding the subordination will be respected in bankruptcy.

The issues can become more complicated, however, because parties often insert a variety of other provisions into "subordination agreements" that go well beyond subordination of claims or liens and purport to govern creditor conduct in the event that the borrower files for bankruptcy. For instance, an agreement might require that a junior creditor not seek relief from the automatic stay to foreclose on its collateral, consent to any debtor-in-possession, or DIP, financing or cash collateral arrangement supported by the senior lender, not seek adequate protection, consent to any asset sale that was approved by the senior lender, not object to the senior lender's claim or challenge its lien, and not propose or enter into any transactions with the debtor without the senior lender's approval. Subordination agreements may also provide for a junior creditor to assign to the senior creditor the junior creditor's right to vote on a Chapter 11 plan.

When the enforceability of these provisions is challenged in bankruptcy, the senior lender may argue that it is protected by § 510(a) and that even aside from § 510(a), it is protected by the freedom of contract-agreements entered into between commercially sophisticated parties are generally enforceable. On the other hand, the junior lender may argue that § 510(a) protects only subordination provisions and not anything that the parties decide to insert into a document that is labeled as a "subordination agreement." The junior creditor might also contend that agreements to waive fundamental bankruptcy rights contravene public policy and therefore should not be enforced. This argument may be joined in by the debtor or other parties, who point out that the challenged provision affects not only the parties that agreed to it, but also the debtor, the estate and the reorganization process. There are valid arguments on both sides of these issues and balancing the interests of enforcing subordination agreements and fostering creditor involvement in bankruptcy is an evolving area of the law.

These arguments can also raise the question of bankruptcy court jurisdiction over intercreditor disputes: More than a few times, a bankruptcy judge has told a senior lender that objects to an action taken by a junior lender on the basis that it contravenes an intercreditor agreement to "go sue them in state court if you think they have breached your contract." On the other hand, some bankruptcy judges have held that they have jurisdiction over such disputes because of the impact that they have on the reorganization process.

In this context, In re Coastal Broadcasting Systems Inc., 2013 WL 3285936 (D.N.J. June 28, 2013) (currently on appeal to the Third Circuit), addressed a dispute over the enforceability of a vote-assignment provision in a subordination agreement. Junior creditors had objected to the debtor's plan and, among other things, challenged a provision of the subordination agreement that provided for an assignment of the junior creditors' plan voting rights to the senior creditor. The junior creditors argued that this provision was contrary to the express terms of the Bankruptcy Code, specifically § 1126(a), which permits the holder of a claim to vote to accept or reject a claim, but is silent as to the ability of any other party to vote such claim.

The junior creditors argued that § 1126(a) means that only the holder of the claim-the original creditor-can vote its claim in a Chapter 11 case. The court in Coastal Broadcasting, after acknowledging a split in authority on the issue, disagreed and held that § 1126(a) does not prevent the assignment of voting rights. The subordinated creditors also argued that because the right to vote on a Chapter 11 plan is a fundamental right of creditors in bankruptcy, it would violate public policy to permit the assignment of such rights. The court also rejected this argument, noting that "[c]reditor rights, including their attendant voting rights, can be freely traded in the ordinary course." The court concluded that the agreement validly authorized the senior creditor to vote the junior creditors' claims on the Chapter 11 plan, and affirmed confirmation of the plan over the junior creditors' objection.

Coastal Broadcasting is notable for several reasons. First, it cuts against the expectations of many insolvency and restructuring professionals, who believe that even those bankruptcy judges who broadly support the "freedom of contract" are likely to draw the line when it comes to transferring the right to vote on a plan. Second, because the

Coastal Broadcasting decision is on appeal to the Third Circuit, the decisions of which govern the bankruptcy courts in Delaware, the ultimate resolution of the appeal could guide the enforcement of provisions in subordination agreements in one of the country's busiest bankruptcy courts. Finally, while Coastal Broadcasting dealt with the narrow question of whether § 1126(a) overrides a prebankruptcy contractual assignment of plan voting rights, the case's rationale that § 510(a) validates a creditor's contractual agreement to modify its otherwise applicable rights under the Bankruptcy Code could have similar application to the host of other rights commonly relinquished by junior creditors in subordination agreements.

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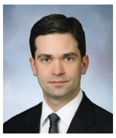

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