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LENDING & RESTRUCTURING ALERT DECEMBER 2011

Another Court Weighs In on the Enforceability of Assignment of the Right to Vote on a Bankruptcy Plan

Senior lenders often insist that subordinate lenders assign to them, under subordination and intercreditor agreements, their right to vote on a plan of reorganization proposed for the borrower should it end up in chapter 11. The intention of such assignments is to prevent junior lenders from facilitating or preventing confirmation of bankruptcy plans contrary to the desires of senior lenders. Lenders should be aware, however, that courts disagree whether such plan voting rights assignments are enforceable. In fact, the United States Bankruptcy Court for the District of Massachusetts held recently, in In re SW Boston Hotel Venture, LLC,[1] that such an assignment is unenforceable.

Background

SW Boston Hotel Venture, LLC ("SW Boston") and its related entities (collectively, the "Debtors") filed for bankruptcy in April 2010. SW owned the W Hotel and Residences project. The Debtors' senior secured lender financed construction of most of the project. SW also obtained a subordinate loan from the City of Boston to complete the construction of the project. The City and the Debtors' senior lender entered into an intercreditor and subordination agreement pursuant to which the City agreed to assign to the senior lender the City's right to vote its claim if SW were to end up in a bankruptcy proceeding.[2]

The Debtors subsequently filed chapter cases and proposed a plan of reorganization that they sought to confirm over the objection of the senior lender. The lender voted to reject the plan and submitted a ballot on behalf of the City rejecting the plan based on the voting rights assignment it held under the intercreditor and subordination agreement between the parties. The City supported the plan and submitted a ballot accepting the plan. The lender moved to strike the City's vote.

The Bankruptcy Court's Ruling

The bankruptcy court held that the assignment of the City's voting rights was unenforceable. The court explained that "[a]lthough 11 U.S.C. § 510(b) provides for the enforceability of subordination agreements, such agreements cannot nullify provisions of the Bankruptcy Code. To the extent a provision in a subordination agreement purports to alter substantive rights under the Bankruptcy Code, it is invalid."[3] The bankruptcy court reasoned that an assignment of voting rights was contrary to the substantive rights conferred upon creditors under section 1126(a) of the Bankruptcy Code, which provides that "[t]he holder of a claim or interest … may accept or reject a plan."[4] Accordingly, the

[1] 2011 WL 5520928 (Bankr. D. Mass. Nov. 14, 2011).
[2] The provision in the subordination agreement states, "In the event of … a bankruptcy … reorganization … whether or not pursuant to bankruptcy laws … Junior Lender will assign to Senior Lender the voting rights of Junior Lender in such proceeding."
[3] 2011 WL 5520928 at *10.
[4] 11 U.S.C. § 1126(a).

court held that the City's ballot was valid and that the senior lender could not submit a rejecting vote on behalf of the City.

Decisions of Other Courts on this Issue

In In re North LaSalle Street Partnership,[5] the United States Bankruptcy Court for the Northern District of Illinois struck down a bankruptcy voting assignment provision contained in a subordination agreement. There, too, the senior lender sought to enforce the voting right assignment in order to vote, on behalf of a junior lender, to reject a debtor's plan. The North LaSalle court reasoned that, although section 510(a) of the Bankruptcy Code provides for the general enforceability of subordination agreements, the subordination provision did not apply in that case because "[s]ubordination … affects the order of priority of payment of claims in bankruptcy, but not the transfer of voting rights."[6]

In re Hart Ski Mfg., Co.[7] did not involve the determination of whether an assignment of bankruptcy voting rights in a subordination agreement was enforceable. But statements by the court in that case have been cited by other courts to support the proposition that certain fundamental bankruptcy rights cannot be contracted away, even though section 510(a) of the Bankruptcy Code allows for the subordination of other claims and rights between creditors. In Hart Ski, a seller whose claim was subordinate to the debtor's senior financing company under a subordination and intercreditor agreement, filed an adversary complaint seeking adequate protection or relief from the automatic stay. The senior financing company objected. The bankruptcy court for the District of Minnesota refused to enforce the subordination agreement to the extent it involved rights unrelated to distribution of assets, and permitted the subordinate seller to exercise its right to seek adequate protection or to lift the automatic stay. In limiting the reach of section 510(a), that court explained:

> 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. To hold that, as a result of a subordination agreement, the 'subordinator' gives up all its rights to the 'subordinee' would be totally inequitable.[8]

Conversely, other courts have held that there is no basis to curtail the enforceability of subordination agreements under section 510(a) of the Bankruptcy Code, including

[5] 246 B.R. 325 (Bankr. N.D. Ill. 2000).
[6] In re 203 N. LaSalle St. P'ship, 246 B.R. at 331.
[7] 5 B.R. 734 (Bankr. D. Minn. 1980).
[8] In re Hart Ski Mfg., Co., 5 B.R. at 736 (emphasis added).

assignments of bankruptcy voting rights. In In re Aerosol Packaging, LLC,[9] the senior lender sought to enforce, among other things, a voting assignment provision in the subordination agreement that permitted it to vote the claims of the subordinate lender in any bankruptcy proceeding of the debtor. There, the lender was seeking to vote the subordinate lender's claims in favor of the debtor's plan. The bankruptcy court for the Northern District of Georgia held that the assignment was enforceable, even though section 1126(a) of the Bankruptcy Code provides that creditors may vote on a plan of reorganization. It stated: "Section 1126(a) grants a right to vote to a holder of a claim, but does not expressly or implicitly prevent that right from being delegated or bargained away by such holder. Section 510(a) renders a subordination agreement enforceable to the extent enforceable under applicable non-bankruptcy law."[10]

Similarly, in In re Inter Urban Broadcasting of Cincinnati, Inc.[11], a junior lender entered into a subordination agreement pursuant to which it subordinated its claims against the debtor to the senior lender, and assigned to the senior lender its right to vote on a plan of reorganization. In the bankruptcy case, the senior lender and the debtor filed competing plans. The senior lender voted in favor of its own plan, and also voted on behalf of the junior lender to accept its plan and to reject the debtor's plan, pursuant to the subordination agreement. The bankruptcy court denied the debtor's motion to disqualify the senior lender's votes, denied confirmation of the debtor's plan, and confirmed the senior lender's plan. On appeal, the District Court for the Eastern District of Louisiana affirmed the bankruptcy court's decision. The court held that the debtor had presented no evidence to rebut the general principle that subordination agreements are enforceable in bankruptcy to the same extent they are enforceable under non-bankruptcy law.

Observations

Lenders should be aware of the lack of consistency in the case law regarding the enforceability of bankruptcy voting rights assignments that have become common in intercreditor and subordination agreements. The conflicting reported decisions make it difficult to predict whether courts will uphold voting rights assignments. Some of the cases feature holdings that are detrimental to debtors' reorganization efforts, while others aid debtors' attempts to confirm a plan. Some cases involve enforcement of a voting assignment provision to cause junior creditors to reject debtors' plans, while others involve a senior lender's attempt to compel junior creditors to fall "in-line" with a debtor's restructuring efforts. There is no bright line rule or consistent approach taken by courts on this issue. The result may depend upon the views of the particular judge to whom the case is assigned.

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[9] 362 B.R. 43 (Bankr. N.D. Ga. 2006).
[10] In re Aerosol Packaging, LLC, 362 B.R. at 47.
[11] 1994 WL 646176 (E.D. La. Nov. 16, 1994).