Feature

KEY POINTS

- A US District Court recently issued an opinion holding that a provision in an intercreditor agreement subrogating a senior lender to the rights of a junior lender extends to the right of such junior lender to vote on a chapter 11 plan of reorganisation in the borrower's bankruptcy case.
- It is a general principle of US bankruptcy law that a party that succeeds to all of a creditor's rights with respect to a claim may also succeed to the creditor's voting rights.
- Junior lenders wishing to preserve rights under the US Bankruptcy Code in the event of a borrower's bankruptcy should expressly carve out or reserve such rights in intercreditor agreements or other applicable documents if they are otherwise being required to agree to subrogation.
- By comparison, while English law would typically permit enforcement of *Avondale* style subrogation provisions, an argument can be made that, with respect to a scheme of arrangement, a senior creditor's voting of a junior creditor's claim pursuant to such a provision should be discounted to the extent that it is not representative of the *bona fide* interests of the junior creditor.

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Contractual subrogation in bankruptcy and the right to vote

A US district court has affirmed a decision holding that contractual subrogation of a senior lender to a junior lender's rights includes the right to vote on a chapter 11 plan of reorganisation. This article considers the court's opinion and draws a comparison with English practice.

The US District Court for the District of Arizona recently issued an opinion in the bankruptcy case of Avondale Gateway Center Entitlement, LLC (the 'Debtor') affirming a Bankruptcy Court decision holding that the contractual subrogation, through a subordination agreement, of a senior secured lender to the rights of a junior secured lender authorised the senior lender to vote on the Debtor's chapter 11 plan of reorganisation on behalf of the junior lender. *See Avondale Gateway Ctr Entitlement, LLC v Nat'l Bank of Ariz (In re Avondale Gateway Ctr Entitlement, LLC)*, No CV10-1772-PHX-DGC, 2011 WL 1376997 (D Ariz, 12 April 2011). Specifically, the district court held that:

(i) under the contractual subrogation clause at issue, the senior lender 'step[ped] into the shoes' of the junior lender with respect to its claims against the Debtor and acquired all of the junior lender's rights with respect to those claims; and
(ii) because the right to vote on a plan of reorganisation flows from a creditor's claim in bankruptcy (and because the right to vote may be assigned), the senior lender succeeded to that right as the effective holder of the junior lender's claims and was entitled to vote the junior lender's claims.

BACKGROUND

Prior to its bankruptcy, the Debtor borrowed $30.7m from the National Bank of Arizona ('NBA') secured by a first-lien mortgage on a parcel of vacant land, and $18m from MMA Realty Capital, LLC ('MMA'), secured by a second-lien mortgage on the same land. In connection with this financing, the Debtor, NBA and MMA entered into a Subordination and Intercreditor Agreement (the 'Subordination Agreement'). The Subordination Agreement contained a subrogation clause (the 'Subrogation Clause') that read, in relevant part:

> '[MMA] agrees that [NBA] shall be subrogated to [MMA] with respect to [MMA's] claims against Borrower [ie, the Debtor] and [MMA's] rights, liens and security interests, if any, in any of the Borrower's assets and the proceeds thereof . . . until the Senior Debt shall have been paid in full, in cash.'

The Debtor subsequently filed for reorganisation under chapter 11 of the Bankruptcy Code and proposed a chapter 11 plan of reorganisation. MMA voted to accept the plan. NBA, on the other hand, cast *two* votes – one for itself and, based on the Subrogation Clause, one on behalf of MMA – rejecting the plan. The Debtor challenged NBA's right to vote on behalf of MMA. The bankruptcy court held that the Subrogation Clause authorised NBA to do so, struck MMA's ballot, and accepted NBA's ballot with two votes against the plan thereby leading to a rejection of the proposed chapter 11 plan.

ANALYSIS

Effect of subrogation on plan voting rights

The Subrogation Clause did not expressly assign MMA's voting rights to NBA, unlike in other cases where the right to vote itself was expressly transferred. Nonetheless, the District Court held that the right to vote is a derivative right possessed by the holder of a claim in bankruptcy. Subrogation is the wholesale substitution of one party (the subrogee) in place of another (the subrogor) with respect to a claim. Because a subrogree succeeds to *all* of the subrogor's rights under a claim, under the Subrogation Clause, NBA expressly succeeded to all of MMA's rights with respect to MMA's claims against the Debtor. The District Court thus held that, because MMA's right to vote on the plan was derivative of MMA's claims against the Debtor, NBA succeeded to those rights as subrogee of MMA and became the effective holder of MMA's claims.

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Timing of subrogation

The Debtor argued that NBA's right to subrogation would not arise until NBA paid MMA's claims. Under Arizona law, the right to subrogation can arise by contract ('conventional' subrogation) or by the payment of the subrogor's claim by the subrogee ('equitable' subrogation). In cases of conventional subrogation, the language of the contract controls when subrogation is triggered. The District Court found that the Subrogation Clause did not contractually condition subrogation on payment of MMA's claims, but expressly made subrogation effective from the execution of the Subordination Agreement until NBA's claims were paid in full.

Enforceability of subrogation in bankruptcy

The Debtor also argued that the Subrogation Clause was not enforceable with respect to the right to vote on a plan of reorganisation. The Debtor primarily relied on case law standing for the proposition that 'subordination' does not allow for the waiver of voting rights in bankruptcy because subordination affects only the order of priority of payment of claims in bankruptcy and not the transfer of voting rights. The District Court found such case law to be inapposite in the case of *subrogation*, which involves not merely a reordering of the priority of claims, but rather one party stepping into the shoes of another party and succeeding to *all* of the latter party's rights.

Further, the District Court held that, while a subrogation agreement is not enforceable under Arizona law with respect to non-assignable rights, bankruptcy law permits plan voting rights to be assigned, so the Subrogation Clause was enforceable with respect to such rights. The District Court cited several decisions in which courts held that voting rights may be assigned independently of the claims to which they relate. At least one other court has reached a contrary conclusion. As noted above, however, subrogation does not involve merely the assignment of a creditor's voting rights, but rather the substitution of the subrogee in place of the creditor-subrogor with respect to a claim. Courts have consistently held that the right to vote a claim may be transferred to a purchaser of the claim, and similarly, a subrogee succeeds to all of the subrogor's rights under the claim.

Implications of *Avondale*

The District Court's opinion in *Avondale* gives significant powers in bankruptcy to senior lenders which, by virtue of rights granted to them in intercreditor agreements, can succeed, as subrogees, to the rights of junior lenders. Subrogation to *all* of the rights of another lender with respect to that lender's claims against a borrower necessarily embraces all applicable rights, including voting rights, that such lender has as a creditor under the Bankruptcy Code when the borrower files for bankruptcy.

The specific implication of *Avondale* is that a senior lender will automatically obtain the rights of a junior lender to vote on a chapter 11 plan of reorganisation when the senior lender has obtained all of the junior lender's rights with respect to the junior lender's claims against the borrower, regardless of whether the intercreditor agreement expressly assigns such voting rights to the senior lender. This suggests that, when a junior lender wishes to preserve its rights under the Bankruptcy Code to vote on a borrower's plan of reorganisation, it should expressly carve out or reserve such rights in the intercreditor agreement or other applicable documents if it is otherwise being required to agree to subrogation. It is important to note that, with subrogation, a junior lender would also lose the rights it typically would have as an unsecured creditor because it loses all of its rights to the subrogee. A junior lender that is a subrogor therefore arguably would have no rights at all to appear before a bankruptcy court on even the simplest of issues until all of the senior lender's obligations have been satisfied in full.

> "With subrogation, a junior lender would also lose the rights it typically would have as an unsecured creditor because it loses all of its rights to the subrogee."

Subrogation of the type provided for in the Subrogation Clause has thus far been atypical in the intercreditor arrangements usually found in syndicated leveraged financings, but it is possible that *Avondale* may make such subrogation more common in corporate credits. On the other hand, such subrogation has been more typically found in real estate related financings.

Comparison with English practice

The closest English law analogue to a chapter 11 plan is a scheme of arrangement. Classes of affected creditors are entitled to vote to approve the scheme with a required approval threshold of 75 per cent in amount and 50 per cent in number of the claims in each class held by the creditors that actually vote. On its face, if a subrogation clause of the sort considered in *Avondale* applied in the context of an English law scheme, that provision should operate similarly in the relevant class vote structure as it would under the US chapter 11 plan process. Under English market practice, however, as exemplified by form documentation of the Loan Market Association, standard intercreditor agreements do not provide senior lenders with subrogation rights like those at issue in *Avondale*. It is not surprising, therefore, that no English court appears to have opined on the issue. Accordingly, it is difficult to predict whether an English court would permit a senior creditor to vote the claims of a junior creditor under such an arrangement.

On the one hand, English courts will generally uphold contracts freely entered into by competent parties. *See Printing and Numerical Registering Company v Sampson* [1875] LR 19 Eq. 462 (Ch) at 465 ('[C]ontracts when entered into freely and voluntarily shall be held sacred and shall be enforced by courts of justice'). Exceptions to the

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Biog box

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general principle of contract enforceability exist for contracts that offend public policy. *Chitty on Contracts 30th Ed., Volume 1 – General Principles*, at 16-005. There are five categories of contract that will be invalidated on public policy grounds: (i) contracts that are illegal by common law or legislation; (ii) contracts injurious to good government with respect to domestic or foreign affairs; (iii) contracts that interfere with the proper working of the machinery of justice; (iv) contracts injurious to marriage and morality; and (v) contracts against the public economic interest. *Id*. The contractual subrogation provision at issue in *Avondale* would not likely fall within any of these exceptions to enforceability.

On the other hand, an argument could be made that an *Avondale* style subrogation provision should not be enforced in the context of scheme voting. In deciding whether to sanction a scheme of arrangement, an English court will first consider whether the scheme meeting was properly convened, the scheme classes were properly constituted and the requisite majorities were met. *See In re Rodenstock GmbH* [2011] EWHC 1104 (Ch). Assuming those criteria are met, the court must determine whether to exercise its discretion to sanction the scheme 'as being one which has been voted for by creditors acting *bona fide* in their interests and without coercion of the minority, and a Scheme which, objectively, an intelligent and honest creditor acting in its own interests as such might reasonably approve.' *Id*. In evaluating whether this standard has been met, the court may consider, among other things, the level of support for the scheme, the nature of the negotiations that led to the scheme, the competing alternatives and the level of support enjoyed by such alternatives, how dissenting creditors would likely fare outside the scheme, and whether the parties supporting the scheme 'have been motivated in reaching a decision to support the Scheme by anything other than an independent and prudent perception of their own commercial interests.' *Id.*

Importantly, this last element refers to supporting creditors voting in the 'commercial interests' of the holders of the claims being voted. An argument could be made that, in the context of a scheme vote cast by a senior creditor on behalf of a junior creditor's claim in support of the senior creditor's own interest, a court should really look to the interests of the junior creditors themselves and, in so doing, reject an attempt by a senior creditor to vote a junior creditor's rights under a scheme. ■

Construction of guarantee

SALT AND ANOTHER V CORRIS DEVELOPMENTS LTD **[2011] EWHC 2105 (CH) (CHANCERY DIVISION) (BERNARD LIVESEY QC SITTING AS A DEPUTY JUDGE OF THE HIGH COURT) (29 JULY 2011)**

Facts

Mr Salt and his colleague are architects and directors (the 'Directors') of Much Ltd ('Much'). In November 2007, Much borrowed £200,000 from Corris Developments Ltd ('Corris'). The debt was to be repaid in May 2008 but payment was not made. In December 2008 the Directors signed a deed of guarantee (the 'Guarantee'). In April 2010 a winding-up order was made against Much. Nothing was recovered by Corris from Much in the liquidation.

In the meantime, statutory demands were served on the Directors in March 2010. The Directors applied to set the demands aside. The Registrar found in favour of Corris. The Directors appealed to the High Court.

Conclusion

The High Court found that the Registrar was correct to find in favour of Corris. The Directors had two grounds of appeal:

(i) The Registrar was wrong to find there was no implied agreement by Corris to forbear from making demand on Much prior to 30 June 2009 or at all.
The Directors argued that emails in November 2008 led to the conclusion that the purpose in giving the Guarantee was to gain time to sell properties and this was only likely so long as Corris did not make demand against Much for repayment.
Livesey QC concluded that there was no good reason to construe the Guarantee in the manner for which the Directors argued. The Guarantee made perfect sense in the terms in which it was presently written. When a demand was made in May 2009, neither of the Directors cried 'foul' or quoted the 30 June 2009 date mentioned in the Guarantee.

(ii) The Registrar was in error of law in concluding that the effect of the words 'as principle [sic] obligators' in the Guarantee was to place the Directors in the same position as regards the loan as Much; and the Registrar was wrong to hold that the demand under the Guarantee created a debt liability instead of being a 'see-to-it' guarantee.
Livesey QC concluded that an acknowledgement by the Directors of an obligation to make payment of all sums then due from them under the Guarantee 28 days after a demand, amounts to an unequivocal statement that the sums they were called upon to pay were a liability which they owed in debt not damages. This acknowledgement strengthened the case that the term 'as principle [sic] obligators' implied the Directors were principal debtors in relation to the underlying loan.

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