INTERCREDITOR ISSUES IN BANKRUPTCY

By: David M. Neff*

The proliferation of mezzanine loans as a way to obtain cash needed to close real estate deals has fueled intercreditor battles in the days leading up to and after a Chapter 11 filing. Typically, the warring parties are the first mortgage lien lender and one or more junior creditors, including a mezzanine lender. Unlike a first mortgage loan, a mezzanine loan is not often secured by a lien on the borrower’s real estate. Instead, the mezzanine loan is usually secured by an ownership interest in the borrower and, sometimes, by a junior lien on the real estate.1 Thus, the main right of a mezzanine lender is typically to foreclose on the ownership interests in the borrower.2 To make sure that the mezzanine lender’s remedies are limited, the senior lender will insist on the execution of an intercreditor agreement that makes it clear that after a default its debt must be satisfied before any funds flow to a junior creditor, like the mezzanine lender.

A. Restrictions on Pre-Bankruptcy Collection Efforts

An intercreditor agreement typically bars the mezzanine lender from filing a bankruptcy petition for the borrower and from soliciting, directing or causing the mezzanine borrower or any entity that controls the borrower from having a bankruptcy filed for the borrower or any “SPE Constituent Entity” (usually meaning any borrower affiliate up the ownership chain). The breadth of such restrictions was examined by the New York Supreme Court in Bank of America, N.A. v. PSW NYC LLC.3

*David M. Neff, Partner, Perkins Coie LLP, Chicago, IL.
PSW arose out of the financial distress of the Peter Cooper Village and Stuyvesant Town property in New York City. Tishman Speyer Development Corp. acquired the property in 2007 with financing that consisted of first lien mortgage debt as well as junior mezzanine debt secured by the ownership interests in the various mezzanine borrowers. The senior and junior lenders entered into an intercreditor agreement that prevented the junior lenders from soliciting or causing a bankruptcy petition to be filed against any borrower. After the loans went into default, the senior lenders accelerated their loan and the junior lenders transferred their $300 million of loans to PSW for $45 million. The senior lenders requested that PSW confirm that it would cure any defaults under the senior loan if it acquired the interests of any of the mezzanine borrowers. After PSW balked, the senior lenders moved for a preliminary injunction prohibiting PSW from orchestrating a bankruptcy by the borrowers until the senior loan was paid in full and for a declaration that PSW had to cure all senior loan defaults prior to obtaining any of the mezzanine borrowers’ interests. Although the court found that PSW had not yet taken any action to solicit the filing of a bankruptcy case by any of the borrowers, it held that the language of the intercreditor agreement unambiguously required PSW to cure all senior loan defaults (and pay the $3.6 billion first lien debt in full) if it acquired any of the mezzanine borrowers’ interests. As a result, the court enjoined PSW from acquiring or selling the interests of the mezzanine borrowers (by foreclosure sale or otherwise) without first paying off the senior lenders.

Highland Park CDO I Grantor Trust, Series A v. Wells Fargo Bank, N.A., also examined the limitations on a mezzanine lender’s rights. The first mortgage and mezzanine loans in Highland Park were guaranteed by four individuals. The mortgage lender and the mezzanine lender executed an intercreditor agreement that subordinated the mezzanine lender’s rights to recovery to the mortgage lender’s rights under the mortgage loan documents, which included the guarantees. Highland ultimately acquired the interests under the mezzanine loan and sued the guarantors. Soon thereafter, the mortgage lender filed a foreclosure suit. Highland then sought a declaration that it had the right to pursue the guarantors even though the mortgage loan remained unpaid. The mortgage lender filed a counterclaim seeking a declaratory judgment that Highland was barred from enforcing the guarantees until the mortgage loan was paid in full.

The court found the plain language of the intercreditor agreement prevented the mezzanine lender from receiving any payment until the mortgage loan was paid in full. In particular, the intercreditor agreement subor-
ordinated all of the mezzanine loan documents (including the guarantees) to the mortgage loan documents. The court entered a declaratory judgment barring Highland from recovering on its guarantees until the mortgage loan was paid in full.

B. Section 510(a) of the Bankruptcy Code

What happens to intercreditor rights in bankruptcy is perhaps not as certain as the language of the Bankruptcy Code suggests. Under section 510(a) of the Code, “[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.” A number of courts have analyzed what that language means.

For instance, in *Ion Media Networks, Inc. v. Cyrus Select Opportunities Master Fund, Ltd. (In re Ion Media Networks, Inc.)*, the debtors entered into agreements several years before filing bankruptcy with their first lien and second lien lenders. The lenders entered into an intercreditor agreement that prohibited the second lien lenders from challenging the priority of the first lien lenders’ claims, effectively agreeing to remain “silent” as to any such issues. When contemplating bankruptcy, the debtors negotiated a restructuring support agreement that included a debtor-in-possession financing package from the first lien lenders that recognized their security interests in the debtors’ valuable FCC licenses. One of the holders of second lien debt, Cyrus Select Opportunities Master Fund, Ltd., aggressively opposed the first lien lenders’ lien claims. The debtors filed an adversary proceeding to enjoin Cyrus from challenging the validity or priority of the liens granted to the first lien lenders and objecting to the debtors’ plan and disclosure statement. The court found that the intercreditor agreement barred Cyrus from challenging the priority of the first lien lenders’ claims and opposing any plan that was consistent with the first lien lenders’ rights under the loan documents. In doing so, it distinguished cases (discussed below) refusing to enforce assignments of the right to vote on a plan, finding that no such restriction existed in this case. As a cautionary tale, the court expressed displeasure with Cyrus for driving up administrative expenses in the case notwithstanding the plain language of the intercreditor agreement and invited aggrieved parties to seek reimbursement from Cyrus.

The court in *In re Erickson Retirement Communities, LLC*, held similarly with respect to an agreement to “remain silent.” The petition subordination agreements in *Erickson* required junior creditors to subordinate their right to payment until the senior lenders were paid in full, and junior creditors were prohibited 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 agreement of the agent for the senior lenders until the senior lenders were paid in full. One junior lender filed a motion seeking the appointment of an examiner. The court agreed with the senior lenders that the subordination agreement was enforceable under § 510(a) and the junior creditor lacked standing and/or had contractually waived the right to seek an examiner in the bankruptcy cases. The court explained that the request for an examiner was tantamount to a collection action that was barred by the subordination agreements. The court found that the lack of any allegations of fraud or mismanagement combined with the timing of the examiner motion (after the debtors had successfully auctioned their assets and reached settlements with many creditors incorporated in a plan), demonstrated that the motion is “unmistakably aimed at slowing down the confirmation process and gaining leverage to enhance or create recoveries for the Subordinated Creditors. This is the very type of obstructionist behavior that the agreements are intended to suppress.”
In contrast, the court in In re Boston Generating, LLC,19 refused to enforce a prepetition subordination agreement. In Boston Generating, the debtor filed a motion to sell its assets one day after filing bankruptcy. The second lien lenders objected to the bid procedures. The first lien lenders claimed that the second lien lenders were barred from doing so under the terms of an intercreditor agreement. The court found that the plain language of the intercreditor agreement did not preclude objection to bidding procedures.20 When the debtors then sought to sell their assets for less than what the first lien lenders were owed, the second lien lenders objected and the first lien lenders again argued that the intercreditor agreement barred any such objection.

The court first noted that the parties had stipulated that the first lien lenders were not making an election of remedies by consenting to a sale for an amount that was insufficient to pay them in full under 11 U.S.C.A. § 363(f)(2).21 The court stated that had they not so stipulated, it may have found that the second lien lenders lacked standing to object to the sale under language in the intercreditor agreement that barred them from taking any action to hinder an election of remedies by the first lien lenders.22 The court then found that the language of the intercreditor agreement did not clearly prohibit the second lien lenders from objecting to the sale.23 In particular, the court found that the second lien lenders reserved their right to assert interests as unsecured creditors, which would include the right to object to a sale.24 Thus, even though the second lien lenders’ objection to the sale violated the spirit of the intercreditor agreement, the court allowed them to object because they were not violating the actual language of that agreement.25

In In re Caesars Entertainment Operating Co.,26 the court addressed whether a senior creditor waived its rights to make a § 1111(b) election in its loan agreement. To finance its leveraged buyout, the debtor borrowed funds from first lien lenders and it and its subsidiaries entered into a collateral agreement stating that the underlying loan was non-recourse “under any law.” Subsequently, the debtor borrowed more money from unsecured note holders, guaranteed by the debtor’s subsidiaries. Later the debtor borrowed again from some of the first lien note holders, subject to the terms of the original collateral agreement. The first lien lenders and first lien note holders also entered into an intercreditor agreement. The intercreditor agreement specifically provided that the first lien lenders and first lien note holders waived any claim against the collateral agent should the debtor file for bankruptcy and the collateral agent make a § 1111(b) election on behalf of the first lien lenders. The collateral agreement provided that should there be any conflict between the collateral agreement and the intercreditor agreement, the intercreditor agreement would control.

After the debtor filed bankruptcy, the first lien lenders and first lien note holders asserted fully secured claims against the debtor and each of its subsidiaries under § 1111(b). One unsecured note holder objected, arguing that the first lien lenders and first lien note holders had waived any right to assert recourse under the collateral agreement.

The court found that the language in the collateral agreement read in isolation favored the unsecured note holder’s argument that the secured creditors had waived their rights of recourse, as § 1111(b) would constitute “any law.”27 But the court found that the collateral agreement must be read in connection with other documents as they were all part of one transaction.28 The court then found that the specific language in the intercreditor agreement (which controlled over the collateral agreement) specifically referenced the rights
to recourse of the first lien lenders and noteholders.  

C. Enforceability of Assignment of Right to Vote Claims

A typical intercreditor agreement provides that if the mezzanine lender is deemed a creditor of the senior lender’s borrower in a bankruptcy case, the senior lender can file proofs of claim for the mezzanine lender and, if impaired under the plan, the senior lender can vote the mezzanine lender’s claims and can make the § 1111(b) election for the mezzanine lender. The extent to which courts will enforce these rights is not uniform.

In Bank of America, National Association v. North LaSalle Street Limited Partnership (In re 203 North LaSalle Street Partnership), after remand from the Supreme Court, the debtor attempted to confirm a new Chapter 11 plan. The first mortgage lender, Bank of America, filed an adversary proceeding asserting it had the right to vote the claims of the debtor’s general partner (which had been separately classified) under the terms of a subordination agreement.

The court first distinguished the bank’s right to payment from its right to vote another creditor’s claims. For the former, the court ruled that the subordination agreement would be enforceable under state law. For the latter, the court found that the right to vote is a core bankruptcy right that cannot be overridden by contract. As a result, the court allowed the debtor’s general partner to vote its claim notwithstanding the subordination agreement terms.

The court in In re SW Boston Hotel Venture, LLC, found 203 North LaSalle persuasive. The debtor in SW Boston obtained a first mortgage loan from Prudential and a junior loan from the City of Boston. Prudential and the City entered into an intercreditor agreement that granted Prudential the right to vote the City’s claims in any bankruptcy by the debtor. The debtor filed a plan that Prudential rejected on behalf of the City, but the City voted to accept. Prudential contended that only its vote should count as the City had assigned its right to vote its claim to Prudential. Following 203 North LaSalle, the court rejected Prudential’s contention and counted the City’s vote. In particular, the court found that agreements cannot nullify Bankruptcy Code provisions and that § 1126(a) affords holders of claims the right to vote their claims.

Although other courts have followed the holdings in 203 North LaSalle and SW Boston, some have enforced intercreditor agreement provisions allowing the senior lender to vote the junior creditor’s claim. Still other courts have enforced restrictions on junior creditors in prepetition agreements on issues such as objecting to the use of cash collateral.

D. Conclusion

Bankruptcy courts are likely to enforce subordination provisions among creditors, such as those typically found in commercial intercreditor agreements, but less so with respect to provisions impairing core bankruptcy rights such as the right to file a proof of claim. Because the rights dealt with in intercreditor agreements are implicated throughout reorganization cases and are not uniformly enforced by the courts, it is incumbent on parties who seek to enforce rights under such agreements to be diligent and persistent in bankruptcy cases.
ENDNOTES:

1See Ajemian, Marianne, Are Mezzanine Loans Really the Lesser of Two Evils?, 31-3 Prac. Real Est. Law. 35 (2015); Heller, J. Dean, Short of Foreclosure: Less Drastic Remedies for the Real Estate Mezzanine Lender, 26-3 Prac. Real Est. Law. 51 (2010); Berman, Andrew R., Once a Mortgage, Always a Mortgage—The Use (and Misuse of) Mezzanine Loans and Preferred Equity Investments, 11 Stan. J.L. Bus & Fin. 76 (2005).

2See Ajemian, Are Mezzanine Loans Really the Lesser of Two Evils?, 31-3 Prac. Real Est. Law. 35; Heller, J. Dean, Short of Foreclosure: Less Drastic Remedies for the Real Estate Mezzanine Lender, 26-3 Prac. Real Est. Law. 51; Berman, Once a Mortgage, Always a Mortgage—The Use (and Misuse of) Mezzanine Loans and Preferred Equity Investments, 11 Stan. J.L. Bus & Fin. 76.


12See In re Ion Media Networks, Inc., 419 B.R. at 593-95.

13See In re Ion Media Networks, Inc., 419 B.R. at 595.

14See In re Ion Media Networks, Inc., 419 B.R. at 590 n.4. The court also made plain its thoughts: “Here, a sophisticated economically motivated and woefully out of the money creditor has deliberately chosen to ignore the terms of an unambiguous agreement that, read literally, precludes it from opposing confirmation.” In re Ion Media Networks, Inc., 419 B.R. at 590.

15In re Erickson Retirement Communities, LLC, 425 B.R. 309 (Bankr. N.D. Tex. 2010).

16In re Erickson Retirement Communities, LLC, 425 B.R. at 313.

17See In re Erickson Retirement Communities, LLC, 425 B.R. at 314-15. In any event, the court held that if it was statutorily required to appoint an examiner, it would appoint one with no duties. See In re Erickson Retirement Communities, LLC, 425 B.R. at 317.

18In re Erickson Retirement Communities, LLC, 425 B.R. at 315.


25See In re Boston Generating, LLC, 440 B.R. at 320. The court noted that such right to object was “a somewhat hollow victory” as the court ended up approving the sale. In re Boston Generating, LLC, 440 B.R. at 320-21.


27In re Caesars Entm’t Operating Co., 562 B.R. at 174.

28See In re Caesars Entm’t Operating Co., 562 B.R. at 180-82.

29See In re Caesars Entm’t Operating Co., 562 B.R. at 181.


33See In re 203 N. LaSalle St. P’ship, 246
See In re 203 N. LaSalle St. P’ship, 246 B.R at 332. The court in Caesars rejected that holding, finding that debtors can be protected from contractual waivers of the benefits of bankruptcy, but not creditors, “particularly not large, sophisticated creditors represented by large, sophisticated law firms.” See In re Caesars Entm’t Operating Co., 562 B.R. at 179-80.


See In re SW Boston Hotel Venture, LLC, 460 B.R. at 52.

See In re SW Boston Hotel Venture, LLC, 460 B.R. at 52.


See Aurelius Capital Master Ltd. v. TOUSA Inc., No. 08-61317-CIV, 2009 WL 6453077 (S.D. Fla. Feb. 6, 2009) (affirming lower court’s enforcement of a provision under which a junior creditor agreed not to object to debtor’s use of its cash); see also Broad. Capital, Inc. v. Davis Broad., Inc. (In re Davis Broad., Inc.), 169 B.R. 229 (Bankr. M.D. Ga. 1994) (recognizing in dicta the enforceability of a subordination agreement in bankruptcy) (reversed on other grounds).

RECENT DECISIONS FROM THE APPELLATE COURTS

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SECOND CIRCUIT

Trikona Advisers Ltd. v. Chung, 846 F.3d 22 (2d Cir. 2017). Chapter 15 does not prevent a district court from granting preclusive effect to a foreign court’s factual findings. The case arose from two concurrent proceedings: a wind-up proceeding for an investment company in the Cayman Islands and a suit for fiduciary breach between its owners in the district court of Connecticut. One of the company’s owners opposed the wind-up proceeding in the Cayman Islands by arguing that the other owner breached his fiduciary duties and thus insolvency relief would not be “just and equitable,” as required under Cayman Islands insolvency law. Granting the petition for wind-up, the Cayman Islands court held that these allegations were without merit. The Connecticut district court later granted preclusive effect to the findings and dismissed the suit for fiduciary breach. On appeal, the plaintiff argued that the foreign court’s ruling could not be given preclusive effect because no application for recognition was made for the wind-up proceeding, as required under Chapter 15. The Second Circuit affirmed that the requirements of Chapter 15 did not apply in the present case, noting that Chapter 15 applies only in cases when either a United States court or a foreign court is asked to assist in the administration of an insolvency case in the other forum. “Chapter 15 does not apply when a court in
the United States simply gives preclusive effect to factual findings from an otherwise unrelated foreign liquidation proceeding, as was done here.”

FOURTH CIRCUIT

*Birmingham v. PNC Bank, N.A. (In re Birmingham)*, 846 F.3d 88 (4th Cir. 2017). Chapter 13 debtor cannot cram down mortgage on the debtor’s principal residence on the basis that escrow funds are “additional collateral” in the mortgage documents. The debtor argued the additional collateral forfeited the protection from modification in § 1322(b)(2). The Fourth Circuit determined that escrow funds were “ancillary items” under BAPCPA and were therefore part of the total secured claim.

*Lynch v. Jackson (In re Jackson)*, _______ F.3d _______, 2017 WL 59011 (4th Cir. Jan. 5, 2017). On direct appeal, Fourth Circuit affirms that Chapter 7 debtors, in their means test calculation, can claim the full National and Local Standard expense amounts for certain categories, notwithstanding that actual expenses are lower. The court read § 707(b)(2)(A)(ii)(I) to distinguish between “applicable” expenses and “actual” expenses. Because Congress used both terms, the debtor was entitled to use the “applicable” expenses under the National and Local Standards for certain categories, and their “actual” expenses for other categories. To determine otherwise, would punish the frugal debtor, whose expenses were lower than the applicable standards.

FIFTH CIRCUIT

*Kingdom Fresh Produce, Inc. v. Stokes Law Office, L.L.P. (In re Delta Produce, L.P.)*, 845 F.3d 609 (5th Cir. 2016). (i) Bankruptcy court had authority to adjudicate claims under the Perishable Agricultural Commodities Act (PACA) because the PACA claimants expressly or impliedly consented to the bankruptcy court’s authority when they failed to object, filed claims and joined the case; (ii) district court lacked appellate jurisdiction to review bankruptcy court’s two interim fee awards because they were interlocutory, not final orders; (iii) sole objecting claimant to special counsel’s fees being paid from the PACA trust only had standing to challenge special counsel’s fee award to the extent of the percentage of the fees allocable to the objecting party; and (iv) special counsel could not be paid fees from the PACA trust assets until full payment of all PACA claimants.

SEVENTH CIRCUIT

*Smith v. Capital One Bank (USA), N.A. (In re Smith)*, 845 F.3d 256 (7th Cir. 2016). Credit card company’s lawsuit against nondebtor husband did not violate codebtor stay under § 1301(a) because the credit card debt was not a liability attributed to the debtor.

NINTH CIRCUIT

*Kupfer v. Salma (In re Kupfer)*, ______ F.3d _______, 2016 WL 7473790 (9th Cir. Dec. 29, 2016). The statutory cap on a landlord’s claims against a tenant in § 502(b)(6) applies only to claims that result directly from the termination of a lease, not to collateral claims. Ninth Circuit vacated and remanded bankruptcy court’s decision to cap an arbitration award of past and future rent and directed the lower court to apply the following test: assuming that all other conditions remain constant, would the landlord have the same claim against the tenant had the lease not been terminated? It concluded that the arbitration award for past rent was independent of the termination of the lease and is not capped, whereas the future rent arose from termination of the lease and is capped. Next, it instructed the court to first categorize all remaining fees and costs as either directly resulting from termination of the lease, or not, and apportion the amounts accordingly.

ELEVENTH CIRCUIT

2017). Eleventh Circuit did not have jurisdiction to consider bankruptcy court’s unauthorized dismissal of a noncore proceeding. The president of Chapter 7 debtor filed a state court action against members of the law firm serving as counsel for the Chapter 7 trustee, alleging that the firm conspired to improperly influence the judge presiding over the Chapter 7 case by hiring his spouse to join the firm’s bankruptcy department. The Eleventh Circuit found that the claim was noncore because judicial misconduct can arise in any legal proceeding. However, because a ruling on the improper influence claim could affect the administration of the bankruptcy estate, the noncore proceeding was related to the bankruptcy case. Under Wellness, related noncore proceedings require the parties’ consent before a bankruptcy court can enter a final order or judgment. The Eleventh Circuit held that because the parties in this action did not consent, the order of dismissal was unauthorized, and the bankruptcy court should have submitted findings and conclusions to the district court for entry of a final order.
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