

Financial Restructuring and Insolvency

Insolvency Notes

April 2011

Court Provides Senior Creditors With an Additional Mechanism for Obtaining the Right to Vote a Junior Creditor's Claim in a Bankruptcy Reorganization



Roberto Kampfner and Lauren Fujii

A senior creditor can obtain significant leverage over a chapter 11 debtor if it is able to vote not only its claim but the claims of junior creditors in connection with the solicitation of a plan of reorganization. Obtaining such leverage, however, has proven problematic in the past. Among other things, courts have been reluctant to enforce pre-bankruptcy assignments or waivers of voting rights contained in intercreditor agreements, holding that such assignments or waivers may violate the Bankruptcy Code and rules. In *Avondale Gateway Center Entitlement, LLC v. National Bank of Arizona*, Case No. CV 10-1772, 2011 WL 1376997 (D. Ariz. Apr. 12, 2011), the United States District Court of the District of Arizona (the "District Court") brushed those concerns aside and held that voting rights are freely transferable under the doctrine of subrogation. This decision, if adopted by other courts, may provide senior creditors with a fully enforceable mechanism for obtaining voting rights from junior creditors.

The Intercreditor Agreement and Subrogation Clause

The facts in *Avondale* are relatively simple. Prior to filing its chapter 11 petition, Avondale Gateway Center Entitlement, LLC (the "Debtor") obtained loans from two separate creditors and secured such loans with liens on the Debtor's land. The first creditor (the "Senior Creditor") was granted a first-priority lien. The second creditor (the "Junior Creditor") was granted a second-priority lien. In order to memorialize their respective priorities, the Senior Creditor and the Junior Creditor entered into a Subordination and Intercreditor Agreement (the "Intercreditor Agreement") containing standard subordination provisions. The Intercreditor Agreement also contained an unusual provision, which stated that:

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

This provision is unusual because subrogation generally allows a surety or guarantor to "stand in the shoes" of a creditor whose claim it has satisfied. In this case, the Intercreditor Agreement provided the Senior Creditor with subrogation rights even though the Senior Creditor was not required to first (or ever) satisfy the Junior Creditor's claim.

Our global network of more than 2,000 lawyers in 25 countries advises clients on complex, groundbreaking work affecting cross-border business in almost every area of law across emerging and established markets. We work with some of the world's most respected and well-established companies—including two-thirds of the *Global Fortune 100* and half of the *Fortune 500*—as well as start-up visionaries, governments and state-owned entities.

"White & Case has a better ability than any other firm to represent both debtors as well as creditors in restructuring cases. This gives it a very strong perspective on the overall market, and an ability to anticipate things that firms which are more debtor-specific or creditor-specific would not."

Legal 500 USA

The Courts' Involvement

After filing its bankruptcy petition, the Debtor filed and solicited a plan of reorganization. The Junior Creditor voted to accept the plan and the Senior Creditor cast two votes to reject it, one vote on its own behalf and one vote on behalf of the Junior Creditor. The Debtor challenged the Senior Creditor's ability to vote on behalf of the Junior Creditor, but the Bankruptcy Court ruled against the Debtor, holding that the subrogation clause in the Intercreditor Agreement authorized the Senior Creditor's actions.

On appeal, the District Court affirmed the Bankruptcy Court. The Debtor first argued that the subrogation clause was inapplicable because the Senior Creditor had never paid off the Junior Creditor's claim, which is generally a prerequisite to obtaining subrogation rights. The District Court found this argument unpersuasive, noting that Arizona law recognized two different types of subrogation—equitable and contractual. The District Court held that, unlike equitable subrogation, contractual subrogation does not require the Senior Creditor to pay off the Junior Creditor prior to obtaining subrogation rights; rather, a Senior Creditor can "step into the shoes" of a Junior Creditor as a matter of contract.

Next, the Debtor argued that the subrogation clause was too narrow to encompass voting rights. Among other things, the Debtor noted that the subrogation clause never specifically mentioned voting rights, referring only to the Junior Creditor's "claims" and "liens" against the Debtor. The District Court rejected these arguments as well, reasoning that unlike assignments, which require a specific description of the rights assigned, subrogation "is the wholesale substitution of one party for another." As a result, the Senior Creditor was entitled to assert whatever rights the Junior Creditor could assert against the Debtor, including the right to vote on a plan of reorganization, whether or not those rights were specifically mentioned in the subrogation clause of the Intercreditor Agreement.

According to the District Court, a senior creditor can obtain the right to assert all of a junior creditor's rights simply by using the word "subrogation" rather than "assignment" or "waiver" in an intercreditor agreement. In short, this opinion, if accepted by other courts, could provide senior creditors with a fully enforceable avenue for obtaining the voting rights of junior creditors.

Limitations of *Avondale*

Although the *Avondale* case grants senior creditors broad rights, it may not be adopted by other courts. Importantly, it seems that the District Court may have misunderstood the Arizona cases, holding that payment of a claim is not required where subrogation is contractual. In short, subrogation generally only arises where a third party, such as a guarantor or a surety, is *required*, by law or contract, to pay a creditor's claim. Under those circumstances, a subrogee may wish to bargain for the right to "step into the shoes" of a creditor prior to actually paying such creditor's claim. Allowing the subrogee to do so is not only consistent with the principles of subrogation, but it is fair because the subrogee will ultimately bear the risk of loss vis-à-vis the debtor.

The most common examples of contractual subrogation can be found in the insured-surety relationship and, indeed, both of the cases cited by the District Court in the *Avondale* opinion are insurance cases. A surety often seeks the contractual right to "stand in the shoes" of its insured well before it satisfies a covered claim. This allows a surety to direct the insured's defense, negotiate settlements and mitigate losses. Moreover, such a result makes sense because the insurance company will bear the ultimate risk of loss, not the insured.

That principle, however, has no application where the "subrogee" has no obligation to satisfy the claim to which it is purportedly subrogated. In such a case, the subrogee does not bear the ultimate risk of loss and it cannot "step into the shoes" of a creditor whose claim it will never own. In *Avondale*, the Senior Creditor was not required to pay the Junior Creditor's claim and, indeed, doing so would have undermined the purpose of the Intercreditor Agreement—to make sure that the Senior Creditor's claims were paid first. Under such circumstances, the subrogation clause accomplishes nothing more than the assignment of the Junior Creditor's voting rights and it is unclear whether other courts would find that the use of the word "subrogation" rather than "assignment" dispositive as to whether the Junior Creditor's voting rights were subject to transfer.

Conclusion

The *Avondale* case is notable because it appears to permit the transfer of voting rights from junior creditors to senior creditors via the doctrine of subrogation. However, it remains to be seen whether other courts will follow the District Court's analysis and reach the same conclusion.

Authors

Roberto Kampfner

Partner, Los Angeles
+ 1 213 620 7729
rkampfner@la.whitecase.com

Lauren Fujju

Associate, Los Angeles
+ 1 213 620 7705
lfujju@la.whitecase.com

Editors

Thomas E Lauria

Partner, Global Chairman of the Financial
Restructuring and Insolvency Practice
Miami/New York
+ 1 305 995 5282
tlauria@miami.whitecase.com

Craig Averch

Partner, Los Angeles
+ 1 213 620 7704
caverch@la.whitecase.com

Gerard Uzzi

Partner, New York
+ 1 212 819 8479
guzzi@ny.whitecase.com

New York

White & Case LLP
1155 Avenue of the Americas
New York, NY 10036
United States
+ 1 212 819 8200

Miami

White & Case LLP
Wachovia Financial Center
200 South Biscayne Boulevard
Suite 4900
Miami, Florida 33131-2352
United States
+ 1 305 371 2700

Los Angeles

White & Case LLP
633 West Fifth Street Suite 1900
Los Angeles, California 90071-2007
United States
+ 1 213 620 7700

Washington, DC

White & Case LLP
701 Thirteenth Street, NW
Washington, DC 20005-3807
United States
+ 1 202 626 3600