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David Kravitz
University of Michigan Law School

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NOTE

The Outer Fringes of Chapter 11: Nonconsenting Senior Lenders' Rights Under Subordination Agreements in Bankruptcy

David Kravitz

INTRODUCTION¹

Subordinated debt has long been viewed as a vital component of corporate finance.² During the 1980s, the use of subordinated debt in both leveraged buyouts and more mundane financing transactions increased dramatically.³ As the entities those transactions created collapse into bankruptcy,⁴ the treatment of subordinated debt under the Bankruptcy Code⁵ will become increasingly important.⁶ At the moment, however, "there is no settled black letter law regarding subordination agreements" and there is "a relative lack of reported bankruptcy cases which discuss subordination agreement issues in depth."⁷

The treatment of subordination agreements between unsecured

1. Readers of commercial law literature will recognize the title's reference to Coogan, Kripke and Weiss' classic article about subordination agreements under the Uniform Commercial Code. See Peter F. Coogan et al., *The Outer Fringes of Article 9: Subordination Agreements, Security Interests in Money and Deposits, Negative Pledge Clauses, and Participation Agreements*, 79 HARV. L. REV. 229 (1965).

2. For example, 26 years ago the Second Circuit observed that subordinated debt involved "literally billions of dollars of outstanding loans," and noted that a reduction in lenders' willingness to participate in subordinated debt financing would be "to the detriment of the entire business community." *In re Credit Indus. Corp.*, 366 F.2d 402, 410 (2d Cir. 1966).

3. See Wendell H. Adair, Jr., *Subordinated Debt in the 1990s: Implications for Senior and Junior Lenders*, COM. LENDING REV., Winter 1991-92, at 38, 38 (noting that during the 1980s, the market for publicly traded subordinated debt grew from \$10 billion to over \$200 billion).

4. "There's a bankruptcy filing by former LBOs every day now." Louise Witt, *Profitable Morse Shoe Collapses Under LBO Debt*, BOSTON BUS. J., Feb. 4, 1991, at 3 (quoting Steven Frankel, retail analyst with Adams Harkness & Hill in Boston).

5. 11 U.S.C. §§ 101-1330 (1988). Throughout this Note, the Bankruptcy Code will be referred to as "the Code," and specific section references in the text (e.g., "section 510") are to the corresponding section of the Code (e.g., 11 U.S.C. § 510 (1988)), unless otherwise indicated.

6. The only section of the Bankruptcy Code dealing with the treatment of debt subordination agreements is § 510(a). See *infra* text accompanying notes 64-69 for a discussion of its text and legislative history. Section 510(a) appears relatively infrequently in reported cases. A search of the FBKR-CS database on WESTLAW, conducted in October 1992, revealed only 32 cases that discuss § 510(a). Its use is becoming more frequent, however; of those 32 cases, 10 are dated 1990 or later.

7. *In re Holly's, Inc.*, 140 B.R. 643, 667 (Bankr. W.D. Mich. 1992).

creditors⁸ in chapter 7⁹ bankruptcies is relatively straightforward. After payment of the priority claims listed in section 507,¹⁰ unsecured claims are paid pro rata if the debtor's estate contains insufficient funds to pay all unsecured claims in full.¹¹ However, if a subordination agreement governs the claims of two unsecured creditors, section 510(a) requires that the agreement be enforced,¹² and section 726 recognizes that section 510 could alter the pro rata distribution.¹³ Consequently, the subordinated creditor will have to turn over any distribution it receives to the senior creditor, resulting in "double dividends" for the senior lender: the senior lender receives its own share of the payments, plus that of the subordinated lender.¹⁴

Chapter 11 bankruptcies,¹⁵ however, present a more complex problem. In a chapter 11 reorganization, a confirmed reorganization plan,¹⁶ not the Bankruptcy Code, determines who gets what.¹⁷ To ease confirmation, a debtor may propose a plan providing for partial payments to both senior and subordinated creditors in order to obtain the approval of the subordinated creditors.¹⁸ Such a plan would not

8. Subordination agreements altering lien priority are also enforceable between secured creditors. See U.C.C. § 9-316 (1990); *Holly's, Inc.*, 140 B.R. at 670. To avoid issues arising under Article 9 of the U.C.C., however, the discussion in this Note is restricted to unsecured subordinated debt.

9. Chapter 7 of the Bankruptcy Code, 11 U.S.C. §§ 701-766 (1988), governs liquidations.

10. Section 507 gives priority to claims such as administrative expenses, certain employee wages and benefit plans, consumer deposits, and certain taxes.

11. 11 U.S.C. § 726(b) (1988); see H.R. REP. NO. 595, 95th Cong., 1st Sess. 383 (1978), reprinted in 1978 U.S.C.C.A.N. 5963, 6339 [hereinafter HOUSE REPORT] (describing pro rata distribution).

12. 11 U.S.C. § 510(a) (1988) provides: "A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law."

13. Section 726 prefaces its distribution framework with the phrase "[e]xcept as provided in section 510 of this title." 11 U.S.C. § 726(a) (1988).

14. James L. Lopes, *Contractual Subordinations and Bankruptcy*, 97 BANKING L.J. 204, 223 (1980); Reade H. Ryan, Jr., *The Subordinated World of Junk Bonds*, 105 BANKING L.J. 4, 5 (1988); see also Dee M. Calligar, *Subordination Agreements*, 70 YALE L.J. 376, 377 (1961). For example, if the debtor's estate has \$600,000 available to pay unsecured claims and owes \$500,000 each to a senior, subordinated, and general unsecured creditor, the pro rata distribution would be \$200,000 to each creditor. However, because of the turnover obligation, the subordinated creditor's share goes to the senior creditor, who consequently receives \$400,000, while the general creditor still receives \$200,000. *Id.*

15. 11 U.S.C. §§ 1101-1174 (1988).

16. See *infra* section II.A for a brief discussion of the confirmation process.

17. Section 1123 governs the contents of a plan. Among other requirements, the plan must "specify the treatment of any class of claims or interests that is impaired under the plan." 11 U.S.C. § 1123(a)(3) (1988). A class is impaired if it will receive less than the full value of its claim according to the provisions of § 1124. 11 U.S.C. § 1124 (1988). See generally RICHARD I. AARON, *BANKRUPTCY LAW FUNDAMENTALS* § 12.03 (1991).

18. K.G. McGuinness & L.M. Goldman, *Courts Divide on Lenders' Right to Attack Reorganization Plans*, NATL. L.J., Apr. 22, 1991, at 20, 20. Several cases show examples of this type of plan. *E.g.*, *In re Eagle Bus Mfg., Inc.*, 134 B.R. 584, 591 (Bankr. S.D. Tex. 1991) (plan allowed senior creditors twice the percentage recovery that subordinated creditors received); *Bartle v. Markson Bros., Inc.*, 314 F.2d 303 (2d Cir. 1963) (plan proposed payment to senior creditors of

comply with the subordination agreement because the senior creditors would receive less than full payment, yet the subordinated creditors would receive some value for their claims.

One can imagine that such a plan might be objectionable to a senior creditor who bargained for the right to receive full payment before subordinated creditors. If the senior creditor were outvoted by its class, however, it might be denied the benefit of its bargain.¹⁹ As an illustration of the problem, consider the following hypothetical.

Deadbeat Debtor Inc. owed \$1,000,000 to its president. The president, concerned that the company needed more capital, signed a complete subordination agreement²⁰ with each of five banks to induce the banks to lend. Each bank made a \$100,000 unsecured loan to the debtor. The debtor, now in chapter 11, proposes a reorganization plan as follows: (1) there are two classes, one containing the banks, the other containing the subordinated creditor; (2) the subordinated debt will receive ten cents on the dollar, while the senior bank debt will receive fifty cents on the dollar; (3) the subordinated creditor need not turn over its payments to the senior creditors. The subordinated creditor approves the plan. Of the senior creditors, four of the banks — 80% of the amount and number of claims, sufficient for acceptance²¹—approve the plan, but one, Frugal Financial, does not. Frugal argues that it lent to the debtor relying on the terms of the subordination agreement: it never would have lent to a troubled company that had \$1,000,000 in debt unless it was assured of full payment before the \$1,000,000 creditor received anything. The other banks try to convince Frugal that they are better off taking fifty cents on the dollar and being done with it, since liquidation would bring less,²² but Frugal is adamant that it is entitled to enforce its bargain. The bankruptcy court confirms the plan based on the consent of the two classes, despite Frugal's objection, and Frugal appeals the confirmation order on the grounds that the bankruptcy court had no authority to override a contract between two creditors, regardless of the plan's terms.²³

47.5% of their claim in cash and to subordinated creditors of 15% in cash and 85% in notes); *In re Equity Funding Corp. of Am.*, 416 F. Supp. 132, 152 (C.D. Cal. 1975) (plan proposed paying 76.1% to 80% of senior claims and 31.5% of subordinated claims); *In re Dodge-Freedman Poultry Co.*, 148 F. Supp. 647, 648 (D.N.H. 1956) (plan proposed paying 15% of all unsecured claims).

19. Section 1141(a) provides: "[T]he provisions of a confirmed plan bind . . . any creditor . . . whether or not such creditor . . . has accepted the plan." 11 U.S.C. § 1141(a) (1988). Thus, when a class has satisfied the standards for acceptance in § 1126(c), see *infra* note 81, the wishes of a single class member who disagrees with the majority of its class ordinarily become irrelevant.

20. See *infra* section I.A for a definition of complete, as opposed to contingent, subordination agreements.

21. See 11 U.S.C. § 1126(c) (1988); *infra* section II.A.

22. Assuming that this statement is correct, it prevents Frugal from arguing that the plan violates the best-interests test of § 1129(a)(7)(A)(ii). See *infra* section II.A.

23. This hypothetical is admittedly unrealistic on at least two counts: banks are unlikely to make unsecured loans under the conditions stated, and Frugal appears to be acting irrationally. Despite these criticisms, the hypothetical is useful both because it is a *possible*, if unlikely, scenario, and because it clearly illustrates the problem.

This Note focuses on the options a senior creditor in Frugal's position may have when a reorganization plan provides for payments in violation of a subordination agreement that the creditor wishes to enforce. Part I explains the different types of subordination agreements and discusses their treatment under pre-Code bankruptcy law and under the Bankruptcy Code. Because of the dearth of case law regarding nonconsenting senior lenders and subordination agreements, Part II considers a question in a related area of bankruptcy law where more authority exists: whether a reorganization plan may release a nonbankrupt guarantor from its obligations under the guaranty agreement. Part II examines the split in authority on this issue. Part III considers how bankruptcy courts should treat plans containing provisions that violate subordination agreements, using the guarantor-release case law for guidance. This Note concludes that when a senior creditor wishes to enforce a subordination agreement that a reorganization plan purports to violate, the bankruptcy court should refuse to confirm the plan even if the senior creditor is outvoted by its class.²⁴

I. SUBORDINATION AGREEMENTS

This Part examines the law governing subordination agreements. Section I.A distinguishes between different types of subordination agreements and considers the different purposes they might serve. Section I.B analyzes the law governing subordination agreements in bankruptcy prior to the passage of the Bankruptcy Code in 1978.²⁵ The pre-Code law is still relevant, as courts often look to it in deciding how to construe subordination agreements under the Code.²⁶ Section I.C discusses the language and legislative history of Code section 510(a) governing subordination agreements.

A. *Types of Subordination Agreements*

The basic concept behind subordinated debt is simple: the subordinated creditor agrees that under certain circumstances, the claims of specified senior creditors must be paid in full before any payment may be made to, and retained by, the subordinated creditor.²⁷

24. The related question of whether a senior creditor may mount a collateral attack against a subordinated creditor to recover payments made pursuant to a confirmed plan in violation of a subordination agreement is beyond the scope of this Note. For some differing views on this and related questions, see *Republic Supply Co. v. Shoaf*, 815 F.2d 1046 (5th Cir. 1987) (disallowing collateral attack on a guarantor on res judicata grounds); *In re A.J. Mackay Co.*, 50 B.R. 756 (Bankr. D. Utah 1985) (allowing collateral attack on a guarantor despite res judicata argument); Lopes, *supra* note 14, at 224-25 (speculating that res judicata would bar attack on a subordinated creditor); McGuinness & Goldman, *supra* note 18 (noting arguments on both sides).

25. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. §§ 101-1330 (1988)).

26. See *infra* note 66 and accompanying text.

27. Calligar, *supra* note 14, at 376.

Debt subordination agreements²⁸ involve three players: (1) a common debtor, who owes money to two creditors or groups of creditors; (2) a subordinated creditor, who may not be paid until the senior debt is satisfied;²⁹ and (3) a senior creditor, who must be paid before any subordinated creditor receives any payment.³⁰ The senior and subordinated creditors "may each be a named individual, or a member of a specific or open-ended class."³¹ Implicit in subordination agreements is a "turnover obligation," which provides that if the subordinated creditor receives any payment before the senior creditor is paid in full, the subordinated creditor must turn the payment over to the senior creditor.³²

Details in subordination agreements vary. A *complete* subordination means that upon execution of the agreement, the subordinated creditor will receive no payment until the senior creditor is paid in full.³³ An *inchoate*³⁴ or *contingent*³⁵ subordination permits some payments to the subordinated lender — interest, principal, or both — unless the debtor defaults on the senior debt.³⁶ Bankruptcy always triggers the default provision of a contingent subordination.³⁷

One can also distinguish *private* from *institutional* subordination agreements.³⁸ A private subordination agreement is between a specific senior creditor and a specific junior creditor.³⁹ These agreements usually arise when a creditor who is an insider of the debtor becomes concerned that the company needs more cash and induces large lend-

28. This Note deals only with subordination that is agreed to by the parties involved. Section 510(c) of the Bankruptcy Code permits a court to use "equitable subordination" to reduce the priority of the claims of a creditor who has been "guilty of misconduct." S. REP. NO. 989, 95th Cong., 2d Sess. 74 (1978), reprinted in 1978 U.S.C.A.N. 5787, 5860 [hereinafter SENATE REPORT]. Equitable subordination involves entirely different principles and policies of bankruptcy law than does subordination by agreement, and is therefore beyond the scope of this Note.

29. This is always true for *complete* subordinations. *Contingent* subordinations, in contrast, may permit some payment to subordinated creditors absent default on the senior debt. See *infra* notes 33-37 and accompanying text.

30. Coogan et al., *supra* note 1, at 233; see also *In re Holly's, Inc.*, 140 B.R. 643, 668 (Bankr. W.D. Mich. 1992).

31. Coogan et al., *supra* note 1, at 233.

32. See Calligar, *supra* note 14, at 377; *supra* note 14 and accompanying text. Again, this is strictly true only for complete subordinations. See *infra* notes 33-37 and accompanying text.

33. Ryan, *supra* note 14, at 5; Calligar, *supra* note 14, at 378.

34. Calligar, *supra* note 14, at 377-78. Calligar's use of the term "inchoate" has been criticized as suggesting incorrectly that some further action is required by the senior lender to enforce its rights. See Edward Everett, *Subordinated Debt — Nature and Enforcement*, 20 BUS. LAW. 953, 956 n.8 (1965); Coogan et al., *supra* note 1, at 234 n.20.

35. David G. Carlson, *A Theory of Contractual Debt Subordination and Lien Priority*, 38 VAND. L. REV. 975, 983 (1985).

36. See Calligar, *supra* note 14, at 377-78.

37. See Lopes, *supra* note 14, at 206.

38. *Id.* at 206-07.

39. A private subordination agreement could potentially involve more than one junior lender. *Id.* at 207.

ers to lend to the troubled company by agreeing to subordinate its own claims to those of the outside lenders.⁴⁰ The principal players in private subordination agreements are the two creditors who have agreed between themselves to reorder payment priorities; the debtor may or may not be a party to the agreement.

In contrast, institutional subordination agreements involve the debtor and subordinated creditors as parties, with the senior creditor usually a third-party beneficiary to the agreement.⁴¹ Perhaps the best known type of institutional subordination is the now infamous "junk bond." Junk bonds are high-yield securities issued in large amounts by a company that wishes to raise capital; they are usually subordinated to other debt of the debtor.⁴² The subordination explains the high yield: investors who purchase junk bonds take a substantial risk that in the event of insolvency their obligations will not be paid, so they receive a risk premium in the form of high interest rates. Agreements governing institutional subordinations usually leave the class of senior creditors open; a creditor advancing funds after the agreement's execution joins the existing class of senior creditors.⁴³

Private subordinations are usually complete; institutional ones generally are contingent.⁴⁴ This is because complete subordination forbids any payment to the subordinated creditor before the senior debt is paid off. Thus, a complete subordination provides maximum inducement for lenders entering a private subordination agreement. However, purchase of completely subordinated debt "would not ordinarily constitute an appropriate investment for institutional investors"⁴⁵ because all payment on the debt would be forbidden for an indeterminate time.

B. *Subordination Agreements Under Pre-Code Law*

Prior to the adoption of the Bankruptcy Code in 1978,⁴⁶ the status of subordination agreements in bankruptcy was unclear. No provision

40. See *In re Holly's, Inc.*, 140 B.R. 643, 668 n.37 (Bankr. W.D. Mich. 1992) (quoting Carlson, *supra* note 35, at 976-77); *In re The Lantana Motel*, 124 B.R. 252, 256 (Bankr. S.D. Ohio 1990).

41. See Lopes, *supra* note 14, at 206-07.

42. See Ryan, *supra* note 14, at 4.

43. Everett, *supra* note 34, at 956 (quoting a typical institutional subordination provision providing in part that the subordinated note shall be "subordinate and junior in right of payment . . . to all indebtedness of the Company for money borrowed, whether outstanding at the date of the Notes or incurred after the date of the Notes" (emphasis added)); see also Coogan et al., *supra* note 1, at 233.

44. Lopes, *supra* note 14, at 206-07.

45. Everett, *supra* note 34, at 956.

46. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. §§ 101-1330 (1988)).

of the Bankruptcy Act of 1898⁴⁷ addressed the treatment of subordination agreements. Subordinated creditors wishing to escape a subordination agreement generally argued that because the Act required pro rata distribution of assets to all claims other than those granted statutory priority or that were secured,⁴⁸ the subordination agreement could not be enforced.⁴⁹ Courts responded with one of four theories to justify enforcement of the agreements despite the apparent conflict with the statute.⁵⁰ Briefly stated, the four theories are:

(1) The subordination agreement creates an equitable lien in favor of the senior creditor;

(2) The subordination agreement creates an equitable assignment to the senior creditor of the subordinated debt claim in bankruptcy and dividends payable thereon;

(3) The [subordinated creditor] holds the dividends received as constructive trustee for the holder of the senior debt;

(4) The bankruptcy court has the power to distribute the bankrupt estate in accord with the rights of the parties as fixed by their own contract.⁵¹

When facing a case involving enforcement of subordination agreements, courts continue to recite these four theories.⁵² However, no court has adopted any of the first three theories since 1956.⁵³ Courts and commentators agree that the contract theory is "the most logically supportable and sensible of all the theories."⁵⁴ The other three theories appear to be of historical interest only.

The basis for the contract theory is that "the bankruptcy court has the jurisdictional power to enforce the contractual rights of the parties

47. Bankruptcy Act of July 1, 1898, ch. 541, 30 Stat. 544 (repealed 1978). References in the text to "the Act" are to the 1898 Bankruptcy Act.

48. Bankruptcy Act § 65a, 11 U.S.C. § 105(a) (1976) (repealed 1978) provided that "[d]ividends of an equal per centum shall be declared and paid on all allowed claims, except such as have priority or are secured."

49. See, e.g., *In re Credit Indus. Corp.*, 366 F.2d 402, 408 (2d Cir. 1966); *In re Aktiebolaget Kreuger & Toll*, 96 F.2d 768, 770 (2d Cir. 1938).

50. See Everett, *supra* note 34, at 961-62 ("[T]he courts appear to have uniformly enforced or implemented the subordination agreements presented to them and have thereby clearly established the principle that subordination agreements will be enforced for the benefit of the senior debt." (footnote omitted)).

51. Calligar, *supra* note 14, at 384 (footnotes omitted). A fifth theory has been proposed by Carlson, *supra* note 35. Carlson believes that subordination agreements should be viewed as actual assignments of the junior claim from the subordinated lender to the senior lender. *Id.* at 996. So far, no court has adopted Carlson's theory.

52. See, e.g., *In re Holly's, Inc.*, 140 B.R. 643, 668 (Bankr. W.D. Mich. 1992); *In re Smith*, 77 B.R. 624, 627 (Bankr. N.D. Ohio 1987).

53. The court in *In re Dodge-Freedman Poultry Co.*, 148 F. Supp. 647, 651-52 (D.N.H. 1956), adopted the constructive trust theory. The equitable lien theory appears in *In re Geo. P. Schinzel & Son*, 16 F.2d 289 (S.D.N.Y. 1926). The equitable assignment theory appears in *In re Handy-Andy Community Stores*, 2 F. Supp. 97 (W.D. La. 1932).

54. Calligar, *supra* note 14, at 388; see also Marvin D. Heilesen & Morris W. Hirsch, *Private Subordination Agreements and the U.C.C.: Is Section 1-209 an Un-Wyse Solution?*, 38 BUS. LAW. 555, 562 (1983); Lopes, *supra* note 14, at 209.

in interest[] when distributing a bankrupt estate."⁵⁵ This theory first appeared in the 1930s in *Bird & Sons Sales Corp. v. Tobin*⁵⁶ and *In re Aktiebolaget Kreuger & Toll*.⁵⁷ In both of these cases, the subordinated creditors argued that the language of section 65a of the Act⁵⁸ created an absolute system of pro rata distribution of the bankrupt's assets, and that "the court is without power to recognize rights, however just and equitable, which some members of the class may be shown to have against others."⁵⁹ Both courts flatly rejected this argument, holding that the statute "means no more than that dividends paid to creditors shall be pro rata *except* where there is a priority given by law or by lawful contractual arrangement between the parties."⁶⁰

Other cases have agreed that recognizing and enforcing the parties' contractual arrangements is the proper way to effectuate subordination agreements in bankruptcy,⁶¹ including cases using a third-party beneficiary theory where the senior creditor was not a party to the agreement.⁶² The Second Circuit has perfectly summarized this position: "If the terms of the contracts are clear and unambiguous, it is unnecessary to resort to strained theories to evaluate and determine the proper respective positions of the parties involved."⁶³

C. Subordination Agreements Under the Bankruptcy Code

Unlike the Act, the Code mandates enforcement of subordination agreements in bankruptcy. Section 510(a) of the Code provides: "A subordination agreement is enforceable in a case under this title to the

55. Calligar, *supra* note 14, at 388.

56. 78 F.2d 371 (8th Cir. 1935).

57. 96 F.2d 768 (2d Cir. 1938).

58. See *supra* note 48 for the text of § 65a.

59. *Bird*, 78 F.2d at 373; see also *Kreuger & Toll*, 96 F.2d at 770.

60. *Kreuger & Toll*, 96 F.2d at 770 (citing *Bird*, 78 F.2d at 371) (emphasis added).

61. See, e.g., *First Natl. Bank of Hollywood v. American Foam Rubber Corp.*, 530 F.2d 450, 454 (2d Cir. 1976); *In re Credit Indus. Corp.*, 366 F.2d 402, 407 (2d Cir. 1966); *In re Holly's, Inc.*, 140 B.R. 643, 668-69 (Bankr. W.D. Mich. 1992); *In re Smith*, 77 B.R. 624, 627 (Bankr. N.D. Ohio 1987); *In re Eaton Factors Co.*, 3 B.R. 20, 22-23 (Bankr. S.D.N.Y. 1980); see also U.C.C. § 1-209 cmt. 2 (1990).

62. E.g., *Elias v. Clarke*, 143 F.2d 640 (2d Cir. 1944). For a discussion of *Elias*, see Everett, *supra* note 34, at 966-67. Courts in the past may have been reluctant to use the contract theory alone because it often would have required enforcing rights of a party who had not signed the contract at a time when third-party beneficiary theory was not universally accepted. See Lopes, *supra* note 14, at 209; Everett, *supra* note 34, at 964. Massachusetts, for example, did not accept third-party beneficiary theory until 1979. See *Choate, Hall & Stewart v. SCA Servs.*, 392 N.E.2d 1045, 1046, 1051 (Mass. 1979); see also Everett, *supra* note 34, at 972-73 (noting that as of 1965, subordination agreements governed by Massachusetts law "would presumably be [enforceable] . . . upon the basis of 'equitable subordination' . . . and would therefore not need to rely upon the third party beneficiary contract doctrine"). Today, however, all American jurisdictions accept third-party beneficiary theory as a basic principle of contract law. See CHARLES L. KNAPP & NATHAN M. CRYSTAL, *PROBLEMS IN CONTRACT LAW* 1106 (2d ed. 1987); see also *RESTATEMENT (SECOND) OF CONTRACTS* §§ 302, 304 (1979).

63. *In re Credit Indus. Corp.*, 366 F.2d 402, 407 (2d Cir. 1966).

same extent that such agreement is enforceable under applicable nonbankruptcy law.”⁶⁴ Section 510(a) therefore codified existing case law.⁶⁵ However, because section 510(a) simply refers to “applicable nonbankruptcy law” as the basis for enforcement, courts have continued to look to case law under the Act for guidance when confronted with a subordination agreement.⁶⁶

The section’s legislative history is brief, and bears repeating in full: Subsection (a) requires the court to enforce subordination agreements. A subordination agreement will not be enforced, however, in a reorganization case in which the class that is the beneficiary of the agreement has accepted, as specified in proposed 11 U.S.C. § 1126, a plan that waives [its] rights under the agreement. Otherwise, the agreement would prevent just what chapter 11 contemplates: that seniors may give up rights to juniors in the interest of confirmation of a plan and rehabilitation of the debtor.⁶⁷

The meaning of the legislative history is somewhat unclear. It may simply stand for the unexceptionable proposition that section 510(a) does not preclude senior creditors from waiving their rights under subordination agreements in order to ease confirmation of a chapter 11 plan. It could also, perhaps, be read to suggest that a class of senior creditors may waive its rights under subordination agreements *over the objection of dissenters within the same class*.⁶⁸ As Collier notes, however, “[t]here is no support for this view . . . in the text of section

64. 11 U.S.C. § 510(a) (1988).

65. See, e.g., *Mihalko v. Continental Bank and Trust Co.* (*In re Mihalko*), 87 B.R. 357, 364 (Bankr. E.D. Pa. 1988); *Beatrice Foods Co. v. Hart Ski Mfg. Co.* (*In re Hart Ski Mfg. Co.*), 5 B.R. 734, 735 (Bankr. D. Minn. 1980); *In re Leasing Consultants, Inc.*, 2 B.R. 165, 168 n.1 (Bankr. E.D.N.Y. 1980).

66. See, e.g., *In re Holly’s, Inc.*, 140 B.R. 643, 668-72 & n.38 (Bankr. W.D. Mich. 1992) (discussing numerous pre-Code cases); *In re Smith*, 77 B.R. 624, 627 (Bankr. N.D. Ohio 1987) (citing the *Schinzel*, *Handy-Andy*, *Dodge-Freedman*, and *Bird* cases, as well as *Calligar*, *supra* note 14, for the four theories of enforcement discussed *supra* section I.B, and adopting the contract theory).

67. HOUSE REPORT, *supra* note 11, at 359, reprinted in 1978 U.S.C.C.A.N. 5963, 6315. The Senate Report contains identical language. See SENATE REPORT, *supra* note 28, at 74, reprinted in 1978 U.S.C.C.A.N. 5787, 5860. The commentary from both of these reports is actually to an earlier version of the statute, numbered 510(a)(1), which read: “[T]he court shall . . . enforce any subordination agreement to the same extent that such agreement is enforceable under applicable nonbankruptcy law.” S. 2266, 95th Cong., 2d Sess. 405 (1977), reprinted in App. 3 WILLIAM M. COLLIER, COLLIER ON BANKRUPTCY part VII (Lawrence P. King ed., 15th ed. 1992); H.R. 8200, 95th Cong., 1st Sess. 393 (1978), reprinted in App. 3 COLLIER, *supra*, part III. Following the issuance of the reports, the entire text of the proposed Code was read into the Congressional Record by Representative Edwards, and that text contained § 510(a) as it now stands. 124 CONG. REC. 32,350, 32,361 (1978). Arguably, the earlier version mandates more aggressive enforcement of subordination agreements than the present version, as it contained the command “shall enforce.” However, there is no explanation for or discussion of the change, nor did Rep. Edwards even mention the new § 510(a) in his extended commentary to the proposed Code. See *id.* at 32,398 (mentioning in passing the old § 510(a)(1); discussing in detail only § 510(c)(1)). It therefore seems more reasonable to assume that the language was simply altered when the section was renumbered, with no intention to change the substantive content of the statute.

68. This reading would result from emphasizing the word “class” in the sentence: “A subordination agreement will not be enforced, however, in a reorganization case in which the *class* that

510(a) itself."⁶⁹

Section 510(a)'s simple rule that subordination agreements are to be enforced as they would be outside of bankruptcy⁷⁰ lends some plausibility to Frugal Financial's argument that the bankruptcy court exceeded its authority in confirming a plan that violated a subordination agreement against its beneficiary's will.⁷¹ If Frugal can establish that the plan violates section 510(a)'s seemingly clear language requiring that subordination agreements be enforced under applicable nonbankruptcy law, then Frugal should win on appeal, because a plan must comply with all applicable provisions of the Bankruptcy Code to be confirmed.⁷² The fact that Frugal was outvoted would then become irrelevant. The rest of this Note attempts to resolve this problem.

II. RELEASE OF GUARANTORS

No reported case since the enactment of the Bankruptcy Code deals directly with the rights of nonconsenting senior creditors under subordination agreements.⁷³ However, subordinated creditors have been analogized to limited guarantors for the senior creditor. As one commentator has noted, "[t]he essence of the subordination agreement is a guaranty or indemnification, limited by the amount payable to or received by the subordinated creditor in a bankruptcy proceeding."⁷⁴ Thus, although the nature of the obligations of a guarantor and a subordinated creditor differ somewhat, their similarities may justify

is the beneficiary of the agreement has accepted . . . a plan that waives [its] rights under the agreement." HOUSE REPORT, *supra* note 11, at 359, reprinted in 1978 U.S.C.C.A.N. 5963, 6315.

69. 2 WILLIAM M. COLLIER, COLLIER BANKRUPTCY MANUAL ¶ 510.05, at 510-14 (Lawrence P. King ed., 3d ed. 1991).

70. Outside of bankruptcy, each senior creditor holds an ordinary contract right that other senior creditors cannot waive against the holder's will, even if they are all parties to the same agreement. Enforcing a subordination agreement as it would be enforced outside of bankruptcy therefore suggests that each senior creditor may choose to enforce its rights irrespective of the will of others.

71. See *supra* text accompanying notes 20-23.

72. 11 U.S.C. § 1129(a)(1) (1988).

73. Two commentators have asked, but have not definitively answered, what would happen if a nonconsenting senior creditor wished to enforce its rights under a subordination agreement purportedly waived by its class. See Lopes, *supra* note 14, at 224; Ralph R. Mabey & Penrod W. Keith, *Contractual and Equitable Subordination in Bankruptcy*, in PRACTICING LAW INSTITUTE, DEALING WITH THE REORGANIZING DEBTOR 1990: TRANSACTIONS, NEGOTIATIONS, AND LITIGATION *5 (1990) (available on WESTLAW, PLI database, citation 545 PLI/Comm 241); cf. McGuinness & Goldman, *supra* note 18, at 20 (asking the related question discussed *supra* note 24). In addition, the author of this Note has learned that at least one major New York law firm has requested research memoranda on this issue, suggesting that it has arisen in the "real world."

74. Lopes, *supra* note 14, at 227; see also McGuinness & Goldman, *supra* note 18, at 20. In contrast, a true guarantor is responsible for the entire debt owed to the senior creditor, regardless of whether the guarantor has received or ever expects to receive any payment from the debtor. See GEORGE E. OSBORNE, CASES AND MATERIALS ON THE LAW OF SURETYSHIP 10 (1966).

using the better-developed law of guarantor releases to assist in analyzing subordination agreements.

This Part examines the authority of a bankruptcy court to modify guaranty agreements in chapter 11 proceedings. Section II.A presents a brief overview of the confirmation process under the Code. Section II.B examines the “restrictive view,” which holds that the bankruptcy court may not alter guaranty agreements, even if the creditor consents to the alteration during the confirmation process. Section II.C discusses the “expansive view,” adopted by a few courts, which allows bankruptcy courts to release the liability of third parties against the will of those parties’ creditors. Finally, section II.D considers a middle course that allows creditors to release third parties from liability voluntarily, but does not permit involuntary release.

A. Plan Confirmation in Chapter 11

Any reorganization plan divides up all of the claims of creditors and other interest holders in the debtor into classes and then specifies the treatment that each class will receive.⁷⁵ The plan proponent, usually the debtor,⁷⁶ assigns the claims to particular classes. However, the plan may only place claims or interests in a class that contains other claims or interests that are “substantially similar.”⁷⁷ The plan must also specify which classes are “impaired” under the plan.⁷⁸ Impairing a class means, essentially, “altering any of the legal, equitable, or contractual rights of the claim or interest.”⁷⁹

A reorganization plan may be confirmed under chapter 11 in either of two ways. If all of the impaired classes⁸⁰ vote to accept the plan,⁸¹

75. See 11 U.S.C. § 1123 (1988).

76. Section 1121(b) provides for an “exclusivity period” of 120 days during which only the debtor may propose a plan. Section 1121(d) provides that the court may extend the exclusivity period “for cause,” and in practice, such extensions are routinely granted. JAMES J. WHITE & RAYMOND T. NIMMER, *CASES AND MATERIALS ON BANKRUPTCY* 71, 528 (2d ed. 1992); see *Discussion*, 77 CORNELL L. REV. 1105, 1111 (1992) (comments of the Hon. Edith H. Jones). As a result, the debtor proposes the plan in the vast majority of cases. See WHITE & NIMMER, *supra*, at 528.

77. 11 U.S.C. § 1122(a) (1988).

78. 11 U.S.C. § 1123(a)(2), (3) (1988).

79. AARON, *supra* note 17, § 12.03[1], at 12-13. More precisely, § 1124 defines a class as impaired unless it satisfies any one of three conditions: all rights to which the claim entitles the holder remain unaltered; the plan cures any default, pays damages, and otherwise does not alter rights; or the plan pays the claim in full on the effective date of the plan. 11 U.S.C. § 1124 (1988).

80. Section 1129(a)(8)(B) provides that if a class is not impaired, its vote is not necessary for confirmation.

81. Section 1126(c) provides that a class of claims accepts the plan if creditors holding “at least two-thirds in amount and more than one-half in number of the allowed claims of such class” vote for the plan. Section 1126(d) provides that a class of interests accepts the plan if holders of “at least two-thirds in amount of the allowed interests of such class” vote to accept. A creditor with a right to payment would hold a claim rather than an interest. See 11 U.S.C.A. § 101(5) (West Supp. 1992) (defining “claim”).

and the plan otherwise complies with section 1129(a),⁸² the court "shall confirm" it.⁸³ If, however, any impaired class votes to reject the plan, but the plan satisfies the other requirements of section 1129(a), the plan may still be confirmed by "cramdown" if the plan meets the additional requirements of section 1129(b).⁸⁴

The protections afforded dissenting individual creditors and dissenting classes of creditors deserve a brief examination. Any creditor that votes to reject the plan, whether or not that creditor's class votes for the plan, receives the protection of the best-interests test. This test, codified in section 1129(a)(7), requires that a dissenting creditor receive "property of a value, as of the effective date of the plan, that is not less than the amount that such [creditor] would so receive or retain if the debtor were liquidated under chapter 7."⁸⁵ In a chapter 7 liquidation, the debtor's assets are sold piecemeal and the proceeds mechanically divided among creditors according to the priorities established in section 726;⁸⁶ a dissenting creditor in chapter 11 therefore must receive at least the amount it would in such a liquidation.⁸⁷

If an entire class of unsecured creditors votes to reject the plan, the class is entitled to the protection of the absolute priority rule, codified in section 1129(b)(2)(B), in addition to the best-interests test.⁸⁸ The absolute priority rule requires that the plan either pay all claims in the

82. Section 1129(a) sets forth 13 conditions, all of which must be satisfied for confirmation by consent of the creditors. Briefly, they are: (1) the plan complies with applicable provisions of title 11; (2) the plan proponent complies with applicable provisions of title 11; (3) the plan is proposed legally and in good faith; (4) the court knows about any payments by the proponent, debtor, or person issuing securities or acquiring property, for costs in connection with the case; (5) all insiders' identities are disclosed; (6) any government-regulated rate change has been approved by the appropriate agency; (7) the best-interests test is satisfied; (8) every class either accepts the plan or is not impaired; (9) certain priority claims are paid in full; (10) at least one impaired class accepts the plan, not including insiders; (11) reorganization is likely to succeed; (12) all filing fees have been paid; and (13) certain retiree benefits are paid. 11 U.S.C. § 1129(a) (1988).

83. 11 U.S.C. § 1129(a) (1988).

84. Section 1129(b) requires that, to be confirmable on cramdown, a plan "not discriminate unfairly," and that it be "fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." 11 U.S.C. § 1129(b)(1) (1988). Section 1129(b)(2) defines the "fair and equitable" test, which includes the "absolute priority rule." See *infra* text accompanying notes 88-91. The Code provides no further definition of what discriminating unfairly means in this context.

85. 11 U.S.C. § 1129(a)(7)(A)(ii) (1988).

86. See *supra* notes 10-11 and accompanying text.

87. Although in theory a single creditor can prevent confirmation of a plan by showing that the plan violates the best-interests test, in practice such violations are difficult to prove.

[T]he problems of proof associated with valuing a business are very complex. . . . [T]here is typically a very large disparity between the liquidation and going-concern values of a business. Even if the creditor is being unfairly treated under a plan, the plan, usually based on a going concern value, is likely to net more for the creditor than in a liquidation
Lopes, *supra* note 14, at 229-30.

88. Secured creditors also receive protection under the absolute priority rule, see 11 U.S.C. § 1129(b)(2)(A) (1988), but that provision is not relevant to the discussion in this Note. See *supra* note 8.

dissenting class in full, or provide that "the holder of any claim or interest that is junior to the claims of [the dissenting] class *will not receive or retain* under the plan on account of such junior claim or interest *any property*."⁸⁹ For example, if a plan proposed to pay general creditors fifty cents on the dollar for their claims and allowed shareholders to retain some interest in the reorganized company, the plan could not be confirmed by cramdown over the dissent of the class of general creditors. The plan would violate the absolute priority rule because the general creditors would not be paid in full, yet a class junior to them, the shareholders, would retain some property.⁹⁰ The special protection of section 1129(b) applies only to those classes voting to reject the plan; a class that accepts a plan ultimately confirmed by cramdown is not entitled to the protection of the absolute priority rule.⁹¹

B. Guarantor Release: The Restrictive View

Under the restrictive view, the bankruptcy court has no authority to release an obligation of someone who has not filed a bankruptcy petition. Section 524(e) of the Code provides that "discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt."⁹² Code section 524(e) was derived from section 16 of the 1898 Act,⁹³ which provided that "[t]he liability of a person who is a co-debtor with, or guarantor or in any manner a surety for, a bankrupt shall not be altered by the discharge of such bankrupt."⁹⁴ Courts adopting the restrictive view have interpreted these sections as prohibiting the bankruptcy courts from releasing guarantors' (or other codebtors') obligations, even when no creditor objects to the release.⁹⁵ An analysis of whether these courts

89. 11 U.S.C. § 1129(b)(2)(B)(iii) (1988) (emphasis added).

90. See generally Kenneth N. Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 AM. BANKR. L.J. 133 (1979).

91. Section 1129(b)(1) applies the "fair and equitable" test, which includes the absolute priority rule, only "with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." 11 U.S.C. § 1129(b)(1) (1988) (emphasis added). See also Klee, *supra* note 90, at 141.

92. 11 U.S.C. § 524(e) (1988). The statute allows an exception when dealing with community property as defined in § 524(a)(3). That exception is not relevant to the question of releasing guarantors. See 11 U.S.C. § 524(a)(3) (1988).

93. See, e.g., *Underhill v. Royal*, 769 F.2d 1426, 1432 (9th Cir. 1985).

94. 11 U.S.C. § 34 (1976) (repealed 1978).

95. E.g., *In re Western Real Estate Fund, Inc.*, 922 F.2d 592, 601-02 (10th Cir. 1990); *Seaport Automotive Warehouse v. Rohnert Park Auto Parts (In re Rohnert Park Auto Parts)*, 113 B.R. 610, 616 (Bankr. 9th Cir. 1990); *American Hardwoods, Inc. v. Deutsche Credit Corp. (In re American Hardwoods, Inc.)*, 885 F.2d 621, 625-26 (9th Cir. 1989); *Underhill*, 769 F.2d at 1432; *Union Carbide Corp. v. Newboles*, 686 F.2d 593, 595 (7th Cir. 1982) (per curiam) (pre-Code case); *In re General Homes Corp., FGMC*, 134 B.R. 853, 861 (Bankr. S.D. Tex. 1991); *In re 222 Liberty Assocs.*, 108 B.R. 971, 996-97 (Bankr. E.D. Pa. 1990); *Mellon Bank v. Siegel*, 96 B.R. 505, 506 (E.D. Pa. 1989); *In re Future Energy Corp.*, 83 B.R. 470, 485-86 (Bankr. S.D. Ohio 1988); *In re Elsinore Shore Assocs.*, 91 B.R. 238, 256 (Bankr. D.N.J. 1988); *In re Scranes, Inc.*,

are correct requires answering two questions: First, does the bankruptcy court have subject matter jurisdiction over agreements with guarantors? Second, assuming that the court has jurisdiction, does the Code empower the bankruptcy court to release guarantors' obligations?

1. *Jurisdiction*

If bankruptcy courts do not have subject matter jurisdiction over guaranty agreements between creditors and guarantors, then the Bankruptcy Code is irrelevant. Bankruptcy courts, like any other courts, cannot affect matters outside their jurisdiction.⁹⁶ Since the *Marathon* crisis,⁹⁷ sections 157 and 1334 of title 28 of the United States Code have governed the jurisdiction of bankruptcy courts. Section 1334(b) provides that "the district courts shall have original but not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in or related to cases under title 11."⁹⁸ Section 157(a), in turn, provides that the district courts "may provide" that cases covered by section 1334(b) "shall be referred to the bankruptcy judges for the district."⁹⁹ Therefore, any proceeding even "related to cases under title 11"¹⁰⁰ falls within the bankruptcy court's jurisdiction whenever the district court's local rule allows referral of such proceedings. All district courts have such rules in effect.¹⁰¹

If a proceeding against a guarantor of the bankrupt debtor is not "related" to the case under title 11, then the bankruptcy court lacks subject matter jurisdiction over the guaranty agreement. In *American*

67 B.R. 985, 989 (Bankr. N.D. Ohio 1986); *Hat-Hanseatische Anlage v. Sago Palms Joint Venture (In re Sago Palms Joint Venture)*, 39 B.R. 9, 9 (Bankr. S.D. Fla. 1984).

96. However, if a court acts outside its subject matter jurisdiction and the question is not pursued on appeal, the judgment may not be attacked collaterally. *See Stoll v. Gottlieb*, 305 U.S. 165 (1938). Whether this rule applies to a confirmed reorganization plan is a subject of some debate. *See supra* note 24.

97. In *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982), the Supreme Court declared Congress' grant of jurisdiction to bankruptcy courts under the original 1978 Code unconstitutional, engendering a two-year struggle to create a valid jurisdictional scheme for bankruptcy courts. *See generally* WHITE & NIMMER, *supra* note 76, at 95-99.

98. 28 U.S.C. § 1334(b) (1988).

99. 28 U.S.C. § 157(a) (1988).

100. 28 U.S.C. § 1334(b) (1988).

101. AARON, *supra* note 17, § 3.02[1], at 3-11. However, if the proceeding is a "related" but not a "core" proceeding under 28 U.S.C. § 157(b) (1988), the bankruptcy court is restricted to "submit[ting] proposed findings of fact and conclusions of law to the district court" by 28 U.S.C. § 157(c)(1) (1988), unless all parties consent to having the bankruptcy court resolve the matter. 28 U.S.C. § 157(c)(2) (1988). Without the parties' consent, the district court must enter the final order, and must review de novo "those matters to which any party has timely and specifically objected" from the bankruptcy judge's findings. 28 U.S.C. § 157(c)(1) (1988). Some commentators believe that there will be little practical difference between a bankruptcy court's order in a core proceeding and its proposed findings of fact and conclusions of law in a "related" matter. *See* WHITE & NIMMER, *supra* note 76, at 99.

Hardwoods, Inc. v. Deutsche Credit Corp.,¹⁰² however, the Ninth Circuit held that guaranties may be sufficiently "related" to bring the agreements within the jurisdiction of a bankruptcy court. The guarantors in *American Hardwoods* were the president and vice president of the debtor. They sought an injunction permanently restraining the creditor from enforcing the guaranty on the grounds that "pursuance by [creditor] of its state court action against the [guarantors] would irreparably harm [debtor's] efforts to confirm and administer a reorganization plan."¹⁰³ The court adopted the Third Circuit's definition of "related" proceedings, which held that if "the outcome of the proceeding could conceivably have any effect on the estate being administered in bankruptcy,"¹⁰⁴ the proceeding fell within the bankruptcy court's jurisdiction. The court then noted that if the creditor were permitted to collect on the guaranty, it would probably do so by taking possession of the guarantors' stock in the debtor. That action would leave the guarantors with "little incentive to operate [debtor] and maintain the reorganization plan."¹⁰⁵ The court therefore found that "[creditor's] enforcement of the judgment against the [guarantors] 'could conceivably' affect the administration of [debtor's] plan,"¹⁰⁶ and consequently that the bankruptcy court had subject matter jurisdiction over the motion for a permanent injunction against the creditor.

The central role of the debtor's guarantors in the management of the debtor's estate, influential in the *American Hardwoods* court's determination that the action on the guaranty could affect the reorganization, is quite common.¹⁰⁷ Often an insider, such as Deadbeat Debtor's president in the Frugal Financial case,¹⁰⁸ personally guarantees obligations of the company to increase lenders' willingness to lend, much as insiders subordinate their claims against the debtor to those of outside lenders.¹⁰⁹ In either case, the insider has a personal stake in the company's success, and is willing to incur some personal

102. 885 F.2d 621 (9th Cir. 1989).

103. *American Hardwoods*, 885 F.2d at 622.

104. 885 F.2d at 623 (quoting *Pacor, Inc. v. Higgins*, 743 F.2d 984, 994 (3d Cir. 1984)); see also 17 CHARLES A. WRIGHT ET AL., *FEDERAL PRACTICE AND PROCEDURE* § 4106, at 444 n.26 (2d ed. 1988) (adopting the same definition of a "related" proceeding).

105. 885 F.2d at 624. Because the guarantors were president and vice president of the debtor, this consideration was critical to the case.

106. 885 F.2d at 624.

107. The insider guarantor often becomes important in another bankruptcy context: when a bankruptcy trustee seeks to recover payments to outsider creditors, made outside the ninety-day preference period but inside the one-year insider preference period, on debts guaranteed by an insider as preferences for the benefit of the insider. The issue has sparked controversy among courts and commentators. See *Levit v. Ingersoll Rand Fin. Corp.*, 874 F.2d 1186 (7th Cir. 1989), and authorities cited therein, 874 F.2d at 1189 nn.2 & 3.

108. See *supra* text accompanying note 20.

109. See *supra* notes 39-40 and accompanying text.

financial risk to encourage outside lenders to invest.¹¹⁰

A result contrary to *American Hardwoods* appears in *Bill Roderick Distributing, Inc. v. A.J. Mackay Co.*¹¹¹ *Mackay* involved a confirmed reorganization plan containing a provision that forbade any action against the guarantor if the debtor remained current with payments under the plan. The creditor did not object to the provision, nor did it appeal the plan's confirmation.¹¹² Relying on the plan, the guarantor stopped making payments to the creditor. The creditor then sought a state court judgment against the guarantor, and the guarantor requested an order from the bankruptcy court enjoining the state court action. The bankruptcy court granted the order, finding that the creditor was bound by the terms of the confirmed plan.¹¹³

On appeal, the district court held that the bankruptcy court had exceeded its jurisdiction both in confirming the plan protecting the guarantor and in issuing the order enjoining the creditor's state court proceeding. The court was emphatic in its holding:

The confirmed plan contains two provisions which purport to protect [guarantor] from creditor's claims. These provisions are beyond the authority of the bankruptcy court to confirm, since [guarantor] is not a party to this lawsuit and these provisions do not involve assets of the bankruptcy estate.

....

This court is convinced that stays preventing creditors from proceeding against non-bankrupt codebtors are granted all too often. A bankruptcy court does not have the jurisdiction to grant such a stay simply to "assist" the debtor in reorganizing, or to relieve "pressure" on the debtor.

The bankruptcy court is limited in its authority to carry out the provisions of the federal bankruptcy statutes by the fundamental requirements of jurisdiction. It cannot exceed those limits no matter how compelling the need to do so.¹¹⁴

Oddly, the court never discussed the provisions of the United States Code governing the jurisdiction of bankruptcy courts, nor did it make any attempt to square its pronouncement that "[j]urisdiction exists only over the debtor and his property, and no further"¹¹⁵ with the fact that Congress extended the jurisdiction of bankruptcy courts to include "all civil proceedings related to cases under title 11."¹¹⁶ In fact,

110. Of course, the court must determine in each case whether a guarantor release could have any effect on the reorganization. It is possible that a guarantor could be so unrelated to the debtor that releasing the guarantor from its obligation would have no effect on the reorganization; however, it is difficult to see why a debtor would bother including the provision in that case.

111. 50 B.R. 756 (Bankr. D. Utah 1985).

112. 50 B.R. at 758.

113. 50 B.R. at 758.

114. 50 B.R. at 761-62.

115. 50 B.R. at 762.

116. 28 U.S.C. § 1334(b) (1988).

the court cited no authority for its broad pronouncements about bankruptcy courts' jurisdiction. If the court meant to declare Congress' grant of jurisdiction to bankruptcy courts unconstitutional, it did not explicitly do so, although it did cast doubt on the constitutionality of the codebtor stay provision of Bankruptcy Code section 1301.¹¹⁷ The court's failure even to mention the statutory grants of jurisdiction to bankruptcy courts is inexplicable.

The Ninth Circuit severely criticized *Mackay* in *American Hardwoods*, calling *Mackay*'s analysis "incomplete and unpersuasive."¹¹⁸ Indeed, the plain language of the statutory grant of jurisdiction appears to leave little room for the position that the bankruptcy court's jurisdiction never encompasses a suit by a creditor against the debtor's guarantor, or an agreement to release the guarantor from liability on the debtor's obligation to the creditor. Such proceedings are often closely "related" to a case arising under title 11,¹¹⁹ which is all that the statute requires for the proceeding to fall within the bankruptcy court's subject matter jurisdiction.¹²⁰

2. Power

A determination that bankruptcy courts have jurisdiction over guaranty agreements does not necessarily mean that they may cancel them. The *American Hardwoods* court noted that

[s]ubject matter jurisdiction and power are separate prerequisites to the court's capacity to act. Subject matter jurisdiction is the court's authority to entertain an action between the parties before it. Power is the scope and forms of relief the court may order in an action in which it has jurisdiction.¹²¹

Having decided that the bankruptcy court had jurisdiction over guaranty agreements, the court nevertheless held that "the bankruptcy court was *powerless* to discharge the [guarantors'] liability."¹²²

The *American Hardwoods* court relied on section 524(e) of the

117. Section 1301(a) of the Bankruptcy Code provides:

Except as provided in subsections (b) and (c) of this section, after the order for relief under this chapter, a creditor may not act . . . to collect all or any part of a consumer debt of the debtor from any individual that is liable on such debt with the debtor, or that secured such debt, unless (1) such individual became liable on or secured such debt in the ordinary course of such individual's business; or (2) the case is closed, dismissed, or converted to a case under chapter 7 or 11 of this title.

11 U.S.C. § 1301(a) (1988) (emphasis added). Thus, chapter 13 grants a stay to guarantors of a consumer's debt. The *Mackay* court said of this provision that "[a]lthough Congress apparently believed the statute to be constitutionally valid when it enacted it, . . . the validity of the § 1301 stay is not without question." The court failed to cite any authority in support of its assertion. 50 B.R. at 764.

118. *American Hardwoods*, 885 F.2d at 624.

119. See *supra* notes 102-06 and accompanying text.

120. 28 U.S.C. § 1334(b) (1988). See *supra* text accompanying notes 97-101.

121. 885 F.2d at 624.

122. 885 F.2d at 626 (emphasis added).

Bankruptcy Code for its decision,¹²³ adopting the reasoning of an earlier Ninth Circuit case, *Underhill v. Royal*.¹²⁴ *Underhill* involved a claim by an insider of the debtor that a release from personal liability in a confirmed reorganization plan precluded action against him for securities law violations. The Ninth Circuit, affirming the district court, found that "the bankruptcy court has no power to discharge the liabilities of a nondebtor pursuant to the consent of creditors as part of a reorganization plan."¹²⁵ As in *American Hardwoods*, the *Underhill* court relied on section 524(e), finding that "[t]he broad language of § 524(e), limiting the scope of a discharge so that it 'does not affect the liability of any other entity,' encompasses [the] result [reached by the court]."¹²⁶

Both *Underhill* and *American Hardwoods* cite a pre-Code case, *Union Carbide Corp. v. Newboles*,¹²⁷ for the statement that "the bankruptcy court has no power to discharge the liabilities of a bankrupt's guarantor."¹²⁸ The facts of *Union Carbide* present the guarantor release issue in its starkest form. Mr. and Mrs. Newboles had personally guaranteed a corporation's debt to one of its creditors, Union Carbide. When the corporation defaulted on the loan, Union Carbide sued Mr. and Mrs. Newboles on the guaranty in federal district court. Eight days later, the corporation filed for bankruptcy protection. The reorganization plan, approved by Union Carbide, explicitly released any guarantor's liability. After confirmation, the district court granted summary judgment in favor of Union Carbide in the prepetition action against Mr. and Mrs. Newboles for the unpaid portion of the bankrupt corporation's debt, despite the release in the plan.¹²⁹ Relying on section 16 of the Act,¹³⁰ the Seventh Circuit affirmed the lower court's judgment, holding that bankruptcy courts have no power to release the liability of a guarantor, even if the creditor has consented to the release.¹³¹ *Union Carbide* adopted the most extreme version of the "restrictive" view of guarantor releases, as it denied enforcement of a confirmed explicit release provision to which no party objected.

C. *The Expansive View*

Rejecting the analysis of the restrictive view cases, some courts

123. See *supra* text accompanying notes 92-94 for the text of § 524(e) and its precursor in the 1898 Act.

124. 769 F.2d 1426 (9th Cir. 1985).

125. *Underhill*, 769 F.2d at 1432.

126. 769 F.2d at 1432.

127. 686 F.2d 593 (7th Cir. 1982) (per curiam).

128. *Union Carbide*, 686 F.2d at 595.

129. 686 F.2d at 594-95.

130. See *supra* notes 93-94 and accompanying text.

131. 686 F.2d at 595.

permit a bankruptcy court to enjoin action against third parties permanently, at least in unusual circumstances.¹³² These courts rely on section 105(a) of the Bankruptcy Code, which provides that “[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.”¹³³ The section is derived from section 2a(15) of the Act,¹³⁴ which conferred upon the bankruptcy courts jurisdiction necessary to “[m]ake such orders, issue such process, and enter such judgments, in addition to those specifically provided for, as may be necessary for the enforcement of the provisions of this Act.”¹³⁵

*Menard-Sanford v. Mabey (In re A.H. Robins Co.)*¹³⁶ exemplifies the use of section 105(a) to discharge the liability of third parties. The *Robins* case, one of many stemming from A.H. Robins’ liability due to the Dalkon Shield,¹³⁷ involved a challenge to a plan that prohibited any action against certain third parties whom the claimants believed were joint tortfeasors with Robins. The Fourth Circuit ruled that “the bankruptcy court’s equitable powers support the questioned injunction.”¹³⁸ It interpreted section 105(a)’s broad grant of power as “confer[ring] equitable powers upon the bankruptcy courts,”¹³⁹ and went on to hold that “[p]ermitting a suit by [the claimants] in violation of the Plan is a defeat of the Plan and a resulting defeat of the other creditors.”¹⁴⁰ In that situation, the court felt that the bankruptcy court had appropriately invoked its equitable powers to prevent suit against the third parties.

The *Robins* court also found that the injunction did not violate

132. *E.g., In re A.H. Robins Co.*, 880 F.2d 694 (4th Cir. 1989); *Wysko Inv. Co. v. Great Am. Bank*, 131 B.R. 146 (D. Ariz. 1991) (enjoining payment on a letter of credit); *In re Myerson & Kuhn*, 121 B.R. 145 (Bankr. S.D.N.Y. 1990) (enjoining postconfirmation action against members of bankrupt partnership); see also *MacArthur Co. v. Johns-Manville Corp. (In re Johns-Manville Corp.)*, 837 F.2d 89, 91 (2d Cir. 1988) (holding that permanent injunction against suing third-party insurers was within bankruptcy court’s power because policies were property of the estate); *UNARCO Bloomington Factory Workers v. UNR Indus.*, 124 B.R. 268, 276-79 (N.D. Ill. 1990) (same). A closely related issue is the injunction of actions against third parties while reorganization is pending. See, e.g., *In re Otero Mills, Inc.*, 21 B.R. 777 (Bankr. D.N.M.), *aff’d*, 25 B.R. 1018 (D.N.M. 1982). This Note, however, focuses solely on injunctions that remain in force after confirmation, including those that are part of a confirmed plan.

133. 11 U.S.C. § 105(a) (1988).

134. 11 U.S.C. § 11(15) (1976) (repealed 1978). See HOUSE REPORT, *supra* note 11, at 316, reprinted in 1978 U.S.C.C.A.N. 5963, 6273.

135. 11 U.S.C. § 11(15) (1976) (repealed 1978).

136. 880 F.2d 694 (4th Cir.), *cert. denied sub nom. Menard-Sanford v. A.H. Robins Co.*, 493 U.S. 959 (1989).

137. See *Robins*, 880 F.2d at 696 n.1 for citations to 14 related cases that resulted in published opinions by the Fourth Circuit; that footnote does not list the numerous related cases published by district and bankruptcy courts.

138. 880 F.2d at 701.

139. 880 F.2d at 701.

140. 880 F.2d at 702.

section 524(e). Rejecting the rules of *Underhill v. Royal*¹⁴¹ and *Union Carbide Corp. v. Newboles*,¹⁴² the *Robins* court instead adopted the Fifth Circuit's position that "[a]lthough section 524 has generally been interpreted to preclude release of guarantors by a bankruptcy court, the statute does not by its specific words preclude the discharge of a guaranty when it has been accepted and confirmed as an integral part of reorganization."¹⁴³ The court continued: "we do not think that section [524(e)] must be literally applied in every case as a prohibition on the power of the bankruptcy courts."¹⁴⁴

D. *The Middle Course*

Two courts have attempted to steer a course between the restrictive and the expansive approaches to section 524(e). In *In re AOV Industries*,¹⁴⁵ a creditor objected to the provision of the plan dealing with payment for its class. The provision was unusual in that the funds were to come from two sources: the debtor would contribute \$800,000 to be divided equally among all allowed claims in the class, and two creditors outside the class would contribute almost \$3 million to be divided equally among those class members who agreed to release the contributing creditors from any claims arising out of transactions with the debtor.¹⁴⁶ Two of the creditors in the class objected to the payment plan, claiming that it "invalidly grants a 'discharge' to those entities [offering to fund the plan]."¹⁴⁷ The court disagreed, pointing out that the plan did not discharge the contributing creditors, but rather "provide[d] that any creditor may individually and *voluntarily* release [the contributing creditors] of any alleged liability in return for the extremely valuable consideration tendered by [the contributing creditors]. [The complaining creditors were] completely free to pursue any rights they may have against these entities,"¹⁴⁸ as long as they did not share in the funds offered by the contributing creditors.¹⁴⁹

141. 769 F.2d 1426 (9th Cir. 1985); see *supra* text accompanying notes 124-26.

142. 686 F.2d 593 (7th Cir. 1982); see *supra* text accompanying notes 127-31.

143. 880 F.2d at 702 (quoting *Republic Supply Co. v. Shoaf*, 815 F.2d 1046, 1050 (5th Cir. 1987)).

144. 880 F.2d at 702.

145. 31 B.R. 1005 (D.D.C. 1983), *modified on other grounds*, 792 F.2d 1140 (D.C. Cir. 1986).

146. *AOV*, 31 B.R. at 1008-09.

147. 31 B.R. at 1010.

148. 31 B.R. at 1010.

149. The *AOV* court — a district court — had more trouble with the bankruptcy court's declaration that any releases tendered under the payment provision were "fully enforceable in accordance with their terms, any provision of applicable nonbankruptcy law to the contrary notwithstanding." 31 B.R. at 1010 (quoting the bankruptcy court's unpublished order of confirmation). The court stated that the declaration was "probably beyond [the bankruptcy court's] power." 31 B.R. at 1010. However, the court then found that as an Article III court, it did have power to enforce the releases, and held that "[t]his Court would enforce those releases because it believes that the plan is in the 'best interests of the creditors.'" 31 B.R. at 1010-11.

The debtor in *In re Monroe Well Service, Inc.*¹⁵⁰ modeled its plan after the one in *AOV*, also allowing voluntary release of certain parties in exchange for the right to share in funds provided by the released parties.¹⁵¹ The *Monroe* court agreed with the reasoning in *AOV*, and found the plan unobjectionable as written.¹⁵² The court cited *Underhill v. Royal* for the proposition that a debtor "could not obtain confirmation of a plan which would attempt, over [the creditors'] objection, to discharge the obligations of nondebtors, such as guarantors."¹⁵³ It concluded, however, that in the case before it the release of the third parties was "purely voluntary" and hence "the nondebtor plan funders will not receive a discharge and the debtor's discharge did not, by itself, affect the rights of creditors *vis-a-vis* those plan funders."¹⁵⁴ Because no "discharge" was granted to third parties, the court found that the plan complied with section 524(e).¹⁵⁵

A split in authority exists, therefore, as to the proper interpretation of section 524(e). The Fourth and Fifth Circuits have held that section 524(e) does not necessarily deprive bankruptcy courts of power to release a third party from liability in all circumstances, while the Seventh and Ninth Circuits, along with many lower courts,¹⁵⁶ have held that it does.¹⁵⁷ The *AOV* and *Monroe* courts have tried to split the difference by construing the term "discharge" to exclude releases given to third parties in exchange for additional payment. Rather than attempt to resolve the split, however, Part III of this Note will use the insights of each approach in analyzing the power of bankruptcy courts to extinguish subordination agreements over the objection of their outvoted beneficiaries.

150. 80 B.R. 324 (Bankr. E.D. Pa. 1987).

151. 80 B.R. at 329.

152. 80 B.R. at 334.

153. 80 B.R. at 334.

154. 80 B.R. at 334.

155. 80 B.R. at 334-35.

156. See cases cited *supra* note 95.

157. In *American Hardwoods, Inc. v. Deutsche Credit Corp.* (*In re American Hardwoods, Inc.*), 885 F.2d 621 (9th Cir. 1989), the Ninth Circuit attempted to reconcile *Robins* with the Ninth Circuit line of cases. It stated that "[e]ven if we adopted [*Robins*], it would not dictate a different result," noting that *Robins* "expressly limited its holding to the unusual facts before it." 885 F.2d at 626. However, while *Robins* found the bankruptcy court's injunction appropriate in light of the highly unusual facts of the case, see *infra* text accompanying notes 223-27, the court's reading of § 524(e) was not limited to the specific facts of the case and is inconsistent with the Ninth Circuit approach. Of course, if it wanted to avoid the conflict, the Ninth Circuit could have held that § 524(e) does not invariably forbid release of third parties, yet still have held that on the facts of *American Hardwoods* a third-party release would have been an inappropriate use of the bankruptcy court's equitable powers. Some courts have adopted this approach. See *Dore & Assocs. Contracting, Inc. v. American Druggists' Ins. Co.* (*In re Dore & Assocs. Contracting, Inc.*), 54 B.R. 353, 357, 361 (Bankr. W.D. Wis. 1985); *In re Brentano's Inc.*, 36 B.R. 90, 92 (S.D.N.Y. 1984). However, the *American Hardwoods* court instead stuck with the previous Ninth Circuit approach that third-party release is "specifically proscribed by 11 U.S.C. § 524(e)." 885 F.2d at 625.

III. SUBORDINATION AGREEMENTS UNDER CHAPTER 11

This Part attempts to resolve the puzzle posed by Frugal Financial's efforts to protect its rights under a subordination agreement in chapter 11 proceedings.¹⁵⁸ Section III.A examines confirmation by consent of all classes, concluding that if an outvoted senior creditor objects to a violation of its subordination agreement, the court should find that the plan violates section 510(a) and thus that it cannot confirm the plan. Section III.B considers the cramdown situation, and finds that due to a statutory peculiarity, a dissenting senior creditor in a class voting to accept the plan will be without the arguments available in a confirmation by consent, but that if the entire class of senior creditors dissents, the absolute priority rule will generally require enforcement of subordination agreements. This Part concludes that bankruptcy courts should permit senior creditors to insist on the enforcement of subordination agreements whenever either section 510(a) or the absolute priority rule is applicable to the case.

A. *Plans Confirmed by Consent*

To be confirmed, a plan must "compl[y] with the applicable provisions of [the Code]."¹⁵⁹ Section 510(a) governs subordination agreements,¹⁶⁰ so when creditors involved in a chapter 11 case have entered into subordination agreements, section 510(a) applies¹⁶¹ and a plan must comply with it to be confirmed. The central issue, therefore, is what compliance with section 510(a) entails.

If every senior creditor approves a plan containing a provision making payments to subordinated creditors and expressly providing that they need not turn those payments over to the senior creditors, section 510(a) poses no obstacle to confirmation. Because nonbankruptcy law¹⁶² would not require a creditor to enforce a subordination agreement if it chose not to, a senior creditor's vote for a plan extinguishing the creditor's subordination agreement creates no conflict

158. See *supra* text accompanying notes 20-23.

159. 11 U.S.C. § 1129(a)(1) (1988).

160. See *supra* section I.C.

161. Section 103(a) of the Code provides that "[e]xcept as provided in section 1161 of this title [which deals with railroads], chapters 1, 3, and 5 of this title apply in a case under chapter 7, 11, 12, or 13 of this title." 11 U.S.C. § 103(a) (1988). Section 510(a) is part of chapter 5 of the Code, so it "applies" to any chapter 11 case where it is relevant. See, e.g., *In re The Lantana Motel*, 124 B.R. 252, 255 (Bankr. S.D. Ohio 1990); *Mellon Bank, N.A. v. Union Natl. Bank of Pittsburgh (In re Pittsburgh Cut Flower Co.)*, 118 B.R. 31, 34-35 (Bankr. W.D. Pa. 1990); *Citibank, N.A. v. Smith Jones, Inc.*, 17 B.R. 128, 131 (Bankr. D. Minn. 1982).

162. Section 510(a) requires enforcement of subordination agreements "to the same extent that such agreement is enforceable under applicable nonbankruptcy law," 11 U.S.C. § 510(a) (1988), and "nonbankruptcy law" in this context means contract law. See *Sepco, Inc. v. Valley State Bank (In re Sepco, Inc.)*, 36 B.R. 279, 285 (Bankr. D.S.D. 1984); *supra* section I.B.

with section 510(a).¹⁶³ When senior creditors unanimously vote to approve a plan, it does not deprive any creditor of a right it wishes to retain.

If some individual senior creditors vote against the plan but all classes still approve it,¹⁶⁴ the problem becomes more complicated. Frugal Financial is in this situation.¹⁶⁵ Frugal insists that, notwithstanding the contrary vote of its class and the usual rule that individual class members are bound by the will of the class,¹⁶⁶ the bankruptcy court should not confirm the plan because it violates section 510(a).

Frugal's first argument might be that the language of section 510(a) is clear and unambiguous, rendering further analysis unnecessary.¹⁶⁷ The statute says that a subordination agreement "is enforceable," and that, Frugal could argue, is precisely what it means. "Under 11 U.S.C. § 510(a), full effect must be given to pre-bankruptcy subordination agreements."¹⁶⁸ But because statutory construction is a "holistic endeavor,"¹⁶⁹ a court might balk at reading section 510(a) in a vacuum despite the apparent strength of its plain language. Rather, it might "consider § 510(a) together with other sections of the Bankruptcy Code and the principles and policies of bankruptcy law."¹⁷⁰ Particularly because the meaning of the legislative history regarding this issue is unclear,¹⁷¹ a court might demand more than a plain-language argument.

A court assessing Frugal's position will find little case law for guidance. No reported case under the Code has faced the argument posed by Frugal.¹⁷² Under the Act, one case faced, but did not defini-

163. This much is made clear by the legislative history to § 510(a). See *supra* notes 67-69 and accompanying text.

164. Recall that under § 1126(c), only the holders of two thirds in amount and one half in number of claims in a class must vote in favor of the plan for the class as a whole to accept it. See *supra* note 81.

165. See *supra* notes 20-23 and accompanying text.

166. See *supra* note 19.

167. See *In re Public Serv. Co.*, 108 B.R. 854, 874-80 (Bankr. D.N.H. 1989); 2A NORMAN J. SINGER, STATUTES AND STATUTORY CONSTRUCTION § 46.01 (4th ed. 1984) (describing the "plain meaning" rule).

168. *In re Ionosphere Clubs, Inc.*, 134 B.R. 528, 532 (Bankr. S.D.N.Y. 1991); see also 2 COLLIER, *supra* note 69, ¶510.05, at 510-14 (noting that statutory language does not support excluding nonconsenting senior creditors from its scope).

169. *United Sav. Assn. v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365, 371 (1988) (construing §§ 361 and 362 of the Bankruptcy Code), quoted in *International Primate Protection League v. Administrators of Tulane Educ. Fund*, 111 S. Ct. 1700, 1705 (1991).

170. *In re Holly's, Inc.*, 140 B.R. 643, 676 (Bankr. W.D. Mich. 1992).

171. See *supra* notes 67-69 and accompanying text.

172. Commentators have observed that such an argument might be available. See *supra* note 73.

tively resolve, a similar situation.¹⁷³ In *Bartle v. Markson Bros.*,¹⁷⁴ the bankruptcy court confirmed a plan that proposed payment of 47.5% of the general unsecured claims, and 15% in cash and 85% in notes of the subordinated claims. Enough general creditors voted for the plan to constitute approval of their class, but the dissenting general creditors appealed. They argued that paying the subordinated debt in full while paying only 47.5% of the senior debt violated the best-interests test.¹⁷⁵ The court noted that "[t]his part of the plan strikes us as indeed doubtful."¹⁷⁶ However, because the plan provided more than liquidation would have,¹⁷⁷ and because "the creditors were advised of the subordinate status of the debentures before a majority of them gave their acceptances,"¹⁷⁸ the court asserted that the payment provisions did not necessarily make confirmation erroneous. The court then reversed the confirmation order on other grounds.¹⁷⁹

One commentator has characterized *Bartle* as "arguably authority for the power of the bankruptcy court to bind nonconsenting senior creditors to a plan which extinguishes their contractual rights."¹⁸⁰ However, there are reasons to view the case otherwise, particularly under the Code. First, the Act contained no provision requiring courts to enforce subordination agreements. Although courts were generally unsympathetic to subordinated creditors' attempts to get around the agreements against the senior creditors' will,¹⁸¹ there was nothing in the Act or in the case law to prevent a class of senior creditors from *voluntarily* extinguishing the rights of the entire class, despite the protests of the dissenters, if the plan satisfied the best-interests test. The *Bartle* court reasoned that because the plan satisfied the best-interests test and because the majority of creditors approved the plan knowing that the subordinated debt would receive full payment, confirmation was not "necessarily erroneous in law."¹⁸² Under the Code, however, the best-interests test is no longer the only statu-

173. Other reported cases involving plans that make partial payments to both senior and subordinated creditors, see cases cited *supra* note 18, have not presented the problem of an out-voted senior creditor appealing confirmation.

174. 314 F.2d 303 (2d Cir. 1963).

175. Because no provision of the Act dealt with subordination agreements, the dissenting creditors' only possible statutory basis for reversal was a violation of the best-interests test, codified in the Act at 11 U.S.C. § 766(2) (1976) (repealed 1978), which requires that no creditor receive less in a reorganization than it would in a liquidation. HOUSE REPORT, *supra* note 11, at 412, reprinted in 1978 U.S.C.C.A.N. at 5963, 6368; see *supra* text accompanying notes 85-87.

176. *Bartle*, 314 F.2d at 305.

177. The plan therefore satisfied the best-interests test codified at 11 U.S.C. § 766(2) (1976) (repealed 1978).

178. 314 F.2d at 305.

179. 314 F.2d at 305-06.

180. Lopes, *supra* note 14, at 226.

181. See *supra* notes 47-51 and accompanying text.

182. 314 F.2d at 305.

tory hurdle to clear with regard to subordination agreements. "Since the enactment of the Bankruptcy Code and section 510(a), enforcement of subordination provisions is no longer solely an application of the court's equitable powers. It is mandated by statute."¹⁸³ Thus, under the Code, a court could find the plan in *Bartle* inconsistent with section 510(a) and refuse to confirm it on that basis.

Second, after faint-heartedly approving the payment provisions of the plan, the court in *Bartle* reversed the confirmation order because of a violation of section 14(c)(7) of the Act.¹⁸⁴ Because the court had found "indeed doubtful" a plan that paid subordinated creditors in full before senior creditors,¹⁸⁵ the court might still have denied confirmation on equitable grounds because of these "indeed doubtful" payment provisions if a statutory basis for denying confirmation had not been available. The court's characterization of confirming the payment provision as not "necessarily erroneous *in law*"¹⁸⁶ bolsters this reading of *Bartle*. The court's use of the phrase "in law" may indicate that it intended to stick to legal, as opposed to equitable, grounds for denying confirmation if it could, but that the provision might have been sufficiently inequitable to justify denial of confirmation in equity. Because the court could use section 14(c)(7) to deny confirmation on statutory grounds, it did not need to look to equity. Finally, on any reading of *Bartle*, the court's approval of the payment to subordinated creditors is dictum because of the eventual denial of confirmation. The case thus provides uncertain authority concerning the question of bankruptcy courts' power to modify subordination agreements.

Faced with sparse and ambiguous case law, Frugal might next make a policy argument to convince the court that its reading of section 510(a) is correct. Two important policies are relevant: first, allowing creditors the benefit of their bargain and their foresight by upholding their contingency plans in bankruptcy;¹⁸⁷ and, second, allowing a class to speak for all its members and thus to override the dissenters' wishes.¹⁸⁸

The importance of the first policy in the subordinated debt context is indisputable. Twenty-six years ago the Second Circuit observed that

183. *In re Ionosphere Clubs, Inc.*, 134 B.R. 528, 533 (Bankr. S.D.N.Y. 1991).

184. 314 F.2d at 306. Section 14(c)(7) of the Act denied discharge if the debtor "failed to explain satisfactorily any losses of assets." 11 U.S.C. § 32(c)(7) (1976) (repealed 1978). The court found that the debtor had failed to explain the loss of nearly \$2 million.

185. 314 F.2d at 305.

186. 314 F.2d at 305 (emphasis added).

187. One obvious implementation of this policy in the Code is the rule that a secured creditor may foreclose on its security interest during a bankruptcy case if the debtor does not provide adequate protection for the security interest. See 11 U.S.C. §§ 361, 362(d)(1) (1988); WHITE & NIMMER, *supra* note 76, at 153. Another is that a debtor's discharge does not affect the liability of codebtors on the debt. See 11 U.S.C. § 524(e) (1988); *infra* notes 206-10 and accompanying text.

188. See 11 U.S.C. § 1141(a) (1988); *supra* note 19 and accompanying text.

failing to enforce subordination agreements in bankruptcy "would not only place in jeopardy literally billions of dollars of outstanding loans, but in all probability would prompt lending institutions to reconsider, and possibly curtail, their subordinated debt-financing activities to the detriment of the entire business community."¹⁸⁹ With the explosive growth of subordinated debt in recent years,¹⁹⁰ the court's characterization of the importance of enforcing subordination agreements is more compelling than ever. Recently, a court has noted that permitting a debtor to make partial payment to subordinated creditors in the face of a default on the senior debt "would prevent senior unsecured noteholders from ever feeling safe in their investment."¹⁹¹ A bankruptcy system that would jeopardize enforcement of subordination agreements at precisely the instant that senior creditors need them most¹⁹² would undermine the entire institution of subordinated debt and could severely restrict the willingness of lenders to make funds available to borrowers with heavy debt loads.¹⁹³

On the other hand, overriding the wishes of an outvoted class member in bankruptcy is critical to the proper functioning of chapter 11. Unless cramdown is invoked, confirmation requires the unanimous assent of all impaired classes,¹⁹⁴ but defines a class of claims' acceptance as a simple majority in number and a two-thirds majority in amount.¹⁹⁵ Because all of the claims in a class must be "substantially similar,"¹⁹⁶ the Code's acceptance structure attempts to ensure that, for every type of claim, most of the holders find the plan acceptable. Apparently anticipating some difficulty in obtaining unanimity among creditors, Congress decided to permit a class to accept a plan, notwithstanding the negative votes of some members, if sufficient

189. *In re Credit Indus. Corp.*, 366 F.2d 402, 410 (2d Cir. 1966) (footnote omitted).

190. See, e.g., *Adair*, *supra* note 3, at 38; *McGuinness & Goldman*, *supra* note 18, at 20; *supra* text accompanying notes 2-3.

191. *Fleet Natl. Bank v. Trans World Airlines, Inc.*, 767 F. Supp. 510, 519 (S.D.N.Y. 1991) (footnotes omitted).

192. Without the risk of insolvency, there would be no need for subordination agreements at all. Every creditor would be assured full payment. See *In re Aktiebolaget Kreuger & Toll*, 96 F.2d 768, 770 (2d Cir. 1938) ("Subordination . . . would be meaningless in a solvent corporation. . . ."); Daniel C. Cohn, *Subordinated Claims: Their Classification and Voting Under Chapter 11 of the Bankruptcy Code*, 56 AM. BANKR. L.J. 293, 296 (1982) ("A subordination agreement would be nearly useless if not enforceable in a bankruptcy case.").

193. One could argue that this result might actually be a good thing. Perhaps it could have avoided the overleveraging of the 1980s that was partially responsible for a long and painful recession in the 1990s. However, to allow parties to enter into subordination agreements, to write into the Bankruptcy Code a section that appears to protect them, and only at the late date of plan confirmation to inform the senior creditor that it should not have relied on the agreement, seems to be the least fair and most destabilizing way of avoiding excessive leveraging. Far better would be to outlaw subordinated debt all together, or at least make clear that subordination agreements are at risk in bankruptcy.

194. 11 U.S.C. § 1129(a)(8) (1988).

195. 11 U.S.C. § 1126(c) (1988).

196. 11 U.S.C. § 1122(a) (1988).

agreement existed within the class to satisfy section 1126(c).¹⁹⁷ The rationale behind this decision is straightforward: because section 1122(a) requires that all claims in a class be “substantially similar,” one may reasonably assume that if most of the creditors in the class accept the plan, the plan treats the class fairly. Moreover, always requiring unanimity within a class could permit a “rogue” creditor to sabotage confirmation to the detriment of all concerned, perhaps for its own selfish ulterior motives.¹⁹⁸

Frugal must now convince the court that, in the case of subordinated debt, the first policy should override the second. To do so, Frugal might bolster its plain-language argument by analogizing its position to that of a creditor objecting to the release of a guarantor. Drawing on the cases holding that section 524(e)¹⁹⁹ prohibits the court from confirming a plan that releases a guaranty agreement,²⁰⁰ Frugal might argue the “restrictive approach”: that subordination agreements, like guaranty agreements, are beyond the reach of the bankruptcy court, and a reorganization plan may not affect them.

The first response to Frugal’s argument might be that section 524(e) should not even apply to subordinated creditors.²⁰¹ Section 524(e) provides that the debtor’s discharge does not affect the “liability of any other entity”²⁰² on a debt of the debtor. Its legislative history is one sentence: “Subsection [(e)] provides the discharge of the debtor does not affect co-debtors or guarantors.”²⁰³ A subordinated creditor is not a guarantor or codebtor in the usual sense because the subordinated creditor is not automatically liable to the extent that the debtor fails to pay, while a guarantor would be.²⁰⁴ On the other hand, as one commentator has stated, “[t]he essence of the subordination agreement is a guaranty or indemnification, limited by the amount payable to or received by the subordinated creditor in a bankruptcy proceeding.”²⁰⁵ To decide whether a subordinated creditor is an “en-

197. But Congress apparently did not wish to allow confirmation over the objection of most holders of any particular *type* of claim without the additional protection afforded claimants under the cramdown provisions of § 1129(b). The absolute priority rule, applicable only in cramdown, is designed to protect dissenting classes from unfair treatment. See *supra* text accompanying notes 88-91.

198. For example, a creditor might have an interest in seeing the debtor’s reorganization fail in order to improve the position of a competitor of the debtor in whom the creditor has some financial interest.

199. See *supra* notes 92-94 and accompanying text for the text of § 524(e) and its precursor in the Act.

200. See *supra* section II.B.

201. See Lopes, *supra* note 14, at 226-27; McGuinness & Goldman, *supra* note 18, at 23.

202. 11 U.S.C. § 524(e) (1988).

203. SENATE REPORT, *supra* note 28, at 81, reprinted in 1978 U.S.C.C.A.N. 5787, 5867.

204. See *supra* note 74 and accompanying text.

205. Lopes, *supra* note 14, at 227; see also *In re Holly’s, Inc.*, 140 B.R. 643, 674-75 (Bankr. W.D. Mich. 1992) (holding that an affirmative promise clause whose “practical effect” was that of a guaranty constituted a subordination agreement); Carlson, *supra* note 35, at 996 (describing

tity" with "liability" to a senior creditor within the meaning of section 524(e), one must examine the underlying purpose of the section.

*United States v. Stribling Flying Service*²⁰⁶ illustrates section 524(e)'s usual function. In *Stribling*, the guarantors of a debt which had been reduced in chapter 11 proceedings argued that they should no longer be liable on the full amount of the debt. They claimed that their obligation to guarantee was coextensive with the debtor's obligation to pay, so a reduction in the debtor's obligation should reduce that of the guarantors dollar for dollar.²⁰⁷ The plan apparently made no mention of reducing the guarantors' obligation. The court rejected the guarantors' argument as inconsistent with section 524(e).²⁰⁸

Where the guarantors' only argument rested on the effect of the debtor's discharge somehow carrying over to the guarantors' obligation, as in *Stribling*, one cannot quarrel with the court's conclusion.²⁰⁹ A creditor requires a guarantor presumably because it wants to be assured of payment and is unsure of the debtor's ability to handle the debt.²¹⁰ To hold that the debtor's failure to be able to pay the debt — the very event for which the creditor was planning — automatically deprives the creditor of the right to collect from the guarantor makes little sense. Section 524(e) stands for the proposition that when the debtor has confessed an inability to pay by filing for bankruptcy protection, the guarantor becomes liable on the entire unpaid debt. The debtor's discharge should not preclude the creditor from pursuing other ways of satisfying the debt if it had the foresight to arrange them.

Similar reasoning applies to debt subordination. Senior lenders, when lending to an entity already carrying a heavy debt load, often rely on the fact that they are first in line for payment, much as a creditor relies on a guarantor when making a risky loan.²¹¹ The policy of

a subordinated creditor as a "nonrecourse guarantor"); McGuinness & Goldman, *supra* note 18, at 20 ("[A] subordinated lender can be characterized as a limited surety for the debtor.").

206. 734 F.2d 221 (5th Cir. 1984).

207. 734 F.2d at 222-23.

208. 734 F.2d at 223; see also *In re Sandy Ridge Dev. Corp.*, 881 F.2d 1346, 1350-51 (5th Cir. 1989) (rejecting a guarantor's argument like the one put forth in *Stribling*).

209. See also *R.I.D.C. Indus. Dev. Fund v. Snyder*, 539 F.2d 487 (5th Cir. 1976) (pre-Code case).

210. See, e.g., JAMES J. WHITE & ROBERT S. SUMMERS, *UNIFORM COMMERCIAL CODE* § 13-13, at 576 (3d ed. 1988); WHITE & NIMMER, *supra* note 76, at 144 ("[T]he whole idea of the guarantee is that the guarantor will be liable in the case of . . . failure of the underlying debtor. . . .").

211. "It is also entirely reasonable to expect that senior noteholders would presume that their rights would never be diminished by debenture-holders junior to them." *Fleet Natl. Bank v. Trans World Airlines*, 767 F. Supp. 510, 518 n.7 (S.D.N.Y. 1991); see also McGuinness & Goldman, *supra* note 18, at 20. Enforcing subordination agreements in bankruptcy does not, however, require a showing of reliance by the senior creditor. See *In re Credit Indus. Corp.*, 366 F.2d 402, 410 (2d Cir. 1966); *In re General Homes Corp.*, FGM C, 134 B.R. 853, 864 (Bankr. S.D. Tex. 1991).

not depriving lenders of their insurance²¹² when the debtor receives a discharge extends to subordinated creditors as well as guarantors. Once a subordinated creditor receives any payment from the debtor while the subordination provision is in effect,²¹³ the subordinated creditor's contractual turnover obligation guarantees payment on the senior debt in precisely the amount of payment received, and in that limited sense a subordinated creditor has "liability" to the senior creditor on the debt.²¹⁴ A subordinated creditor therefore appears to fall within the broad language of section 524(e), which applies to *any entity* other than the debtor that has liability on the debt.

However, applying the restrictive view of section 524(e) to subordination agreements leads to peculiar results. Courts applying the restrictive approach to guarantor releases hold that a plan containing such a release may not be confirmed even if every creditor votes for it,²¹⁵ and if the plan is confirmed the guarantor is subject to postconfirmation collateral attack.²¹⁶ One possible justification for disallowing even voluntary release of guarantors is that the guarantor may be neither a creditor nor a debtor, and therefore should neither benefit nor suffer from proceedings to which it is not a party.²¹⁷ That justification does not apply to subordination agreements, where by definition the senior and subordinated creditors are both owed money by the common debtor, and therefore are both parties to the bankruptcy proceedings.²¹⁸ In light of this fact and the general policy of chapter 11 that debtors and creditors should be able to negotiate the agreement that suits them best,²¹⁹ the argument that a creditor cannot *voluntarily*

212. The term *insurance* is used here only in the broad sense that in the event of the debtor's default, the senior lender looks to another party to bear the loss.

213. This will be the case either when the agreement is a complete subordination that requires no default to be effective, or when the specified default event has occurred. See *supra* notes 32-37 and accompanying text.

214. "Liability" means "every kind of legal obligation, responsibility, or duty." BLACK'S LAW DICTIONARY 914 (6th ed. 1990). Because a subordinated creditor's failure to turn over payments received in violation of a subordination agreement would constitute an actionable breach of contract, subordinated creditors have a legal obligation to comply with the terms of subordination agreements, i.e., they have liability for failing to comply. Lopes, *supra* note 14, states that § 524(e) "arguably" applies to subordinated creditors, that guarantor release cases "seem analogous," and that "[i]t would seem" that a subordinated creditor is "at least in some manner a surety." *Id.* at 226-27.

215. See, e.g., *Union Carbide v. Newboles*, 686 F.2d 593, 595 (7th Cir. 1982).

216. See *supra* section II.B.2. But see *Republic Supply Co. v. Shoaf*, 815 F.2d 1046 (5th Cir. 1987), for the view that even assuming that the bankruptcy court did not properly confirm a plan releasing a guarantor, the confirmed plan is entitled to res judicata effect and precludes a creditor who failed to appeal the plan's confirmation from bringing a collateral attack against the guarantor.

217. See *In re A.J. Mackay Co.*, 50 B.R. 756 (Bankr. D. Utah 1985).

218. See *supra* text accompanying notes 27-31.

219. See AARON, *supra* note 17, § 12.01, at 12-2 (describing chapter 11 as "a framework for negotiation").

give up its rights under a subordination agreement is untenable.²²⁰

Although a court would likely find Frugal's argument to apply the restrictive view of guarantor releases to subordination agreements unpersuasive, even the expansive view supports Frugal's position. Section 524(e), whatever its precise meaning, indicates that bankruptcy courts should generally avoid interfering with creditors' right to look to parties other than the debtor for satisfaction of their debts.²²¹ Many courts facing the issue have adopted the restrictive view of guarantor releases;²²² even the courts that take the most expansive view of bankruptcy courts' power to affect creditors' claims against nondebtors have shown some unease in doing so. In *In re A.H. Robins Co.*,²²³ perhaps the leading case for expansive use of bankruptcy courts' equitable powers to enjoin action against nondebtors,²²⁴ the Fourth Circuit carefully enumerated the highly unusual facts of the case that made its injunction appropriate:

In this situation where the Plan was overwhelmingly approved, where the Plan in conjunction with insurance policies provided as a part of a plan of reorganization gives a second chance for even late claimants to recover where, nevertheless, some have chosen not to take part in the settlement in order to retain rights to sue certain other parties, and where the entire reorganization hinges on the debtor being free from indirect claims such as suits against parties who would have indemnity or contribution claims against the debtor, we do not construe § 524(e) so that it limits the equitable power of the bankruptcy court to enjoin the questioned suits. We leave questions concerning cases in which § 524(e) does apply for another day.²²⁵

The Ninth Circuit has read that language as limiting the holding of *Robins* to its facts.²²⁶

Even a more expansive reading of *Robins* does not support bankruptcy courts routinely enjoining actions against nondebtors. The *Robins* court, in construing section 524(e) to allow its injunction, held

220. See *supra* text accompanying notes 162-63. The legislative history of § 510(a) demonstrates that Congress approved of a class of senior creditors giving up rights under a subordination agreement in order to ease confirmation. HOUSE REPORT, *supra* note 11, at 359, reprinted in 1978 U.S.C.A.N. at 5963, 6315; see also *supra* notes 67-69 and accompanying text. When consent of such a class is unanimous, there should be no objection.

221. Courts have denied confirmation of plans solely on the ground that the plans violated § 524(e). See e.g., *Seaport Automotive Warehouse v. Rohnert Park Auto Parts, Inc.* (*In re Rohnert Park Auto Parts, Inc.*), 113 B.R. 610 (Bankr. 9th Cir. 1990); *Mellon Bank v. Siegel*, 96 B.R. 505 (Bankr. E.D. Pa. 1989). Other courts have listed a violation of § 524(e) as one among several sufficient conditions for denial of confirmation. See, e.g., *In re 222 Liberty Assocs.*, 108 B.R. 971, 996-97 (Bankr. E.D. Pa. 1990); *In re Elsinore Shore Assocs.*, 91 B.R. 238, 256 (Bankr. D.N.J. 1988); *In re Future Energy Corp.*, 83 B.R. 470, 485-86 (Bankr. S.D. Ohio 1988).

222. See cases cited *supra* note 95.

223. 880 F.2d 694 (4th Cir. 1989).

224. See *supra* section II.C.

225. *Robins*, 880 F.2d at 702.

226. *American Hardwoods, Inc. v. Deutsche Credit Corp.* (*In re American Hardwoods, Inc.*), 885 F.2d 621, 626 (9th Cir. 1989).

that “[w]hatever the result might be as to the application of § 524(e) in other cases, we do not think that section must be literally applied *in every case* as a prohibition on the power of the bankruptcy courts.”²²⁷ The obvious implication is that in a case with less compelling facts, such a reading of section 524(e) would be appropriate. Other courts, assuming *arguendo* that bankruptcy courts may in some cases enjoin actions against nondebtors, have characterized such use of the equitable authority contained in section 105(a)²²⁸ as “an extraordinary exercise of discretion.”²²⁹ All of this suggests that the case must be a highly unusual one to justify depriving a creditor of its bargained-for right to look to someone other than the debtor for satisfaction of an obligation.

That general rule should be no less true for subordinated creditors than for guarantors. Although section 105 confers significant equitable power on the bankruptcy court, those equitable powers are limited by the specific provisions of the Bankruptcy Code.²³⁰ Sections 510(a) and 524(e) control the reach of the bankruptcy court’s equitable powers to modify rights under subordination agreements.

The middle course approach to the release of guarantors provides some helpful guidance.²³¹ That approach allows creditors voluntarily to release parties other than the debtor as part of the plan, but does not permit the bankruptcy court to release those parties without creditor consent.²³² The courts adopting this approach reasoned that because the releases of the nondebtors were purely voluntary and for valuable consideration,²³³ they did not constitute a “discharge” within the meaning of the Bankruptcy Code, nor did the debtor’s discharge by itself affect the rights of the creditors. The releases therefore complied with section 524(e).²³⁴

227. 880 F.2d at 702 (emphasis added).

228. See *supra* text accompanying notes 133-35 for the text of § 105(a) and its precursor in the Act.

229. *In re Brentano's Inc.*, 36 B.R. 90, 92 (Bankr. S.D.N.Y. 1984); *Dore & Assocs. Contracting v. American Druggists' Ins. Co.* (*In re Dore & Assocs. Contracting*), 54 B.R. 353, 357 (Bankr. W.D. Wis. 1985) (citing *Brentano's*). Both of those courts found that enjoining action against nondebtors would be inappropriate on the facts before them. *Brentano's*, 36 B.R. at 92; *Dore*, 54 B.R. at 361-62.

230. “[W]hatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code.” *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988).

231. See *supra* section II.D.

232. See, e.g., *In re Monroe Well Serv., Inc.*, 80 B.R. 324, 334 (Bankr. E.D. Pa. 1987); *In re AOV Indus.*, 31 B.R. 1005, 1010 (D.D.C. 1983), *modified on other grounds*, 792 F.2d 1140 (D.C. Cir. 1986).

233. In both *Monroe* and *AOV*, the plans provided that in exchange for releasing certain parties from future claims, the releasing creditors would receive a share of funds not available to those creditors refusing to execute the requested release. See *supra* text accompanying notes 145-55.

234. *Monroe*, 80 B.R. at 334; *AOV*, 31 B.R. at 1010.

Applying the middle course approach to subordination agreements would preclude the bankruptcy court from confirming the plan to which Frugal objects. If a subordinated creditor satisfies the definition of "any other entity" with "liability" for a debt of the debtor,²³⁵ and Frugal has refused to release that liability, the bankruptcy court would be without power to release the subordinated creditor's turnover obligation against Frugal's will. The question is whether the policies that justify denying confirmation of a plan that releases a guarantor against the will of the creditor are sufficiently applicable to subordination agreements to vindicate Frugal's plain language reading of section 510(a).

The considerable reluctance of courts to interfere with creditors' ability to realize the benefit of their bargain with regard to guaranties should carry over to their treatment of subordination agreements. The tremendous commercial importance of subordinated debt²³⁶ coupled with the express command of section 510(a) should discourage judicial interference with subordination agreements over the beneficiary's objection. Together, sections 510(a) and 524(e) strongly suggest that the Bankruptcy Code contemplates leaving intact the devices senior creditors use to protect themselves against the default of debtors, and permitting a chapter 11 plan to extinguish a subordination agreement over the objection of its beneficiary undermines that very sound policy.

Although in general a class of claimholders may override the wishes of the dissenters in the class,²³⁷ the Code makes exceptions to that rule when necessary to further a particularly important policy. One example is the best-interests test: a single creditor, if it can prove a violation of the test, can defeat confirmation.²³⁸ Another is the release of guarantors. Most courts facing the issue have held that a plan containing a guarantor release may not be confirmed because the provision violates section 524(e), regardless of whether the creditors approve the provision.²³⁹ Sections 510(a) and 524(e) should be read to carve out another exception to the rule, permitting a senior creditor to show a violation of section 510(a) when a plan purports to extinguish a subordination agreement over the senior creditor's objection.²⁴⁰ Such a showing would prevent confirmation because it would demonstrate

235. Such a subordinated creditor falls within the purview of § 524(e). See *supra* text accompanying notes 213-14.

236. See *supra* text accompanying notes 189-93.

237. See *supra* notes 194-98 and accompanying text.

238. See Richard L. Epling, *Exchange Offers, Defaults, and Insolvency: A Short Primer*, 8 BANKR. DEV. J. 15, 50 n.204 (1991); *supra* text accompanying notes 85-87.

239. See cases cited *supra* notes 95, 221.

240. This resolves the ambiguity in the legislative history noted *supra* text accompanying notes 67-69. Because of the lack of detailed discussion of § 510(a) throughout the enactment process, the most likely scenario is that Congress simply did not consider this question. The probable meaning of the legislative history is that § 510(a) was not meant to prevent a creditor from voluntarily waiving its rights to further a confirmation.

that the plan violates an "applicable provision" of title 11, thus failing the requirement of section 1129(a)(1).

One commentator has stated the probable result of such a rule as follows:

The obvious practical problem of concluding that the bankruptcy court has no power to bind a nonconsenting senior creditor to a provision which extinguishes its rights under a subordination agreement is that the chapter 11 debtor will find it difficult to confirm a plan. Subordinated creditors will not be pleased with the prospect of senior creditors bringing an action to recover the dividends which they receive in the chapter 11. Senior creditors will be reluctant to consent to a plan and extinguish their rights to pursue the subordinated creditor while nonconsenting senior creditors are preserving those rights. Such a conclusion would probably mean that the only possible plan would be one which had the unanimous consent of all senior creditors.²⁴¹

The logic of that position is impeccable, but its prediction is less dire than might first appear. Assuming that all parties are working toward a confirmed plan, the likely result of reading section 510(a) as proposed in this Note is not a breakdown of the confirmation process, but rather negotiation between senior and subordinated creditors to arrive at mutually acceptable terms.²⁴² Indeed, the most likely explanation for the fact that no reported case under the Code has dealt with this issue is that negotiation between senior and subordinated creditors has so far made litigation of this issue unnecessary.²⁴³ Furthermore, since the vast majority of chapter 11 cases already fail to produce a confirmed plan,²⁴⁴ protecting the integrity of such a crucial part of commerce as subordinated debt may outweigh the risk of endangering a few more confirmations.

241. Lopes, *supra* note 14, at 228-29; see also McGuiness & Goldman, *supra* note 18, at 23. Lopes does not adopt either position, but merely presents the arguments for both sides.

242. Of course, the senior creditors would be in a stronger bargaining position, since they would essentially be able to block the confirmation. But they *deserve* a stronger bargaining position; a plan proposing payment to subordinated creditors asks senior creditors to surrender rights they have already bargained for, and they should receive something in return.

243. Even if the issue presented in this Part suddenly became a burning issue in chapter 11 cases, involving many reorganizations, the result should be the same. If the situation arose more often, it would mean that senior creditors were becoming more concerned about enforcing their subordination agreements in bankruptcy, which would simply add force to the position taken in this Note that undercutting the viability of subordinated debt is too high a price to pay for allowing a class to override its members' wishes with regard to subordination agreements.

244. Estimates of the failure rate vary from roughly 70%, see Robert K. Rasmussen, *The Efficiency of Chapter 11*, 8 BANKR. DEV. J. 319, 322 (1991), to 90%. See Edith H. Jones, *Chapter 11: A Death Penalty for Debtor and Creditor Interests*, 77 CORNELL L. REV. 1088, 1089 (1992). But cf. Lynn M. LoPucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies* 78 CORNELL L. REV. (forthcoming April 1993) (manuscript at 4-5, on file with author) (arguing that failure rates are misleading and that most large bankruptcies result in a confirmed plan). Of those few that do manage to confirm a plan, probably at least a third are simply plans providing for an orderly liquidation of the firm. Jones, *supra*, at 1089; Elizabeth Warren, "Why Have a Federal Bankruptcy System?," 77 CORNELL L. REV. 1093, 1097 (1992).

Finally, in extraordinary circumstances, a court might be justified in invoking its equitable powers to override the wishes of a senior creditor who uses a subordination agreement to block confirmation in bad faith. Contract law, the law governing subordination agreements, carries an implied duty of good faith;²⁴⁵ a senior creditor that violates that duty would be outside its rights under the contract, permitting a bankruptcy court to extinguish the creditor's subordination agreement while not running afoul of section 510(a).²⁴⁶ Absent compelling circumstances, however, when a bankruptcy court confronts a plan that purports to extinguish a subordination agreement over the objection of one or more of its beneficiaries, the court should find that the plan is inconsistent with section 510(a) of the Code²⁴⁷ and cannot be confirmed.

B. *Plans Confirmed by Cramdown*

The statutory picture is considerably clearer when a plan is confirmed by cramdown. Section 1129(b), the section governing cramdown, begins with the phrase: "Notwithstanding section 510(a) of this title."²⁴⁸ Therefore, in a cramdown, section 510(a) simply does not apply, so a plan inconsistent with section 510(a) would nonetheless be consistent with section 1129(a)(1).²⁴⁹ There are two possible cramdown scenarios relevant to this Note. The first is when the class of senior creditors accepts the plan over the dissent of some of its members, but some other class rejects the plan. The second is when the class of senior creditors rejects the plan.

If a class of senior creditors consents to a plan which nonetheless has to be confirmed by cramdown because of the dissent of another class, section 1129(b) prevents an unhappy senior creditor in the consenting class from using section 510(a) to enforce its subordination agreement. The creditor would have to rely exclusively on section 524(e). However, given the express command of section 1129(b)(1) to disregard section 510(a) in a cramdown, the argument that section 524(e) on its own would require enforcing a subordination agreement should not succeed. The dissenting senior creditor loses in this situa-

245. See, e.g., U.C.C. § 1-203 (1990); RESTATEMENT (SECOND) OF CONTRACTS § 205 (1979).

246. Recall that § 510(a) does not enforce subordination agreements in all cases, but only to the extent that "applicable nonbankruptcy law" would enforce them. See *supra* notes 162-63 and accompanying text. A "rogue" creditor, like the one hypothesized *supra* note 198, would not be permitted to abuse its contract rights to jeopardize confirmation.

247. The plan would consequently fail to satisfy § 1129(a)(1).

248. 11 U.S.C. § 1129(b)(1) (1988).

249. To be confirmed by cramdown, a plan must still be consistent with all but paragraph (8) of § 1129(a), which requires all classes to consent to the plan. 11 U.S.C. § 1129(b)(1) (1988). However, § 1129(a)(1) requires the plan to comply only with "applicable" provisions of title 11, and on cramdown, § 510(a) is not "applicable."

tion. Without section 510(a) it has no statutory basis for contesting confirmation.

The foregoing result seems bizarre. No policy of bankruptcy justifies protecting subordination agreements held by dissenters in an assenting class when the plan is confirmed by consent but denying them protection in a cramdown. No legislative history or case law deals with section 1129(b)(1)'s exclusion of section 510(a) from cramdown. Close examination of the exclusion, however, reveals that it makes little sense.

Reading section 510(a) expansively, as proposed in this Note, leads to the position that on cramdown a dissenting member of an assenting class has fewer rights than it would on confirmation by consent. That position is nonsensical. Even if section 510(a) is read restrictively, however, the exclusion is redundant. Under that view, a dissenting class member is bound by the will of the class regardless of whether section 510(a) applies.²⁵⁰ Finally, if the class of senior creditors dissents, the absolute priority rule will provide the same protection of subordination agreements that section 510(a) would.²⁵¹

The commentary of Kenneth Klee, one of the only mentions of this part of the cramdown statute, inadvertently points out the problem:

As a general proposition a subordination agreement is enforceable in a reorganization case. However, the confirmation standard of [section] 1129(b)(1) applies "[n]otwithstanding section 510(a)." This means that to the extent a class of senior claims chooses not to enforce the subordination agreement, the minority in the class will be bound notwithstanding section 510(a).²⁵²

But reading section 510(a) restrictively, Klee's statement is true whether or not cramdown under section 1129(b)(1) is invoked. That view contemplates *always* binding the minority to the will of the class with regard to subordination agreements, making the exclusion of section 510(a) from section 1129(b)(1) superfluous. On the expansive reading of section 510(a) proposed in this Note, it makes no sense to deprive a senior creditor in a cramdown of rights it has when a plan is confirmed by consent. A possible solution to this conundrum would

250. Thus, if the class accepts a plan allowing payments to subordinated creditors, the class has waived any rights it would have under § 510(a) and the dissenters in the class have no right to contest the will of the class, so no argument that § 510(a) prevents confirmation is possible.

251. See *infra* text accompanying notes 253-55.

252. Klee, *supra* note 90, at 142 n.70; see also Irving D. Labovitz, *Outline of "Cram Down" Provisions Under Chapter 11 of the Bankruptcy Reform Act of 1978*, 86 COM. L.J. 51 (1981): "While the new standard of § 1129(b) protects dissenting classes, it does not protect dissenting members within a consenting class, and the remaining members of that class cannot invoke Section 510(a), otherwise requiring enforcement of subordination agreements." *Id.* at 52. Although he is not entirely clear on the point, Labovitz seems to imply that § 510(a) might be available to dissenting senior creditors involved in a confirmation by consent even though it is not available in a cramdown. Labovitz does not explain this peculiar result.

be to read the exclusion of section 510(a) as applicable only to challenges under the best-interests test, i.e., in a cramdown an objecting senior creditor could not count the payment it would receive because of the turnover obligation as part of the amount it claims it would receive in a liquidation. However, this reading is both a stretch of the statutory language and without support in the legislative history. One might reasonably expect a clearer statement of such a specific rule. Congress would be well advised to clarify the meaning of this highly ambiguous provision.

If, on the other hand, the entire class of senior creditors dissents, the class is then entitled to invoke the absolute priority rule.²⁵³ If the senior creditors and the subordinated creditors are in different classes, the plan could not be confirmed if the subordinated creditors received any payments while the senior creditors were not paid in full.²⁵⁴ The absolute priority rule would essentially require enforcement of the subordination agreement.²⁵⁵

The fact that in a cramdown the absolute priority rule protects the rights of dissenting classes of senior creditors provides some insight into the proper reading of section 510(a). In effect, this Note proposes that section 510(a) be understood as a miniature absolute priority rule, applicable in all chapter 11 cases, that allows senior creditors to insist that unless they are paid in full, the subordinated creditors receive nothing.²⁵⁶ This reading of section 510(a) would recognize that subordination agreements, like security agreements²⁵⁷ and guaranties, are important devices that creditors use to protect themselves against default, and should not be undermined in bankruptcy.

CONCLUSION

Subordinated debt plays a crucial role in modern commerce. In

253. See *supra* text accompanying notes 88-91. Of course, § 510(a) is still unavailable.

254. 11 U.S.C. § 1129(b)(2)(B) (1988); see *In re General Homes Corp.*, FGMC, 134 B.R. 853, 864 (Bankr. S.D. Tex. 1991) (noting that any distribution to subordinated creditors when senior creditors have not been paid in full would violate absolute priority rule *per se*).

255. This leaves the question of whether senior and subordinated creditors could be put in the same class. Most commentators believe that they could not. See, e.g., Cohn, *supra* note 192, at 315; Lopes, *supra* note 14, at 229 ("If senior and subordinated creditors were placed in the same class, the argument that all the claims in the class were not substantially similar would surely prevail."). But see AARON, *supra* note 17, § 12.03[2], at 12-19 (suggesting that senior and subordinated creditors could be assigned to the same class of unsecured claims). The intricacies of the classification question are left to other writers.

256. This is precisely what both senior and subordinated creditors should expect from a subordination agreement when the common debtor is in bankruptcy. See *supra* section I.A.

257. Commentators have spilled much ink on the question of whether subordination agreements should be treated as security interests subject to article 9 of the U.C.C. See, e.g., Coogan et al., *supra* note 1. Moreover, the drafters of the U.C.C. added a section specifically to clarify the status of subordination agreements vis-à-vis security interests. See U.C.C. § 1-209 (1990). These facts suggest that in important ways, subordination agreements and security interests are closely related.

order to ensure the continued viability of subordinated debt as a financing tool, subordination agreements must be enforced in bankruptcy, even when the creditor wishing to enforce has been outvoted by its class. The protection conferred upon subordination agreements by section 510(a) of the Code should be read expansively to protect even dissenting senior creditors who wish to enforce rights that their class would waive. Any other reading can only undermine expectations and reduce senior lenders' willingness to lend. Subordinated creditors serve a function similar to guarantors in protecting creditors' investments when the debtor defaults, and the two should be treated similarly in bankruptcy. Much as bankruptcy courts usually disapprove plans purporting to release guarantors over the objection of the guaranteed creditors, they should refuse to confirm plans that purport to release subordinated creditors from their turnover obligations against the will of the senior creditors. This result will increase confidence in subordinated financing and further the important policy goal of protecting the devices senior creditors use to protect themselves against the default of debtors.