Clients&FriendsMemo

To Vote or Not to Vote: Court Holds That "Out of Money" Junior Creditor Barred from Objecting to Plan

April 22, 2021

On March 31, 2021, the U.S. Bankruptcy Court for the District of Kansas held in *In re Fencepost Productions Inc.* that even though an assignment of voting rights provision in a subordination agreement was not enforceable in a bankruptcy proceeding, a subordinated creditor nevertheless was barred from participating in proceedings related to a chapter 11 plan and disclosure statement on the basis that the subordinated creditor lacked prudential standing.[1] On the one hand, the decision calls into question the enforceability in bankruptcy proceedings of voting assignment provisions agreed upon in prepetition contractual agreements, and, on the other, affirms the enforceability of prepetition contractual provisions that may alter the priorities set forth in the Bankruptcy Code. If followed by other courts, the decision raises the possibility that definitively "out of the money" creditors may not have standing to object to or participate in plan confirmation.

Factual Background

Fencepost Productions and its debtor affiliates (the "Debtors") entered chapter 11 bankruptcy with a capital structure that consisted of a $14 million loan (the "Senior Loan," and the lender, the "Senior Lender"), which was secured by a lien on the Debtors' personal property.[2] In addition to the Senior Loan, the Debtors' capital structure also included a $5.3 million junior loan (the "Junior Loan," and the lenders, the "Junior Lenders").

Prior to the bankruptcy, the Senior Lender and Junior Lenders had executed a subordination agreement (the "Subordination Agreement"), which provided that payment of "all Junior Liabilities shall be postponed and subordinated to the payment in full in cash of all obligations of all Senior Liabilities."[3] The Subordination Agreement further provided that in any bankruptcy proceeding: (i) any distributions that otherwise would be made to the Junior Lenders were required to be made directly to the Senior Lender; (ii) the Senior Lender would have the right to vote the Junior Lenders' claims with respect to any chapter 11 plan; and (iii) the Junior Lenders were prohibited from filing

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[1] *See In re Fencepost Productions Inc.*, Case No. 19-41545, ECF No. 396 (Bankr. D. Ks. Mar. 31, 2021).

[2] *Id.* at 3.

[3] *Id.* at 3-4.

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any pleadings or taking any other action that would be contrary to the priorities set forth in the Subordination Agreement.[4]

The Debtors ultimately filed a plan of reorganization, which provided that the Senior Lender's claim would be bifurcated into a secured claim and unsecured claim. Unsecured claims—including the Senior Lender's unsecured claim—would receive a 15 percent recovery under the plan.[5] The Junior Lenders' claims were separately classified from other unsecured claims (including the unsecured portion of the Senior Lender's bifurcated claim), and on account of such Junior Loan claims, the Senior Lender would receive $120,000.[6] Finally, under the Debtors' plan, equity was entitled to retain ownership.

The Junior Lenders filed an objection to the plan and disclosure statement, and cast their own votes against the plan. Pursuant to the rights believed afforded to it under the Subordination Agreement, the Senior Lender meanwhile had cast ballots on account of the Junior Loan claims voting in favor of the plan. Finally, the Debtors filed objections to the proofs of claim filed by the Junior Lenders on the grounds that under the Subordination Agreement, all rights to payment and to vote were vested in the Senior Lender.

The Court's Decision

In connection with the Junior Lenders' plan objection and their votes against the plan, the Debtors contended that the Junior Lenders were barred from participating in the plan confirmation process because the Subordination Agreement assigned the Junior Lenders' voting rights to the Senior Lender. The Debtors also argued that as a consequence of the Senior Lender's payment priority over the Junior Lenders, the Junior Lenders had no standing to object to the plan of reorganization and also had no claim to assert within the bankruptcy proceeding. The Junior Lenders argued, however, that the voting rights assignment provision was unenforceable under section 510(a) of the Bankruptcy Code and that the subordination of their claims did not transfer their legal interests to the Senior Lender.

The Court ruled in favor of the Junior Lenders on a number of issues, including with respect to the Debtors' objections to the Junior Lenders' proofs of claim and the enforceability of assignment of voting rights provisions. However, the Court ultimately held that as result of the subordination provisions in the Subordination Agreement and their definitively "out of the money" status, the Junior Lenders lacked prudential standing to object to the plan or disclosure statement.

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4 *Id.* at 4.

5 *Id.*

6 *Id.* at 5.

Assignment of Voting Rights

The Court first addressed whether the Subordination Agreement's provisions that purported to assign the Junior Lender's voting rights were enforceable in the chapter 11 case. The Court held that such provisions were not enforceable. The Court acknowledged that courts are divided on whether Bankruptcy Code section 510(a) requires the enforcement of assignment of voting rights provisions. Section 510(a) of the Bankruptcy Code provides that a "subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law."[7] Some courts have held that such assignment of voting rights provisions are indeed enforceable under section 510(a) of the Bankruptcy Code to the extent that such provisions are included within a subordination agreement.[8] These courts finding in favor of enforceability have reasoned that while the Bankruptcy Code grants creditors the right to vote on a plan, nothing in the Bankruptcy Code expressly precludes a creditor from delegating or assigning away its rights to vote on a plan.[9] Therefore, since there is no conflict between such a provision and the language of the Bankruptcy Code, provisions whereby creditors have agreed to assign such rights to other creditors should be upheld as enforceable according to these courts. However, other courts have held that vote assignment provisions are not enforceable in bankruptcy because section 510(a) of the Bankruptcy Code expressly upholds only provisions that alter payment or lien priorities in bankruptcy, and not other contractual provisions.[10] Therefore, these courts are of the view that since there is nothing in the Bankruptcy Code that expressly permits one creditor to vote on behalf of another with respect to a plan, such arrangements should not be upheld as permissible. In short, because the assignment of voting rights is not a concept specifically addressed in the Bankruptcy Code, the divergence in views appears to stem from some courts focusing on what the Bankruptcy Code expressly allows, while others focus on what the Bankruptcy Code expressly prohibits.

In *Fencepost Productions*, the Court ultimately held that provisions that modified or assigned the Junior Lenders' voting rights were not enforceable. In so ruling, the Court agreed with other court decisions that held that Bankruptcy Code section 510(a) protects contractual provisions that alter priorities, and not any other provisions.[11] The Court further noted that the Subordination Agreement at issue did not purport to appoint the Senior Lender as the agent for the Junior Lenders, and thus

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7 11 U.S.C. § 510(a).

8 *See In re Aerosol Packaging*, 362 B.R. 43 (Bankr. N.D. Ga. 2006); *In re Curtis Ctr. Ltd. P'ship*, 192 B.R. 648 (Bankr. E.D. Pa. 1996).

9 *In re Aerosol Packaging*, 362 B.R. at 47 ("Section 1126(a) grants a right to vote to a holder of a claim, but does not expressly or implicitly prevent that right from being delegated or bargained away by such holder.")

10 *See In re 203 N. LaSalle P'ship*, 246 B.R. 325 (Bankr. N.D. Ill. 2000) ("Subordination thus affects the order of priority of payment of claims in bankruptcy, but not the transfer of voting rights."); *see also In re Hart Ski Mfg. Co.*, 5 B.R. 734 (Bankr. D. Minn. 1980) ("There is no indication that Congress intended to allow creditors to alter, by a subordination agreement, the bankruptcy laws unrelated to distribution of assets.").

11 *See In re 203 N. LaSalle P'ship*, 246 B.R. 325 (Bankr. N.D. Ill. 2000).

the Senior Lender was not in a position to act as a fiduciary to the Junior Lenders.[12] In other words, the Senior Lender was acting to further its own interests and not acting on behalf of the interests of the Junior Lenders.

Proof of Claim Objections

The Court overruled the Debtors' objections to the Junior Lenders' proofs of claim, which, as noted above, the Debtors had objected to on the basis that under the Subordination Agreement, all rights to payment and to vote were vested in the Senior Lender. The Court held that "subordination merely reorders priorities among creditors," but that does not transfer the subordinated creditor's legal interest.[13] Consequently, the Court rejected the Debtors' arguments that the Junior Lenders had no claims to assert within the bankruptcy proceeding. In support of this conclusion, the Court noted that section 1129(b) of the Bankruptcy Code (which sets forth the statutory requirements for plan confirmation) expressly provides that a plan may be crammed down "notwithstanding section 510(a)." Bankruptcy Code section 1129(b) requires, among other things, that a chapter 11 plan not unfairly discriminate against claims and interests, including fully subordinated claims. Thus, the "notwithstanding section 510(a)" language in section 1129(b) led the Court to the conclusion that Congress intended for fully subordinated unsecured claims to be legally protected in a cramdown scenario notwithstanding a subordination agreement. Thus, it follows that even subordinated claims have certain protections afforded by the Bankruptcy Code in a bankruptcy case that cannot be assigned to another creditor—and asserting proofs of claim is one of them.

Junior Lenders Lack Standing to Object to Plan

Despite being found permitted to assert proofs of claim, the Court ultimately held, however, that the Junior Lenders lacked prudential standing to object to the plan and disclosure statement. As a preliminary matter, all creditors and parties in interest generally have statutory standing under section 1109(b) of the Bankruptcy Code to appear and be heard in chapter 11 proceedings, including to object to a plan.[14] However, section 1109(b) does not override the prudential standing doctrine, which includes a "general prohibition on a litigant's raising of another person's legal rights."[15] Prudential standing concerns are especially acute within the bankruptcy context because bankruptcy proceedings often involve numerous constituencies and "one constituency . . . [may seek] to disturb a plan of reorganization based on the rights of third parties who apparently favor the plan."[16]

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[12] Slip. op. at 13.

[13] *Id.* at 14.

[14] *See id.* at 18 (citing 11 U.S.C. § 1109(b)).

[15] *Lexmark Int'l Inc. v. Static Control Components Inc.*, 572 U.S. 118 (2014).

[16] *Kane v. Johns-Manville Corp.*, 843 F.2d 636, 644 (2d. Cir. 1988).

The Court noted that the Junior Lenders—if permitted to object to the plan—would be litigating the rights affecting third parties, but not the Junior Lenders' own interests.[17] The Court found that there was no scenario in which the Junior Lenders would receive any direct benefit or otherwise had any financial stake in objecting to the plan. This is because, as the Court noted, under the Subordination Agreement all payments made to the Junior Lenders were required to be turned over to the Senior Lender until the Senior Loan had been satisfied in full.[18] Further, under the proposed plan, the unsecured portion of the Senior Loan would receive only a 15 percent recovery. Thus, there was no circumstance in which the Senior Loan would be paid in full, and the Junior Lenders would be required to turn over any distributions to the Senior Lender.[19]

Accordingly, the Court held that the Junior Lenders would not benefit from objecting to or voting against the plan, including through any unfair discrimination or cramdown objection to the plan. Further, the Court noted that the plan and disclosure statement made clear that unsecured creditors would receive nothing in a chapter 7 liquidation. Consequently, the Court concluded that only the Senior Lender had a financial stake in the confirmation of the plan of reorganization based on the prepetition contractual arrangement made between the Junior Lenders and the Senior Lender in the Subordination Agreement. The Court therefore held that the Junior Lenders would be litigating the rights of the Senior Lender if they were permitted to vote or object to the plan, which was not permissible under the prudential standing doctrine.

Conclusion

The *Fencepost* decision calls into question the enforceability of provisions in subordination agreements that otherwise are unrelated to the subordination of one creditor's claim vis-à-vis another (*i.e.*, an agreement as to the priority of the respective creditors' claims) and that otherwise impinge on a right under the Bankruptcy Code. Some courts—including the *Fencepost* court—have concluded that section 510(a) of the Bankruptcy Code protects only the enforceability of provisions that alter priorities, and not other provisions. A growing number of courts following this reasoning thus have concluded that voting assignment provisions in subordination agreements are not enforceable under section 510(a) because they are not subordination provisions. Senior creditors therefore should be mindful that not every provision within a subordination agreement may be enforceable in a bankruptcy proceeding, including such voting assignment provisions.

However, where, as in the *Fencepost* decision, a junior creditor is out of the money and the senior creditor will not receive a full recovery, the junior creditor may be barred from participating in plan confirmation proceedings under the prudential standing doctrine. Junior creditors thus should be mindful that when a subordination agreement contains a turnover provision and otherwise

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[17] Slip. Op. at 22.

[18] *Id.* at 16-17.

[19] *Id.* at 17.

subordinates the junior creditor's claims to those of the senior creditor, those provisions effectively may bar the junior creditor from blocking a plan of reorganization, perhaps even notwithstanding whether or not the subordination agreement at issue contains an express bar on the junior creditor from voting on or objecting to a bankruptcy plan.

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

Ingrid Bagby	+1 212 504 6894	ingrid.bagby@cwt.com
Michele Maman	+1 212 504 6975	michele.maman@cwt.com
Thomas Curtin	+1 212 504 6063	thomas.curtin@cwt.com