ALERTS

First Circuit Holds That Junior Creditors Could Be Paid Before Senior Creditors Received Post-Petition Interest

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The U.S. Court of Appeals for the First Circuit held on June 23, 2011, that junior creditors could receive a distribution over the objection of senior creditors who claimed they were entitled to post-petition interest under contractual subordination provisions. *In re Bank of New England Corporation*, ___ F.3d ___, 2011 WL 2476470 (1st Cir. June 23, 2011). In reaching its decision, based on the bankruptcy court's fact findings, the court stressed "that the parties did not intend to subordinate the Junior Noteholders to post-petition interest." *Id.* at *5. A quick history of this 10-year old litigation, arising in a 20-year old bankruptcy case, underscores this significance of the ruling to lenders.

Relevance

The First Circuit had held seven years earlier, when ruling on the same dispute, that the judicially created pre-Bankruptcy Code "Rule of Explicitness" was not a part of New York contract law. *In re Bank of New England Corp.*, 264 F.3d 355 (1st Cir. 2004). The pre-Code equitable rule required explicit language in a subordination agreement for a senior creditor to receive post-petition interest on its debt at the expense of a subordinated junior creditor. *See*, *e.g.*, *Kingsboro Mortg. Corp.*, 314 F.2d 400, 401-02 (2d Cir. 1975) (per curiam). In the court's earlier view, the rule "has no application in the context of bankruptcy where, as here, [New York had] not adopted the rule as one of general applicability." *Id.* at 368. According to the First Circuit in 2004, the bankruptcy court had erred

when authorizing a distribution to junior creditors over the objection of senior creditors who claimed they were entitled to post-petition interest under the parties' contractual subordination provisions. More significant, the court acknowledged its "disagreement" at the time with the Eleventh Circuit, *In re Southeast Banking Corp.*, 156 F.3d 1114 (11th Cir. 1998), and that there was "a circuit split." *Bank of New England*, 364 F.3d 359. Nevertheless, the court remanded the dispute to the bankruptcy court in 2004 to determine whether the parties intended the subordination agreement to provide for the priority payment of post-petition interest, explaining that the "subordination provisions" here were "ambiguous." *Id.* at 368. It directed the bankruptcy court to probe "the intent of the parties — an inquiry which . . . entails questions of fact that must in the first instance be addressed. . . ." *Id.*

Facts

The debtor here had issued six separate series of debt instruments during the 1970s and 1980s. Three offerings, totaling $195 million, contained contractual subordination provisions making these offerings senior debt. *Id.* at 360. The other three issues, totaling $525 million, were subordinated to the senior debt. Id. New York law governed all of the debt instruments. *Id.*

Indenture trustees for the senior debt had initially objected to the bankruptcy trustee's plan to distribute $11 million (now about $100 million) to the junior creditors after he had distributed the full amount of all unpaid principal and pre-petition interest to the senior debt. *Id.* at 361. The senior creditors relied on a provision in their indenture that amounts due to senior creditors "shall first be paid in full" before any payment on junior indebtedness. *Id.* at 360. They argued that they had not yet been paid in full because they had not received post-petition interest. *Id.*

The Remand

The bankruptcy court's directed fact-finding, on remand, enabled the First Circuit to ignore its earlier 2004 legal analysis without comment. In its words, "the bankruptcy court's factual findings as to the intent of the parties were sufficient in themselves to support the conclusion that the parties did not intend to subordinate the Junior Noteholders to post-petition interest." 2011 WL, at *5. Moreover, the bankruptcy court relied "on several . . . pieces of evidence to support its conclusion." *Id.* at *6. For

example, a bank officer for an indenture trustee under a 1989 junior indenture testified that, at the time, his bank believed "that Senior Noteholders would be entitled to 'interest and principal due to the senior holders up to and including the petition, but not post-petition interest.'" *Id.*

An expert for the junior creditors "testified that participants in the debt securities market during the 1980s understood that a debtor's obligation to pay interest on unsecured debt ceased upon the filing of a bankruptcy petition, and that a junior creditor's subordination obligations were co-extensive with that of the debtor's unless the subordination agreements explicitly stated otherwise." *Id.* Moreover, he explained, "lawyers drafting indentures during the mid-1980s knew the cases [articulating the Rule of Explicitness] and would take them into account when drafting subordination provisions." *Id.*

Another expert for the junior creditors testified "that the investment banking community understood that senior debt was paid in full when it had received the amount owed as of the petition date." *Id.* at *6-*7. Documentary evidence, such as the updated 1983 American Bar Association Model Simplified Indenture, "offered practitioners an example of the . . . explicit language [needed to] prioritize post-petition interest. *Id.* at *7. The necessary language, however, was missing in the indentures here. Scholarly articles and a law firm manual for representing indenture trustees "during the 1980s . . . corroborated the Junior Trustees' position regarding the need for explicit language to prioritize the recovery of post-petition interest." *Id.* at*8.

The bankruptcy court rejected the Senior Trustee's expert testimony as "not credible" because it was based on an "illogical conclusion." In its view, the Junior Trustees "proved . . . that the parties . . . did not intend to subordinate the junior notes to post-petition interest on the senior notes." *Id.*

Court of Appeals

The First Circuit found the bankruptcy court's findings "reasonable and not clearly erroneous." *Id.* at *8. Indeed, "it [had] engaged in a comprehensive, fact-intensive inquiry into the parties' intent at the time of the agreements, not an application of a *per se* rule of construction . . . [----] a multi-day trial full of fact and expert witness testimony [with] approximately 200 exhibits . . . ." *Id.* at *9.

Comments

1. So much for the Rule of Explicitness and "a circuit split." In the end, this $100 million dispute turned on facts, not on divergent judicial views.

2. Lenders' counsel should, if they do not already do so, assume, as a matter of prudence, the continued vitality of the Rule of Explicitness. Thus, when senior lenders want post-petition interest, they should, when drafting, use, for example, the following language from the 1983 Model Simplified Indenture § 11.03:

> ". . . holders of Senior Debt shall be entitled to receive payment in full in cash of the principal and interest, including interest accruing after the commencement of any bankruptcy case or similar proceeding, before other creditors are entitled to receive any payment."

Id. at *7.

3. Well drafted documents in the past decade have often provided for senior lenders to get post-petition interest. To the extent the documents are ambiguous, however, get ready for trial with hard evidence showing the parties' intent.

Authored by Michael L. Cook.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

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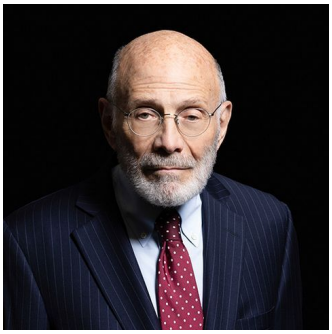

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