

Alert

Delaware Court Enforces Subordination Agreements Despite Senior Indenture Trustee's Late Filing of Senior Claims

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The United States District Court for the District of Delaware, on July 21, 2014, held that an indenture trustee's late filing of senior claims did not waive the lenders' contractual subordination rights, reversing the bankruptcy court. *In re Franklin Bank Corporation*, 2014 U.S. Dist. LEXIS 98327 (D. Del. July 21, 2014). Nor did the senior trustee's late filing show inequitable conduct warranting equitable subordination of the tardily filed senior claims to timely filed junior claims.

Bankruptcy Code ("Code") Section 726(a) provides a scheme for the distribution of estate property subject to the subordination provisions of Section 510. Code Section 510(a) provides that "a subordination agreement is enforceable" in bankruptcy "to the same extent" it would be under "nonbankruptcy law." Section 510(c) gives courts the equitable power to subordinate all or part of an allowed claim.

Facts and the Bankruptcy Court's Ruling

The bankruptcy court had disregarded a series of subordination agreements governing the priority of the Chapter 7 debtor's senior debt over four classes of its junior subordinated debt. The indenture trustee for the junior classes of subordinated notes timely filed a claim. Two and a half years after the deadline to file claims (i.e., the bar date), the indenture trustee for the senior class filed a claim on behalf of the senior noteholders. Four and a half years after the bar date, the senior indenture trustee objected to the allowance and payment of the junior noteholders' claim and, for the first time, argued that the junior debt was contractually subordinated to the senior indebtedness.

The bankruptcy court found that the senior claims had been tardily filed and thus were subordinate to the timely filed claims of the junior indenture trustee, relying on Code Section 726(a), which "generally envisions the payment of timely filed claims before tardily filed claims, subject to any contractual agreement ... by the parties that re-prioritizes the claims." *Id.* at *6. Despite the agreements subordinating the junior debt, the bankruptcy court found that the senior trustee had waived its enforcement rights because of its "gross negligence" and its delay; alternatively, it found that the senior claims should be equitably subordinated.

District Court Ruling

Vacating the bankruptcy court's findings, the district court held that the senior trustee's late claim filings *prior to* any distribution on the claims hardly prejudiced the Chapter 7 trustee. *Id.* at *11 ("The Trustee will merely have to write a check in the same amount to [the senior trustee] as he would have had to do to [the junior trustee]."). Acknowledging that inaction might be deemed a waiver in another case, the

senior trustee's delay in filing the claims here was not a "clear manifestation of intent" to relinquish a contractual protection" and did not "constitute a 'knowing[], voluntar[y] and intentional[]' abandonment of its contractual rights," the applicable standard under a waiver analysis. *Id.* at *12 (citations omitted).

Moreover, the district court found no evidence of "egregious" inequitable conduct "such as fraud, spoliation, or overreaching" and no evidence of harm; and it further found that the bankruptcy court's remedy of equitable subordination for tardiness alone was unjustified. *Id.* at *13. In the district court's view, "even gross negligence does not rise to the" requisite level of misconduct. *Id.* at *14–15. Indeed, "applying equitable subordination ... based solely on lateness is inconsistent with the ... Code." *Id.* at *15. Code Section 726 "is explicitly subject to section 510, which permits the use of subordination agreements to the extent they are enforceable under applicable non-bankruptcy law." *Id.* at *16.

Comment

The decision is consistent with established precedent. *See, e.g., In re Winstar Communications, Inc.*, 554 F.3d 382, 411 (3d Cir. 2009) ("inequitable conduct"; and "injury to the creditors" or "unfair advantage" to the claimant required for equitable subordination); *Md. Nat'l Bank v. Vessel Madam Chapel*, 46 F.3d 895, 901 (9th Cir. 1995) ("mere negligence [or] indifference" does not constitute inequitable conduct); *In re Baker & Getty Fin. Servs., Inc.*, 974 F.2d 712, 718–19 (6th Cir. 1992) (lender may have been "lax, imprudent, and ill-advised," but conduct not "gross or egregious" so as to warrant equitable subordination).

This case shows that: (1) courts ordinarily enforce the parties' contractual rights and will not easily find a lender has waived its contractual subordination rights; and (2) equitable subordination of a lender's claim will require a strong factual showing of "egregious" misconduct.

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

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