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Rules of Thumb for Intercreditor Agreements

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RULES OF THUMB FOR INTERCREDITOR AGREEMENTS

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Intercreditor agreements frequently restrict the extent to which subordinated creditors can participate in the bankruptcy process by, for example, contesting liens of senior lenders, objecting to a cash collateral motion, or even exercising the right to vote on a plan of reorganization. Because intercreditor agreements can reorder the bargaining environment in bankruptcy, some judges have been unsure about their enforceability. Other judges have not hesitated to enforce the agreements, at least when they do not restrict the voting rights of subordinated creditors. This essay argues that intercreditor agreements are controversial because they pose a trade-off: they reduce bargaining costs (by limiting the participatory rights of subordinated creditors), but can give senior lenders outsized influence over the bankruptcy process, to the detriment of investors who were not party to the intercreditor agreement. The essay proposes several rules of thumb that might help judges navigate this trade-off.

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I. INTRODUCTION

Intercreditor agreements set out the relative rights and remedies of creditors extending financing to a common borrower. Some agreements coordinate the collection efforts of a syndicate of lenders with equal priority. These "syndication agreements" will appoint an agent with exclu-

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sive power to enforce the creditors' rights against the borrower and allow a majority of creditors to direct the agent's debt collection decisions. The legal issues emerging from syndication agreements have been addressed before.[1]

Here I focus on issues emerging from intercreditor agreements that establish payment priorities, particularly among secured creditors. These agreements commonly go far beyond simply subordinating the repayment rights of certain creditors. These creditors often give up collection rights. For example, the agreement may impose a standstill period during which only senior creditors may exercise remedies against a defaulting borrower. It may also allow senior creditors to release the subordinated creditors' lien during a foreclosure sale. More controversially, an intercreditor agreement may waive or reassign rights that subordinated creditors would ordinarily possess in the event of the borrower's bankruptcy filing. These creditors may waive their rights to object to DIP financing provided by senior creditors, object to the sale or use of collateral, seek adequate protection, or file a plan of reorganization. An intercreditor agreement may even authorize senior creditors to vote the claims of subordinated creditors.

These agreements are reordering the Code's bargaining environment, and courts have been unsure whether to go along. The caselaw reveals conflicting views on intercreditor agreements, with some courts willing to enforce agreements that waive or assign bankruptcy rights, others less sure, and still others deeply skeptical of the agreements' enforceability.[2] Courts have good reason to be cautious about enforcing waivers and assignments of bankruptcy rights. Agreements with these provisions present a tradeoff. The upside is that they mitigate intercreditor conflict, thereby reducing costs of restructuring and reorganization (and reducing the debtor's cost of capital *ex ante*). The downside is that these agreements give senior creditors influence over the reorganization process that exceeds their economic stake in the outcomes of the process. They can vote the claims of both senior and subordinated claims, for example, even though they have an economic stake only in the senior claims. When senior creditors have influence that exceeds their economic stake, courts should worry that seniors may use that influence in ways that are harmful to creditors who were not party to the intercreditor agreement. Seniors, for example, may strategically block an efficient plan of reorganization in an attempt to extract a higher recovery.

Because waivers and assignments of bankruptcy rights present a tradeoff, the challenge for courts is to enforce them when benefits out-

1. *See, e.g.*, Paul J. Epstein, Beal v. Sommer: *Did Decision on Collective Action in Exercise of Lenders' Remedies Reflect Contracting Parties' Intent?*, 125 BANKING L.J. 240, 243–46 (2008); Michael R. Miller, Note, *No Standing Room: How Lender Collective Action Subverts Basic Principles of Contract Interpretation*, 2012 Colum. Bus. L. Rev. 330, 343–49.

2. *See infra* Part II.

weigh costs. This is a difficult task because it requires information that bankruptcy judges may not possess or have time to study. If a judge enforces an agreement barring objections by subordinated lenders, or allowing senior lenders to vote the claims of subordinated lenders, what harm will be suffered by creditors who are not party to the intercreditor agreement? Rules of thumb may be helpful here and, indeed, may explain the divergent outcomes in the caselaw.[3] In the paragraphs that follow, I summarize this caselaw, discuss the trade-off facing the courts, and assess potential rules of the thumb.

II. JUDICIAL APPROACHES

Looking across the cases, we see different approaches when judges face intercreditor agreements that waive or assign bankruptcy rights. One is to ignore provisions that reorder the bargaining environment, leaving aggrieved senior creditors to seek breach-of-contract damages in state court actions. This approach seems to derive from an intuition that Congress carefully designed a bankruptcy process with many checks and balances, such as the right of any party in interest to object to DIP financing motions, the best interests test, class-based voting rules, voting rules that combine majority and super-majority thresholds, and the absolute priority rule. An intercreditor agreement that bargains around these checks and balances may be sensible to the parties signing the agreement, but harmful to nonsignatories because it eliminates resistance (by subordinated creditors) and prevents coalition-building (between subordinated creditors and nonsignatories).

This approach can seen in an early case addressing intercreditor agreements under the 1978 Code, *In re Hart Ski Manufacturing Co*.[4] There the intercreditor agreement governed the rights of creditors with liens on the same collateral.[5] The court refused to enforce the agreement to the extent that it waived the subordinated creditors' right to seek adequate protection or file a lift-stay motion.[6] Enforcing such a waiver would be "totally inequitable":

> The intent of § 510(a) (subordination) is to allow the consensual and contractual priority of payment to be maintained between creditors among themselves in a bankruptcy proceeding. There is no indication that Congress intended to allow creditors to alter, by a subordination agreement, the bankruptcy laws unrelated to distribution of assets.
>
> The Bankruptcy Code guarantees each secured creditor certain rights, regardless of subordination. These rights include the right to assert and prove its claim, the right to seek Court ordered protec-

3. *See infra* Part II.
4. 5 B.R. 734 (Bankr. D. Minn. 1980).
5. *Id.* at 735.
6. *Id.* at 736.

> tion for its security, the right to have a stay lifted under proper circumstances, the right to participate in the voting for confirmation or rejection of any plan of reorganization, the right to object to confirmation, and the right to file a plan where applicable. The above rights and others not related to contract priority of distribution pursuant to Section 510(a) cannot be affected by the actions of the parties prior to the commencement of a bankruptcy case when such rights did not even exist.[7]

Similar intuition was expressed in *In re 203 N. LaSalle Street Partnership*,[8] on remand from the Supreme Court. There the agreement gave the senior lender the right to cast votes on behalf of the subordinated lender.[9] The court refused to enforce the vote-reassignment, emphasizing that the reassignment would destabilize the bargaining environment of the Code:

> [S]ince bankruptcy is designed to produce a system of reorganization and distribution different from what would obtain under nonbankruptcy law, it would defeat the purpose of the Code to allow parties to provide by contract that the provisions of the Code should not apply . . . .
>
> Subordination affects only the priority of payment, not the right to payment. If the assets in a given estate are sufficient, a subordinated claim certainly has the potential for receiving a distribution, and Congress may well have determined to protect that potential by allowing the subordinated claim to be voted. This result assures that the holder of a subordinated claim has a potential role in the negotiation and confirmation of a plan, a role that would be eliminated by enforcing contractual transfer of Chapter 11 voting rights.[10]

This approach or "rule of thumb"—to be deeply skeptical of efforts to contract around the Code's bargaining environment—continues to influence bankruptcy courts.[11]

A very different rule of thumb is to enforce intercreditor agreements in the same way that a court enforces any subordination agreement: absent a prohibition in nonbankruptcy law or the Code, subordination agreements are fully enforceable in bankruptcy thanks to section 510(a). A good illustration comes from *In re Aerosol Packaging, LLC*.[12] The court allowed senior creditors to vote the claims of subordinated creditors:

7. *Id.*

8. 246 B.R. 325 (Bankr. N.D. Ill. 2000).

9. The agreement stated that the "[Subordinate Lender] hereby irrevocably agrees that the [Senior Lender] may, at its sole discretion, in the name of [Subordinate Lender] or otherwise, . . . file, prove, and vote or consent in any [bankruptcy] proceedings with respect to, any and all claims of [Subordinate Lender] relating to the [Subordinate Lender's claims]." *Id.* at 328.

10. *Id.* at 331–32.

11. *See, e.g.*, *In re* Croatan Surf Club, No. 11–00194–8–SWH, 2011 WL 5909199, *2 (Bankr. E.D. N.C. Oct. 25, 2011) (refusing to enforce a vote-reassignment provision, citing *Hart Ski Mfg. Co.*, 5 B.R. at 735, and *203 N. LaSalle St. P'ship*, 246 B.R. at 325); *In re* SW Boston Hotel Venture, 460 B.R. 4, 4 (Bankr. D. Mass. 2011) (same), *vacated in part on other grounds*, 479 B.R. 210 (B.A.P. 1st Cir. 2012).

12. 362 B.R 43 (Bankr. N.D. Ga. 2006).

> 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. Section 510(a) renders a subordination agreement enforceable to the extent enforceable under applicable nonbankruptcy law. The Subordination Agreement appears to be enforceable under Georgia law, which is the applicable nonbankruptcy law. Federal Rules of Bankruptcy Procedure 3018 and 9010 explicitly permit agents and other representatives to take actions, including voting, on behalf of parties.[13]

Several other cases have applied similar logic.[14]

Another line of cases takes the middle road. These cases do not involve voting rights. They deal with intercreditor agreements that force subordinated creditors to remain silent during the Chapter 11 case. Courts have enforced these agreements to bar the creditors from seeking appointment of an examiner,[15] objecting to use of cash collateral,[16] and objecting to a reorganization plan.[17] Initially, these cases look a lot like the previous decisions allowing senior creditors to vote the claims of subordinated creditors. The courts begin with familiar analysis: these intercreditor agreements are unambiguous, enforceable under nonbankruptcy law, enforceable in bankruptcy thanks to section 510(a), and not at odds with any provision of the Code.[18] Why should a court "disturb the bargained-for rights" of senior lenders pursuant to a "plainly worded contract[] establishing priorities and limiting obstructionist, destabilizing and wasteful behavior" by subordinated creditors?[19]

But the courts do not stop there. They have gone on to consider the merits of the motions or objections raised by subordinated creditors. In *In re Erickson Retirement Communities, LLC*, the court found that subordinated creditors had bargained away the right to seek appointment of an examiner, but nonetheless went on to consider the merits of the motion.[20] We see the same move in *In re Ion Media Networks, Inc*. There the court held that the intercreditor agreement barred subordinated credi-

13. *Id.* at 47.

14. *See, e.g.*, *In re* Coastal Broad. Sys., Inc., No. 12–5683 (RMB), 2013 WL 3285936, at *6 (D. N.J. June 28, 2013); *In re* Curtis Ctr. Ltd. P'ship, 192 B.R. 648, 660 (Bankr. E.D. Pa. 1996).

15. *See, e.g.*, *In re* Erickson Ret. Cmtys, LLC, 425 B.R. 309, 316–17 (Bankr. N.D. Tex. 2010) ("The Michigan Retirement System Entities are sophisticated commercial entities who knowingly waived all legal and statutory rights that would be in conflict with their obligation to 'standstill' until [senior lender debt] is paid in full.").

16. *See, e.g.*, Aurelius Capital Master, Ltd. v. TOUSA Inc., Nos. 08–61317–CIV, 08–61335–CIV, 2009 WL 6453077, at *8 (S.D. Fla. Feb. 6, 2009).

17. *See, e.g.*, *In re* Ion Media Networks, Inc., 419 B.R. 585, 597 (Bankr. S.D.N.Y. 2009) ("The Transaction Documents make clear that [the subordinated lender], by purchasing second lien debt that was expressly subject to the Intercreditor Agreement, agreed to remain silent in the event of a chapter 11 case.").

18. *See, e.g.*, *Erickson Ret. Cmtys*., 425 B.R. at 313–14.

19. *Ion Media*, 419 B.R. at 595.

20. 425 B.R. at 316–17.

tors from objecting to the reorganization plan.[21] It then held that, even if these creditors had standing to object, their objections lacked merit.[22]

Thus, while these cases purport to enforce the intercreditor agreement, they give subordinated creditors precisely what they bargained away—the opportunity to object. To be sure, senior creditors retain the right to sue subordinated creditors for breach-of-contract damages.[23] But measuring those damages is difficult. In *Ion Media Networks*, the court suggested that senior creditors could at least recover the increase in administrative costs attributable to the objections filed by subordinate creditors.[24] But, demonstrating a causal connection between administrative costs and these objections will be hard, especially in a case like *Ion Media Networks*. When it considered the merits of the objections in that case, the court explained that it had an "independent obligation to review the Plan to make sure that it satisfies the standards for plan confirmation set forth in section 1129."[25] How, then, should we characterize the administrative costs associated with flyspecking the plan? Are they attributable to the subordinated creditors' violation of the intercreditor agreement, or do they arise from the court's independent duty to review the plan?

But the more important question is whether courts should ever enforce intercreditor agreements that waive or assign bankruptcy rights. We see different approaches (rules of thumb) in the caselaw, but the principles guiding these approaches are unclear. What harm arises when the parties write contracts that vary the Code's bargaining environment? Is the harm greater in some contexts than others?

III. A TRADEOFF

It may be helpful to focus on a tradeoff presented by intercreditor agreements. These agreements reduce decisionmaking costs in the event of default, but also give senior lenders power to exploit subordinated creditors and potentially other investors in the firm.[26] They reduce decisionmaking costs by preventing subordinated creditors from objecting to

21. 419 B.R. at 595.

22. *Id.* at 598–603; *see also* Aurelius Capital Master, Ltd. v. TOUSA Inc., Nos. 08–61317–CIV, 08–61335–CIV, 2009 WL 6453077, at *1 (S.D. Fla. Feb. 6, 2009) (finding first that the subordinated creditors lacked standing to object to the use of cash collateral, but holding that that objection was equitably moot, nonjusticiable, and lacked merit).

23. Donald P. Seberger, *Subordination and Inter-Creditor Agreements*, *in* SECURED TRANSACTIONS § 9.25 (Fishman et al. eds., 2013), *available at* http://www.iicle.com/links/SecuredTrans07-10S-Ch9-Seberger.pdf (noting that a "senior lender is in a position to assert a claim for not only breach of contract but also breach of fiduciary duties if the junior creditor fails to comply with the payment terms of the subordination agreement.").

24. *Ion Media Networks*, 419 B.R. at 590 n.4.

25. *Id.* at 598.

26. This tradeoff is presented by all decisionmaking rules, including majority rule, as Buchanan and Tullock emphasized. Majority rule reduces decisionmaking costs (relative to unanimous rule), but exposes the losing minority to exploitation. *See generally* JAMES M. BUCHANAN & GORDON TULLOCK, THE CALCULUS OF CONSENT: LOGICAL FOUNDATIONS OF CONSTITUTIONAL DEMOCRACY ch.8 (1962).

proposals or otherwise increasing administrative costs, and by giving senior lenders power to act on their behalf. These effects on decisionmaking (or administrative) costs are important to the courts. In *In re Ion Media Networks*, for example, the court highlighted the "public policy" served by enforcing waivers of bankruptcy rights in these agreements: "Affirming the legal efficacy of unambiguous intercreditor agreements leads to more predictable and efficient commercial outcomes and minimizes the potential for wasteful and vexatious litigation."[27] The caselaw is littered with examples of such "vexatious litigation."[28]

But intercreditor agreements expose other creditors to exploitation because senior creditors can use their control over the subordinated claims to block efficient plans of reorganization, silence potentially important resistance to the sale or use of collateral, and prevent coalition building between subordinated and other creditors. Because senior creditors control the bankruptcy rights of subordinated claims, but do not own those claims, they are undeterred from using those rights to destroy value for those claims and other investors. This is not worrisome if the only parties suffering harm are the subordinated creditors who bargained away their rights to object, presumably for compensation. But it is worrisome if the harm extends to other investors—creditors and equityholders—who were not party to the intercreditor agreement. With respect to them, the intercreditor agreement imposes a negative externality.

By silencing subordinated creditors, an intercreditor agreement can eliminate the most important resistance to collateral sales or financing motions, particularly first-day motions. Subordinated creditors may have superior information to general unsecured creditors because they hold security interests in the debtor's collateral and have therefore more closely monitored the debtor's condition prior to bankruptcy. If junior creditors become "silent second liens," they cannot object to case developments that benefit senior lenders at the expense of all other creditors. To be sure, the affected creditors (and shareholders) can take steps to protect themselves by forming committees and objecting to motions filed by senior lenders. But it takes time for an unsecured creditors' committee to form.[29] It may also take time for the committee or other creditors

27. *Ion Media Networks*, 419 B.R. at 595; *see also In re* Erickson Ret. Cmtys, LLC, 425 B.R. 309, 315 (Bankr. N.D. Tex. 2010) ("This is the very type of obstructionist behavior that the agreements are intended to suppress.").

28. *See, e.g.*, *In re* Adelphia Commc'ns Corp., 359 B.R. 54, 63 (Bankr. S.D.N.Y. 2006) ("[A] culture has developed in large chapter 11 cases in which many consider it acceptable, and indeed expected, to use the litigation process as a means to assert or follow through on threats, and to seek various kinds of relief, to secure 'leverage' in efforts to increase recoveries.").

29. *See, e.g.*, *In re* Shorebank Corp., 467 B.R. 156, 158 (N.D. Ill. 2012) (noting that the unsecured creditors' committee was formed on March 2, 2012, about two weeks after the Chapter 11 filing on Feb. 15, 2012); Official Comm. of Unsecured Creditors v. Nucor Corp. (*In re* SGL Carbon Corp.), 200 F.3d 154, 158 (3d Cir. 1999) ("Two weeks after SGL Carbon filed its petition and issued the press release, the United States Trustee formed a nine member Official Committee of Unsecured Creditors."). *See generally* Michelle M. Harner & Jamie Marincic, *Committee Capture? An Empirical Analysis of the*

to gather sufficient information to understand the consequences of motions filed by senior lenders. An intercreditor agreement may pose the greatest risk of harm to other creditors (those not bound by the agreement) when senior lenders file first-day motions and the only creditors in a position to object are already silenced by the agreement.

The intercreditor agreement may also allow senior creditors to exercise "hold up" power. Any creditor can threaten to hold up the bankruptcy process—by filing objections, demanding valuations, seeking appointment of trustees or examiners—in order to extract better treatment (or a bribe).[30] But the threat is not credible in many cases, because the threatened action may harm the creditor as much (or more) than it harms others. Think of the unsecured creditor who wants a higher recovery and threatens to file numerous objections that will slow the case and burn firm value. Filing objections is costly, and any burn in firm value will often cause greatest harm to junior investors, including unsecured creditors and shareholders (because they are paid last in a system committed to the absolute priority rule). The unsecured creditor's threat will be credible, then, only when the threatened action will disproportionately harm other creditors who are expected to receive recoveries through the reorganization process. When the threat is credible, these creditors might be willing to pay the unsecured creditor to settle the objections.[31]

Senior creditors can make credible threats when they control the bankruptcy rights of subordinated creditors. They can vote the subordinated creditors' claims, or prevent them from filing objections, even if doing so reduces recoveries for these and all other investors. Suppose, for example, that seniors control the votes of junior creditors, whose claims are classified in a reorganization plan together with those of other creditors who are not bound by the agreement. If the junior creditors' claims represent a sufficiently large share of the claims in the class, senior creditors will effectively control the class without actually owning any of the claims in the class.

In other words, actions that would be irrational for a subordinated creditor will be rational for a senior creditor that controls but has no economic stake in the subordinated creditor's claims. *In re SW Boston*

Role of Creditors' Committees in Business Reorganizations, 64 VAND. L. REV. 749 (2011) (documenting the role of creditors' committees in business cases).

30. *See Adelphia Commc'ns Corp.*, 359 B.R. at 58 (describing various techniques that have been used to hold up bankruptcy proceedings in order to improve recovery).

31. The threat can be credible, for example, when junior investors are "out of the money" in the sense that they expect no payoff if the firm is liquidated or reorganized. In such a case, junior investors may try to delay ultimate resolution of the case in the hope that the firm's value (or the judge's appraisal) will increase. Delay imposes little or no costs on these junior investors (because they are already out of the money), but they can benefit from it. This and other credible threats to delay the reorganization process have been discussed by many scholars. *See, e.g.*, Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 Yale L.J. 1930, 1955–57 (2006); Anthony J. Casey, *The Creditors' Bargain and Option-Preservation Priority in Chapter 11*, 78 U. CHI. L. REV. 759, 785 n.107 (2011).

Hotel Venture, LLC,[32] may offer an illustration. The debtor's proposed plan had been accepted by all classes except the bank, which held a secured claim and filed many objections to cramdown.[33] The bank was party to an intercreditor agreement that gave it power to vote the claims of subordinated secured creditors.[34] Although these creditors had submitted their own vote in favor of the plan, the bank sought to override their vote and vote their claims against the plan.[35] The only effect of doing this was to raise the cost of cramming down a plan that had been accepted by all other classes, including several impaired classes, and that offered full repayment of the bank's claim.[36] Although the bank disputed the interest rate, the subordination agreement allowed it to recover any deficiency from the subordinated creditors, who were also being paid in full.[37] Here, then, it appears that the senior creditors attempted to use the intercreditor agreement to hold-up the reorganization process.

The risk of exploitation by senior creditors is very similar to the risks associated with "empty voting,"[38] which occurs when investors acquire influence in a bankruptcy case—voting rights, standing to file objections—without owning claims or interests. They can do this through the use of financial derivatives. An investor, for example, can simultaneously purchase and short-sell a debtor's shares or notes. Although it formally owns shares (or notes), and therefore has voice in the bankruptcy process, the creditor has no meaningful economic interest in those shares. It has fully hedged its exposure to ups and downs in share price: if the price rises, the creditor owns a more valuable stock, but also has a more costly liability (the short). The two offset.[39] Empty voting occurs when an investor votes or otherwise influences the bankruptcy case, but does not fully bear the costs or benefits of its influence. The investor can adversely affect the bankruptcy process by fostering inefficient plans or blocking efficient ones.[40]

An inefficient plan, for example, could be confirmed along the following lines: suppose senior lenders propose a plan that is opposed by all other classes. Ordinarily, the plan would be unconfirmable—and would

32. 460 B.R. 38 (Bankr. D. Mass. 2011), *vacated in part on other grounds*, 479 B.R. 210 (B.A.P. 1st Cir. 2012).

33. *Id.* at 47

34. *Id.*

35. *Id.* at 48.

36. *Id.* at 49.

37. *Id.* at 17.

38. *See generally* Henry T. C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625 (2008).

39. Examples from recent cases are collected by Jonathan C. Lipson, *The Shadow Bankruptcy System*, 89 B.U. L. REV. 1609, 1649–50 (2009).

40. To be sure, empty voting may be substantially more worrisome than vote-assignment provisions because empty voting is much less detectible. Intercreditor agreements can be read by the parties. It may be impossible to know whether a creditor has fully hedged its exposure to a particular claim. Due to this lack of transparency, empty voting can make it much harder for parties to negotiate in bankruptcy.

not even be eligible for cramdown—because it violates section 1129(a)(10), which requires that at least one impaired class vote in favor of the plan.[41] An intercreditor agreement could be used to bypass this requirement. By voting the claims of junior creditors, seniors can force their (impaired) class to vote in favor of the plan.

The downside of intercreditor agreements (and empty voting) is clear: they potentially allow a senior lender to harm other creditors and the estate in an effort to increase its own payoffs. Intercreditor agreements, in other words, foster a dictatorship by senior lenders. But a democracy may be no better. The upside of intercreditor agreements is that they prevent subordinated creditors from taking actions that increase reorganization costs.

Hence the tradeoff. The court's job is to strike the right balance between minimizing decision costs and avoiding senior creditor exploitation.

IV. BALANCING THE TRADEOFF

Because intercreditor agreements present a tradeoff, neither extreme—always enforce or never enforce—is optimal. An ideal court would enforce waivers or assignments of bankruptcy rights when benefits outweigh costs. But an ideal court has complete information and the time and expertise to process it instantaneously. An ideal court also has discretion to make the appropriate tradeoff. Our world is different.

It is different because the Bankruptcy Code may not give judges discretion to balance the tradeoff. Section 510(a) directs judges to enforce subordination agreements in bankruptcy.[42] This could be read as a mandate to enforce intercreditor agreements *in toto*. Alternatively it could be read as a mandate to enforce the subordination provisions of such agreements, but nothing else. The latter reading is plausible if we view section 510(a) as Congress' effort to single out a particular intercreditor agreement for enforcement. By enforcing subordination agreements, the argument goes, Congress was implicitly denying enforcement to other types of intercreditor agreements. Both readings of section 510(a) leave little (or no) judicial discretion to balance (1) reductions in decision making costs, against (2) risks of exploitation by senior creditors.[43]

Even if judges lack authority to do this balancing, they can force the parties to do it instead. Consider, for example, a first-day motion for postpetition financing. Suppose senior secured creditors offer to supply

41. 11 U.S.C. § 1129(a)(10) (2012).
42. 11 U.S.C. § 510(a).
43. Section 105(a) offers little help here either, because the Supreme Court has made clear that it merely aids the court in carrying out other provisions of the Code. It is not an independent source of discretion. *See* Law v. Siegel, 134 S. Ct. 1188, 1194 (2014).

the financing, but with onerous terms such as a covenant requiring a quick sale of core assets. Junior secured creditors oppose the financing but are silenced by the intercreditor agreement. No other creditor has objected to the motion. The judge's primary worry in a case like this is that she has not received sufficient information to evaluate the motion for postpetition financing. She is receiving one-sided information from the debtor (allied with the secured creditor). The proposed financing may be value-maximizing, or it may harm other creditors who are not yet sufficiently organized or informed to participate in the case.

There is a simple solution to the judge's problem: *delay*. The motion for postpetition financing is asking the judge to make an irreversible decision. The judge, however, can wait to make that decision at a point in time when she has sufficient information to weigh the costs and benefits. The greater the uncertainty about the potential harm to the estate from a quick decision, the greater the value of waiting.[44] Moreover, by waiting, the judge gives time for an unsecured creditors' committee to form and for other stakeholders to file objections. In this way, the bankruptcy process benefits from the intercreditor agreement (avoiding infighting among signatories to the agreement) without exposing the estate to harm.

The judge's ability to delay and gather information is a powerful way to minimize the downsides of many intercreditor agreements. If the primary effect of an agreement is to limit opposition to senior creditor proposals, the judge need only give time for opposition to form among creditors who have not signed the agreement. Even if judges lack discretion to selectively enforce intercreditor agreements, they can demand greater delay when they are most concerned about the consequences of these agreements.

Delay may be unnecessary when enforcement of the intercreditor agreement will affect only the allocation of payoffs among creditors that signed the agreement. For example, a provision barring juniors from challenging seniors' liens will affect the relative payoffs of these creditors, but is unlikely to harm creditors who did not sign the agreement.

A judge might also be willing to enforce an agreement without delay when the agreement's signatories have security interests in all or substantially all of the debtor's assets and their claims are deeply undersecured. In a situation like this, where secured debt exceeds firm value, the only likely beneficiaries of the Chapter 11 process are the parties who signed the intercreditor agreement. There is likely little harm from enforcing the intercreditor agreement: it will bind the parties to their agreement, but have no impact on other investors, who are highly unlikely to receive a recovery.

44. The judge, in other words, is deciding the optimal time to exercise a real option. *See* Douglas G. Baird & Edward R. Morrison, *Bankruptcy Decision Making*, 17 J.L. ECON. & ORG. 356 (2001).

Similar logic would imply that intercreditor agreements should be enforced whenever the bankruptcy case is primarily a battle between senior and subordinated creditors. *In re 203 N. LaSalle Partnership* may have been a case like this.[45] The debtor's creditors included a bank with a nonrecourse mortgage ($93 million), insiders with a nonrecourse mortgage ($11.3 million), priority tax claims ($2.3 million), and a small amount of unsecured debt (amounting to $90,000).[46] If a judge were satisfied that, regardless of the outcome of the Chapter 11 case, priority tax and unsecured claims would be paid in full, this is just a fight between senior and subordinated creditors.

There are a variety of difficulties with this rule of thumb. One is that, if the Chapter 11 case actually boils down to a fight among secured creditors, all of whom are parties to an intercreditor agreement, it is not clear why there is a bankruptcy filing in the first place. The filing might be an attempt by some signatories to gain an extracontractual advantage over others. If so, the case should be dismissed. The filing might also be an effort by the secured creditors to divert value from nonsignatories. This is precisely the negative externality that we worry about when the creditors seek enforcement of an intercreditor agreement. And, of course, there is a school of thought that Chapter 11 cases are never purely redistributional because postfiling increases in going concern value might belong to unsecured creditors.[47] These considerations suggest that, even when secured debt appears to exhaust firm value, enforcement of the intercreditor agreement could harm investors who have not signed the agreement. A judge might want to delay making a decision until she is confident about the effects on those investors.

Vote assignment provisions present special problems. These may pose the greatest risk of harm to investors who are not party to the intercreditor agreement. As discussed above, a senior creditor can block a plan, or overcome dissent, by voting the claims of junior creditors. In this way, seniors can use vote-assignment provisions to harm the estate and investors generally. Judicial delay is less helpful in this setting: when a senior files a motion that juniors cannot oppose (due to the intercreditor agreement), judicial delay gives other potentially affected creditors time to mount an objection. The judge can then decide whether to grant the motion. But when a senior proposes voting the claims of juniors, judicial delay offers little help. With or without delay, the senior creditor will vote the claims of juniors and that vote will determine the fate of the re-

45. 246 B.R. 325 (Bankr. N.D. Ill. 2000).

46. These numbers are reported in *Bank of Am. Nat'l. Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 438 (1999).

47. *See, e.g.*, Michelle M. Harner, *The Value of Soft Assets in Corporate Reorgnizations*, 2015 U. ILL. L. REV. 509; Edward J. Janger, *The Logic and Limits of Liens*, 2015 U. ILL. L. REV. 589. At least one court agrees. *See In re* Residential Capital, LLC, 501 B.R. 549, 612 (Bankr. S.D.N.Y. 2013). *But see* Douglas G. Baird, *The Rights of Secured Creditors After* Rescap, 2015 U. ILL. L. REV. 847.

organization plan (unless delay gives other creditors time to form a coalition that can successfully resist the senior creditor).

Vote-assignment provisions, then, present the most difficult challenge for bankruptcy judges. Some discretion is available here: a judge can designate votes that were not cast in "good faith."[48] Absent clear evidence of abuse, however, it may be difficult for a judge to assess whether the senior is voting junior claims in order to maximize or hedge an economic recovery (permitted) or to advance some ulterior motive (not permitted).[49]

In this setting, where the risk of harm to other creditors is high, it might make sense for judges to deny the enforceability of vote-assignment provisions. The Code already implements a complex, if not Byzantine, process for balancing decisionmaking costs against exploitation risks. Even if an intercreditor agreement can improve on this balance, it does so without the knowledge or consent of creditors who have not entered the agreement. A primary virtue of the Code's balancing is that it applies to and is anticipated by all parties.

48. 11 U.S.C. § 1126(e) (2012).
49. *See, e.g.*, *In re* Adelphia Commc'ns Corp., 359 B.R. 54, 63 (Bankr. S.D.N.Y. 2006).