SUBORDINATION AGREEMENTS

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THE past two decades have witnessed an impressive increase in the ulitization of subordination agreements. Indeed, in modern corporate financing, the subordination agreement has become almost commonplace, albeit a complex instrument surrounded by misconception and confusion. Nevertheless, the basic concept of a subordination agreement is simple: It is the subordination of the right to receive payment of certain indebtedness (the subordinated debt[1]) to the prior payment of certain other indebtedness (the senior debt) of the same debtor. Put another way—in the circumstances specified in the subordination agreement, the senior debt must be paid in full before payment may be made on the subordinated debt and retained by the subordinating creditor.

One type of subordination agreement is typified in corporate issues of subordinated bonds and debentures; while the other basic type is most often used in connection with bank loans to corporate borrowers. The expansion in the volume of both these forms of corporate financing has contributed to the increased employment of the subordination agreement.

Starting in the late 30's and early 40's with issues by sales finance and small loan companies, spreading to the oil and chemical industries, thence to the industrials and most recently to the public utilities, subordinated bond and debenture issues have proved their ability to supply the needs of expanding companies. For the corporation which desires leverage in its financial set-up, subordinated securities are superior in many instances to preferred stock issues, or, at the least, a valuable alternative therefor as a source of funds. Moreover, since these issues are regarded by senior debt holders as equity capital rather than debt,[2] they furnish an equity base upon which may properly rest a commensurate increase in the issuing corporation's ability to obtain short-term bank financing. In fact, from the point of view of the bank (the senior creditor), subordinated debt is preferable to equity

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1. The term "subordinated debt" means the indebtedness which is subordinated. Alternative terms in current use are "junior debt" and "inferior debt." "Senior debt" means the indebtedness for the benefit of and to which the subordinated debt is subordinated. Alternatives to senior debt are "superior debt," "prior debt," (not in time) and, in certain cases where the senior debt is held by banks, "bank debt." The term "debtor" refers to the common debtor, *i.e.*, the borrower from the senior debt holder (sometimes called the "senior creditor" or "the holder of the senior debt") and from the subordinating creditor ("the subordinator" or "the holder of the subordinated debt"). Either debt may have been incurred prior in time to the other.

2. 10 J. OF FINANCE 1, 10 (1955).

capital,[3] since in the event of the debtor's bankruptcy the senior creditor will receive "double dividends" out of the bankrupt's estate—the dividends paid on the senior debt and, by reason of the subordination agreement provisions requiring them to be turned over to the senior creditor, the dividends paid on the subordinated debt. For example, assume that a bankrupt company has $600,000 of assets and has outstanding $500,000 of senior debt, $500,000 of subordinated debt, and $500,000 of other debt. On a distribution of all the assets of the company the senior debt would receive $400,000—the $200,000 dividend paid on the senior debt plus the $200,000 dividend paid on the subordinated debt—and the other debt would receive $200,000. If the subordinated debt had been preferred stock, however, the senior debt would have received only $300,000, with the remaining $300,000 being paid on the other debt.

Those corporations which, either by choice or circumstance, do not or cannot issue their obligations to the public or place them with institutional investors, will most likely turn to commercial banks for relatively short-term financing. Typically, in the case of a small corporation seeking financing from its local bank, whether for working capital, plant expansion, or other purposes, a condition of the bank's commitment may be the subordination of any loans by the corporation's principals or suppliers to the prior payment of the bank loan. The junior creditor will often be willing to have the debt owed him subordinated if the effective functioning of the debtor's business is dependent upon obtaining the additional financing. In other cases the bank may require that the corporation obtain subordinated loans from stockholders or other willing creditors. This type of subordination agreement would most likely provide that so long as any bank loan is outstanding these creditors may not be paid.

Currently, and unhappily, it cannot be said that those persons expert in this field always agree on the content or even the structure of subordination agreements. The reason for this confusion is the dearth of decisional law and the surprising absence of other writings on this subject.

This article will explore the two basic types of subordination agreements, the legal theories under which they are enforced, some drafting pitfalls which face those executing such agreements, and legal problems which may arise notwithstanding careful drafting of subordination agreements.

Types of Subordination Agreements

There are two basic types of subordination agreements. The "inchoate" type of subordination is so drawn that it does not become operative until a voluntary or involuntary distribution of assets of the debtor is made to its creditors; the specific event which triggers the subordination, such as bank-

3. Of course, an economic difference to the debtor between equity capital and subordinated debt is the fact that interest paid on subordinated debt would be an income tax deduction available to the debtor.

ruptcy or insolvency, will be specified in the agreement. Until such financial distress occurs, the subordinated debt may be amortized, payments may be made to a sinking fund therefor, or the subordinated debt may be redeemed or refunded by the debtor through other means, subject only to the specific limitations imposed by the instrument providing for or evidencing such debt. The inchoate type of subordination is, therefore, the most advantageous from the point of view of the subordinator and, because the junior debt may have been redeemed by the time insolvency strikes the debtor, the least beneficial to the senior creditor.

The other type is the "complete" subordination agreement, under which no payment of principal or interest on the subordinated debt is permitted so long as the debtor is obligated to the senior creditor, or so long as a specifically identified senior debt remains unpaid. Variations on the complete subordination may be obtained by merely limiting payment on the subordinated debt to a specified amount until the senior debt is retired, rather than prohibiting such payments entirely. Likewise, the inchoate agreement may be made more stringent, for example, by prohibiting payments to the subordinator during the continuance of any default in payment of the senior debt, rather than waiting until actual bankruptcy of the debtor.

The inchoate type of agreement is often found in corporate indentures which provide for subordinated bond or debenture issues. The beneficiaries of such a subordination are all of a particular class or classes of creditors, such as banks, other institutional lenders, or even all other creditors.

The complete subordination is more often drawn in favor of a particular creditor, or relating to a particular senior debt. An example is the printed bank form drawn in favor of the bank as to then outstanding and future loans by the bank to the debtor.

Under both types of subordination agreements, upon the distribution of the assets of the debtor, the senior debt must be paid in full before any payment is made on the subordinated debt, and all payments or distributions on the subordinated debt which would otherwise be paid to the holder of that debt must be paid over directly to the holder of the senior debt. Thus, both the inchoate and the complete subordinations have the practical effect of making the subordinated debt a type of security for the senior debt, available to the senior creditor upon a distribution of the assets of the debtor. However, in the case of the inchoate subordination, the "security," may decrease or even vanish because payments are permitted on the subordinated debt. In the case of the complete subordination, however, the subordinated debt is "locked-in" and its distributional value in bankruptcy becomes, in effect, just as much a security benefiting the senior debt holder as would, for example, a chattel mortgage in the hands of the foreclosing mortgagee.

Evaluation of the "security" will, of course, require a complex analysis of the proportionate relationship between senior debt, subordinated debt, other debt, security for any such debt, and equity capital to determine the extent to which each would share in the distribution of those assets potentially available.

Inchoate Subordinations

The usual inchoate subordinated bonds and debentures include the word "Subordinate" in their titles; a short paragraph will recite the fact of subordination, refer to the indenture under which they have been issued for a complete statement of the subordination provisions, and state that the holder, by accepting the bond or debenture, agrees to and becomes bound by such provisions.[4]

The inchoate subordination is then implemented by a provision such as:

> In the event of any distribution, division or application, partial or complete, voluntary or involuntary, by operation of law or otherwise, of all or any part of the assets of the Company (the issuer), or the proceeds thereof, in whatever form, to creditors of the Company, or upon any indebtedness of the Company, by reason of the liquidation, dissolution or other winding up of the Company or the Company's business, or any sale, receivership, insolvency or bankruptcy proceeding, or assignment for the benefit of creditors, or any proceeding by or against the Company for any relief under any bankruptcy or insolvency law or laws relating to the relief of debtors, readjustment of indebtedness, reorganizations, compositions or extensions, then and in any such event, any payment or distribution of any kind or character, either in cash, securities or other property, which shall be payable or deliverable upon or with respect to any or all of the Debentures [5] shall be paid or delivered direct to the holders of the Senior Indebtedness for application on said Senior Indebtedness, until said Senior Indebtedness shall first have been fully paid and satisfied and before any payment is made on the Debentures.

Taken literally, this clause would require that, in a reorganization of the debtor, any securities received by subordinated debt holders would have to be turned over to the senior debt holder. But, should the plan of reorganization provide that mortgage bonds, preferred stock, or similar higher class security, be issued to the senior debt holder and that common stock be issued to the subordinated debt holder (thus giving effect to the subordination), the latter should not be required, in terms of the intent of the subordination agreement,

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4. Typical language for inchoate subordination provisions appearing in corporate indentures is:

> The indebtedness evidenced by the Debentures and the payment of the principal of and premium, if any, and interest thereon shall be subordinate and subject in right of payment, to the extent and in the manner hereinafter set forth, to the prior payment in full of all Senior Indebtedness, whether now outstanding or hereafter incurred, and each holder of Debentures, or any coupon, by his acceptance thereof, agrees to and shall be bound by the provisions of this Article.

5. If the issuer of subordinated indebtedness is permitted to issue junior subordinated indebtedness, *i.e.*, indebtedness which would be subordinated to the principal subordinated indebtedness (the subordinated debentures), a clause along the following lines would be inserted at this point:

> including any such payment or distribution which may be payable or deliverable by virtue of the provisions of any securities which are subordinate and junior in right of payment to the Debentures . . . .

to turn the common stock over to the senior debt holder. To meet just such a possibility, some institutional purchasers of subordinated securities have insisted on a clause excepting from the above-quoted provision "any such payment or distribution authorized by an order or decree giving effect, and stating in such order or decree that effect is given, to the subordination of the Subordinated Indebtedness to the Senior Indebtedness, and made by a court of competent jurisdiction in a reorganization proceeding under any applicable bankruptcy law." This is often coupled with another exception covering "any such payment or distribution of securities which are subordinate and junior to the payment of all Senior Indebtedness then outstanding."

Some of the larger bank lenders prefer instead something like the following as a modification of the "turn-over" clause:

> . . . but subject to the power of a court of competent jurisdiction to make other equitable provision reflecting the rights conferred in this Note [the subordinated debt instrument] upon the Senior Indebtedness and the holders thereof with respect to the subordinated indebtedness represented hereby and the holder thereof by a lawful plan of reorganization under applicable bankruptcy law.

A glaring defect to the full realization of the senior creditor's benefits is inherent in the inchoate subordination. From the practical point of view, probably one of the least successful ways for a creditor to collect money from a debtor is to put the debtor into bankruptcy. Thus, creditors are reluctant to take that step which is essential to the full effectuation of the inchoate subordination. One way of alleviating this hardship, from the point of view of the senior creditor, is to have the indenture provide that during the continuance of any default in the payment of either principal of or interest on the senior debt, no payment (whether of principal, interest, premium, or to a sinking fund) will be made on the subordinated debt. Thus, the subordination would become operative upon the occurrence of any such default prior to bankruptcy.

When bankruptcy of the debtor ensues, it is obviously important that there be as great an amount of assets as possible available for senior creditors. Since the inchoate type of subordination does not become effective until the debtor is in financial trouble, and regular payments on the subordinated debt are usually permitted until then, it may well be that the subordinated debt will have been completely retired by the time the trouble develops. Bank senior creditors, therefore, often include in loan agreements provisions which limit payments or prepayments of the subordinated debt to an agreed basis; this will have the effect of keeping the subordinated debt in existence for a longer time. From the point of view of the subordinator, however, a limitation on payment on the subordinated debt on conditions which the subordinator may not know exist might well be objectionable. For example, such a limitation based on earnings of the debtor might result in a payment on the subordinated debt being received by the junior creditor in good faith, only to have to disgorge it later because of it having been made in violation of the terms of the senior bank loan agreement.

In many cases, at the time a corporation requests short-term financing from a bank, the corporation may already have outstanding subordinated bonds or debentures. Upon a review of the indenture pursuant to which these bonds or debentures were issued, the bank may find that some of these desired provisions, such as the limits on the payment of the junior debt, are not included in the indenture. To attain a satisfactory senior creditor position the bank may then require that the substance of the missing clauses be provided by way of covenants in the senior debt instrument. To enforce such covenants, the senior debt instrument would provide for the acceleration of the senior debt upon the violation by the debtor of any of such covenants. Almost invariably the senior debt instrument will also provide for such acceleration if "the subordinated debt or any part thereof shall become due and payable by involuntary acceleration of maturity thereof."

Complete Subordinations

Most subordination agreements of the complete type are entered into for the express benefit of, and are addressed to, the holder of the senior indebtedness. A complete subordination agreement can take the form of a three party agreement (i.e., the bank, the borrower, and the subordinator), or an agreement signed only by the subordinator and the debtor, or, as in most cases, an instrument addressed to a particular bank and signed only by the subordinator. In some forms the debtor signs a short form of acceptance or agreement provided at the foot of the instrument. The printed bank form is particularly appropriate when the subordinator is an officer, director, or stockholder of the borrowing corporation since it is unlikely the agreement will require revision to reflect the intent of the parties. When the subordinator is a general creditor, and especially when the subordination agreement is being negotiated in connection with a bank loan then being made to the debtor, the agreement usually takes the three party form.

Very often the complete subordination agreement takes the form of a continuing agreement covering then existing and all future indebtedness of the debtor to the subordinator, and it will subordinate such indebtedness to both existing and future financial accommodations of the bank to the borrower.[6] Such an agreement will provide for termination only after due notice is given to the bank and only as to loans and extensions of credit made by the bank to the borrower after the bank's receipt of such notice of termination.

6. In Bank of America Nat'l Trust & Sav. Ass'n v. Erickson, 117 F.2d 796, 799 (9th Cir. 1941), the subordination agreement in issue did not specifically provide for the subordination of the subordinated debt to future indebtedness of the debtor to the senior creditors. The following dictum of the court on this point is interesting:

> The agreement of the two officers was to subordinate until all other obligations of the debtor, 'including interest accrued and to accrue thereon, have been fully paid, satisfied and discharged whether through bankruptcy . . . or other means . . . .' The agreement was to continue for a specific period; and a fair construction of the language and purpose of the contract obliges us to conclude that the claims were subordinated to all legitimate debts of the corporation, whether present or prospective.

Many bank subordinations of the complete type provide that in the event of any violation of the subordination agreement by either the subordinating creditor or the debtor, the senior debt becomes immediately due and payable. Carrying this a bit farther, such subordination agreements often provide that the senior debt will become due and payable upon the involuntary acceleration of the subordinated debt. Such a provision might appear to be contradictory to another typical provision: that the subordination provisions are to be definitive only of the rights of the senior creditor and the subordinator and that the obligation of the debtor to pay the subordinated debt in accordance with its terms is not to be impaired. There is no contradiction, however, as between the debtor and the subordinating creditor. The subordinated debt is still due and payable according to its terms. It is by reason of the subordination by the subordinating creditor running in favor of the senior creditor that payments on the subordinated debt are deferred in accordance with the terms of the subordination agreement. The acceleration provision relates to involuntary acceleration of the subordinated debt or the payment of the subordinated debt at its stated maturity in violation of the subordination provisions requiring that no such payment be made. In other words, although the junior creditor will not be paid until the senior debt has been satisfied, the obligation of the debtor to pay the junior debt according to its tenor remains, but the junior creditor cannot enforce that obligation. The junior creditor cannot receive his payments because of his agreement with the senior creditor, and not because his debtor's obligation has been impaired.

Although most complete subordinations provide that no payment of the subordinated debt will be made to the subordinator, there are lesser degrees of complete subordination agreements. Many agreements, for example, permit the payment of interest on the subordinated debt so long as the borrower is not in default under any of the senior debt instruments. Various exemptions may be carved out from the subordination.[7]

Most bank subordination agreements contain provisions covering the following additional points: should either the subordinating creditor or the debtor be a partnership, the agreement is not to be affected by any change in the partnership; the borrower and the subordinating creditor are to furnish financial statements of account between them and to permit the bank to examine their records; notice of acceptance of the agreement by the bank is waived; failure or delay in exercising rights does not act as a waiver of such rights; and the state whose laws are to govern is specified.

Inchoate or Complete?

Having distinguished the two basic types of subordination agreements, how should a court interpret an agreement which fails to make the distinction,

7. For example, payments of principal of the subordinated debt may be permitted in accordance with a predetermined earnings formula, or from the proceeds of the sale of certain capital assets or a different issue of subordinated securities.

and simply states that "debt *A* is hereby subordinated to debt *B*?" On the one hand, the argument may be advanced that as a matter of language the word "subordinate" means to place in a lower order or inferior position, and that the mere use of such word imports a complete type of subordination which prohibits any payment on the subordinated debt until the senior debt is fully paid. On this line of reasoning, therefore, additional language is necessary to turn such a complete subordination into an inchoate subordination. In other words, the subordination provision must also provide specifically that the subordination is to be effective only in the event of a distribution of assets of the debtor by reason of bankruptcy, insolvency, or other dissolution or liquidation proceeding. The opposing argument, that only an inchoate subordination is created by the simple provision mentioned above and that additional language is necessary to create a complete subordination, has as its basis the view that the word "subordinate" has no meaning in law except as the cases have delineated the concept of subordination. The argument continues: the cases have arisen only in bankruptcy matters, where the courts have sustained the validity of subordinations to the extent only that dividends payable on the subordinated debt out of the assets of the bankrupt are turned over to the senior debt holder. A dictum in *In re Aktieboleget Kreuger & Toll*[8] can be cited: "Subordination to the general creditors of the participating debentures would be meaningless in a solvent corporation . . . ."[9] It is clear that there is no real authority supporting either side of the argument—the law has not progressed to that point. The argument serves only to emphasize the need for well-drawn subordination agreements.

THEORIES OF VALIDITY AND ENFORCEABILITY

There is no doubt that subordination agreements of both types are valid agreements between the parties and will be enforced by the courts. Most of the cases on the subject have arisen in bankruptcy proceedings. Although the decisions evidence different theories upon which enforcement rests, in every case save one[10] the subordination agreement was enforced, and the

8. 96 F.2d 768 (2d Cir. 1938).

9. *Id.* at 770.

10. Matter of Goodman-Kinstler Cigar Co., 32 Am. Bankr. R. 624 (S.D. Cal. 1914). In this one exception the Bankruptcy Referee held that an inartistic attempt to subordinate (the would-be subordinator having endorsed at the foot of a financial statement addressed to a lending bank by a debtor who subsequently became bankrupt an agreement "that you [the bank] are to be paid in full before we receive anything on our account") did "not have the effect of an assignment, legal or equitable, of the claim of the claimant [the would-be subordinator] against the bankrupt or of any dividends that might be declared thereon." *Id.* at 625-26. The Referee declared that an essential element to an equitable assignment, that of an actual appropriation of a fund sought to be assigned, was lacking. He also was of the view that "the bankruptcy court should not be involved in the enforcement of a covenant between the bank and the claimant which does not amount to an equitable assignment, and the bankruptcy court has no jurisdiction to enforce such a covenant," and advised the bank to "take its cause of action . . . to a State Court and try

dividends paid from the bankrupt estate on the subordinated claims were allocated to the senior debt.

Four separate theories of enforceability have evolved:

(1) The subordination agreement creates an equitable lien in favor of the senior creditor;[11]

(2) The subordination agreement creates an equitable assignment to the senior creditor of the subordinated debt claim in bankruptcy and dividends payable thereon;[12]

(3) The subordinator holds the dividends received as constructive trustee for the holder of the senior debt;[13]

(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.[14]

The basic rationale which appears from all the cases is that a bankruptcy court, being "a court of equity, with all the necessary powers to ascertain and determine the rights of persons in and upon the property and assets surrendered by the bankrupt"[15] will do equity between the parties so long as public policy and the Bankruptcy Act are not violated.

The Equitable Lien Theory

The equitable lien theory of enforcement of subordination agreements was succinctly stated by Judge Learned Hand in *In re Geo. P. Schinzel & Son*,[16] in 1926. In this case, at a meeting between the subsequently bankrupt cor-

it there." *Id.* at 628. This holding, cited in an unreported case, *In re* Delpark, Inc., Bankrupt, In Bankruptcy No. 51899, S.D.N.Y., 1937, was therein criticized by Judge Coffey as one which "is along purely legalistic lines, overlooks substance and, in principle, is at variance with what this court has determined in *In re* Geo. R. Schinzel & Son, Inc., 16 F.2d 289 (S.D.N.Y. 1926)." See also, Bird & Sons Sales Corp. v. Tobin, 78 F.2d 371 (8th Cir. 1935), in which the "remarks of the referee" in the Goodman-Kinstler case were rejected. The Goodman-Kinstler decision is not good law.

11. Searle v. Mechanics' Loan & Trust Co., 249 Fed. 942 (9th Cir. 1918); *In re* Geo. P. Schinzel & Son, Inc., 16 F.2d 289 (S.D.N.Y. 1926).

12. *In re* Handy-Andy Community Stores, Inc., 2 F. Supp. 97 (W.D. La. 1932).

13. In the Matter of Dodge-Freedman Poultry Co., 148 F. Supp. 647 (D.C. N.H. 1956), *aff'd sub nom.* Dodge-Freedman Poultry Co. v. Delaware Mills, Inc., 244 F.2d 314 (1st Cir. 1957).

14. Bird & Sons Sales Corp. v. Tobin, 78 F.2d 371 (8th Cir. 1935); *In re* Aktiebolaget Kreuger & Toll, 96 F.2d 768 (2d Cir. 1938); *In re* Associated Gas & Elec. Co., 53 F. Supp. 107 (S.D.N.Y. 1943), *aff'd* in Elias v. Clarke, 143 F.2d 640 (2d Cir. 1944) (a reorganization under Chapter X of the Bankruptcy Act); Bank of America Nat'l Trust & Sav. Ass'n v. Erickson, 117 F.2d 796 (9th Cir. 1941); In the Matter of Delpark, Inc., Bankrupt, In Bankruptcy, No. 51899, S.D.N.Y., 1937; St. Louis Union Trust Co. v. Champion Shoe Mach. Co., 109 F.2d 313 (8th Cir. 1940); see *In re* George C. Bruns Co., 256 Fed. 840 (7th Cir. 1919) (where, in a composition, the court enforced a guarantee of payment as a subordination).

15. *In re* Handy-Andy Community Stores, Inc., 2 F. Supp. 97, 98 (W.D. La. 1932). See also Annot., 100 A.L.R. 660 (1936).

16. 16 F.2d 289 (S.D.N.Y. 1926).

poration and a number of its creditors, some, but not all, of the creditors executed an agreement with the bankrupt under which persons supplying goods to the bankrupt were to have a priority over the claims existing at the time of the agreement. In refusing to sustain the Referee's order disallowing a claim by the suppliers for priority, Judge Hand said of these creditors:

> When former creditors continued to sell to the bankrupt, they got no pledge or mortgage as security; if they have any similar right, it must be by an equitable lien.

and of the creditors who signed the agreement:

> By signing the agreement, such creditors intended that the supplying creditors should have the first call on any payments made, and from this arose an equitable claim as against the signing creditors.[17]

The equitable lien theory was also utilized in *Searle v. Mechanics' Loan & Trust Co.*[18] to hold those junior creditors who signed a subordination agreement to their bargain. Although by its terms the agreement never went into effect because the required 90 per cent of the creditors of the bankrupt failed to sign it,[19] the signing creditors were estopped from objecting since they and all other parties believed that the agreement had become effective and funds to carry on the bankrupt's business had been advanced by the senior creditors over a period of five months. The court held:

> Owing to the fact that not all of the creditors of the bankrupt signed the trust agreement, the appellees' lien was not enforceable against the whole of the fund realized on the disposition of the bankrupt's estate. But clearly the creditors who actually signed the agreement thereby created an equitable lien on their interest in the funds which thereafter came into the control of the bankrupt court for administration. That court had jurisdiction to protect the lien claimants in the distribution of the funds payable as dividends.[20]

It should be observed that the court had no hesitancy in assuming that the bankruptcy court had sufficient jurisdiction to determine the rights to the bankrupt estate and all controversies relating to the estate.

The Equitable Assignment Theory

The equitable assignment theory has been used only in *In re Handy-Andy Community Stores, Inc.*[21] There, two individual creditors, being also officers and stockholders of the principal debtor, which subsequently became bankrupt, in order to induce the bank to purchase a $15,000 note of the bankrupt, agreed with the bank that "we, as individual creditors of said corporation,

17. *Ibid.*
18. 249 Fed. 942 (9th Cir. 1918).
19. *Id.* at 944.
20. *Id.* at 945.
21. 2 F. Supp. 97 (W.D. La. 1932).

should agree to subordinate our claim for said $20,000 to yours for $15,000 in respect of all assets of the corporation . . . and that in the event of insolvency or liquidation, your note aforesaid shall be paid as between you and us by preference and priority, over our claim."[22] The individual subordinators further agreed in case of bankruptcy to file their claim and make the "proper assignment thereof, should the same become necessary." When bankruptcy ensued, the bank claimed to be entitled to receive dividends on the subordinated claims of the individual creditors by reason of the subordination agreement. The individuals opposed this claim on the grounds that the agreement did not include an assignment and could not be sustained as a subrogation.[23]

Reversing the Referee's decision, which had supported the junior creditors, the court said:

> While the document does not convey a present title to the claimants, it amounts to an agreement to do so, in so far as relief in a court of equity is concerned, which becomes enforceable when the necessary conditions arise requiring it. For this reason, the legal title to the claims standing in the names of [the junior creditors], it was entirely proper for them [the bank] to prove the same before the referee.[24]

The Constructive Trust Theory

The constructive trust theory has been used only in *In re Dodge-Freedman Poultry Co.*[25] Freedman, the president and principal stockholder of Dodge-Freedman Poultry Company (the Debtor-Petitioner), in consideration of the extension of credit by Delaware Mills (Delaware) to the Poultry Company, executed a subordination agreement with Delaware under which he subordinated all of his claims against the Poultry Company, totaling $50,000, to the debt owed by the Poultry Company to Delaware, and agreed that no payments would be made to him until all amounts owing to the senior creditor had been satisfied. In January 1955, the Poultry Company filed a petition for an arrangement under Chapter XI of the Bankruptcy Act. The Plan of Arrangement subsequently adopted provided for a dividend of fifteen per cent to be paid on all unsecured claims in full satisfaction thereof. One such claim, proved by Mrs. Freedman, but found by the court to be Freedman's, was the $50,000 owing to Freedman. Before it was paid, however, Mrs. Freedman, by affidavit filed under General Order 41 of the Bankruptcy Act, waived her right to share in the dividend. Freedman's purpose was obvious. By waiving his claim, he hoped to enable the Poultry Company which he owned and directed to retain the $7,500 which would otherwise be paid to Delaware. Delaware,

22. *Id.* at 98.

23. On the subrogation issue the court held: "I do not consider that there is any question of subrogation involved, but simply the interpretation and enforcement of a valid contract which a court of equity under the circumstances revealed here is bound to respect." *Id.* at 99.

24. *Id.* at 98.

25. 148 F. Supp. 647 (D.N.H. 1956).

having received its fifteen per cent dividend on its own claim, leaving an unpaid balance in excess of $36,000, filed another proof of claim asserting its right to a $7,500 dividend (the dividend Freedman would have received had his claim not been waived) by virtue of the subordination agreement. The Poultry Company objected to the allowance of this claim. It contended that the subordination agreement gave Delaware "no property interest in the debt owed . . . to Harry Freedman, at least not until such debt was actually paid to him."[26] Delaware, citing *Bird & Sons Sales Corp. v. Tobin*, contended that the equity power of a bankruptcy court automatically converts a subordination agreement into an assignment upon the filing of the petition in bankruptcy. The Referee refused to sanction Freedman's "inequitable and deliberate act of avoidance" and ruled that Freedman was estopped from voluntarily waiving his right to a dividend. The Referee found that the subordination agreement "is and always was an equitable assignment" of Freedman's claim and ordered the $7,500 dividend thereon paid to Delaware. The court agreed with the Referee's order but disagreed with his reasoning. It specifically rejected both the equitable assignment and the equitable lien theories, the former on the ground that "there was no manifestation of intention, either written, oral, or by conduct, on the part of Freedman to relinquish control, or to make any appropriation to Delaware Mills, Inc."[27]

But the rejection of these theories left the court in a doctrinal dilemma. The forbearance agreement embodied in the subordination agreement prevented Freedman from collecting dividends on his own behalf as long as Delaware's claim remained unsatisfied. By waiving his right to a dividend, however, Freedman would violate the purpose of the subordination agreement by returning to the debtor money which both Freedman and Delaware had intended that Delaware, the senior creditor, would receive. The court therefore ruled that as a subordinating creditor Freedman had the right to collect the dividend only on behalf of the party equitably entitled to it. In short, Freedman was found to be a constructive trustee for Delaware Mills.[28]

In the light of the attempt made by the subordinator in *Dodge-Freedman* to escape the consequences of his subordination, it might be well to insert in

26. *Id.* at 649.

27. *Id.* at 651.

28. The court, for a definition of constructive trust, quotes from 4 SCOTT, TRUSTS § 462 (2d ed. 1956) as follows:

> A constructive trust arises where a person who holds title to property is subject to an equitable duty to convey it to another on the ground that he would be unjustly enriched if he were permitted to retain it. When a person holds the title to property which he is under an obligation to convey to another, and when that obligation does not arise merely because he has voluntarily assumed it, he is said to hold the property in constructive trust for the other and he is called a constructive trustee of the property. He is not compelled to convey the property because he is a constructive trustee; it is because he can be compelled to convey it that he is a constructive trustee.

148 F. Supp. at 652.

future subordination agreements a provision prohibiting waiver, forgiveness, or cancellation of the subordinated debt.

Further, it would be good practice for the subordination agreement to contain a provision giving the senior creditor power to file proof of claim on the subordinated indebtedness or to compel the holder of the subordinated debt to file proof of claim and to assign such claim to the senior creditor. Although, as a practical matter, it is unlikely that such a provision can be obtained where the outstanding subordinated debt is publicly held and is represented by a trustee, there is no sound reason for its absence in a bank subordination agreement of the complete type. Of course, the objective is to have proof of claim filed on behalf of the subordinated debt, and as a practical matter it is most improbable that the holder thereof would not file such proof of claim. In an extreme case, should the subordinator not so file and the senior creditor not have power to do so, and should the courts refuse specifically to order the proof of claim to be filed and the dividend on the subordinated debt paid over to the senior creditor, the result would be the elimination of the subordinated debt from any share in the assets of the debtor. This would place the subordinated debt, vis-à-vis the senior creditor, in the position of capital stock. Once proof of claim on the subordinated debt is filed, no assignment of the claim would be necessary—the subordination provisions would be effective to accomplish the payment of the dividend on the subordinated debt directly to the holder of the senior debt.

The Contract Theory

The theory that the bankruptcy court has the jurisdictional power to enforce the contractual rights of the parties in interest, when distributing a bankrupt estate, is the most logically supportable and sensible of all the theories. A concise expression of this theory appears in the *Bank of America Nat'l Trust & Sav. Ass'n v. Erickson*:

> The Bankruptcy Court has undoubted power to subordinate a general claim to other claims in the same category where for any reason, legal or equitable, it ought to be subordinated. The court may administer the estate and order its distribution conformably to the rights of creditors as fixed by their own contracts, if these are lawful.[29]

This theory was also adopted in *In re Delpark, Inc.*, in which opinion Judge Caffey further addressed himself to the jurisdictional question as follows:

> The jurisdiction of this court is adequate. Its exercise is an unavoidable incident of causing the estate to be distributed and of determining the controversies in relation to the distribution pursuant to subdivision 7 of Section 2 of the Bankruptcy Act. [Citations] It is not necessary that there be a plenary suit. All the interested parties were properly before the court which at the time was engaged in making a distribution.[30]

29. 117 F.2d 796, 798 (9th Cir. 1941).

30. See note 10 *supra*.

This is not to say that an equity court will in the first instance entertain a suit to enforce the payment of money pursuant to contract. In the instances discussed, the bankruptcy proceeding was in being and the parties were before the court.

Thus, *Collier on Bankruptcy* states:

> When the worst happens, and bankruptcy distribution ensues, the [subordination] agreement is presented to the bankruptcy court in support of a claim to priority in the payment of dividends ahead of creditors who agreed to be subordinated in liquidation. Such agreements are almost uniformly enforced by bankruptcy courts in spite of jurisdictional or statutory limitations suggested previously in this paragraph.[31]

Each of these theories is conclusionary; they are ways of rationalizing, rather than reaching, a desired result. In total, they show a general willingness on the part of courts to find a legal reason to enforce subordination agreements. Where the parties have agreed to make an assignment, as in the *Handy-Andy* case, the equitable assignment theory can be utilized. But *Dodge-Freedman* indicates that the equitable assignment theory, as well as the closely-related equitable lien theory, may not apply where the court feels that the parties have failed explicitly to articulate an intent either to assign or to create a lien. In this case, a constructive trust, which rests only on the relationship of the parties and the "conscience of equity"[32] can be invoked to legitimize the desired result. No court has yet based its decision on the concept of a resulting trust, but this brethren to the constructive trust might well prove to be as successful a theory as its better-known kin.

The notion of the bankruptcy court using its equity power to enforce the private contract of the parties has run head-on into two difficulties: one, a matter of statutory interpretation and the other, a question of contracting parties. First, the argument has been advanced[33] that subordination agreements may not be enforced because the allocation of bankruptcy dividends specified by the subordination agreement is inconsistent with the provisions of the Bankruptcy Act providing for pro rata dividends on claims. This argument has been consistently rejected. The courts have uniformly held that subordination agreements creating priorities among debts are not inconsistent with the Bankruptcy Act, are not contrary to public policy, and will be given effect by the bankruptcy court through the exercise of its equity power. This argument was first raised in the leading *Bird & Sons* case and emphatically rejected by a unanimous court.[34] In *In re Aktiebolaget Kreuger & Toll* the

31. 3 COLLIER, BANKRUPTCY § 65.06 (14th ed. 1956).

32. Beatty v. Guggenheim Exploration Co., 225 N.Y. 380, 386, 122 N.E. 378, 380 (1919); 4 SCOTT, TRUSTS § 462 (2d ed. 1956).

33. Bird & Sons Sales Corp. v. Tobin, 78 F.2d 371 (8th Cir. 1935); *In re* Aktiebolaget Kreuger & Toll, 96 F.2d 768 (2d Cir. 1938); *In re* Associated Gas & Elec. Co., 53 F. Supp. 107 (S.D.N.Y. 1943).

34. Bird & Sons Sales Corp. v. Tobin, 78 F.2d 371, 373 (8th Cir. 1935):

[Appellant] contends that the order now presented for review is violative of secargument was rejected by the Circuit Court of Appeals for the Second Circuit as follows:

> Section 64b of the Bankruptcy Act, . . . for reasons of public policy creates priorities regardless of the parties' contracts and overrides inconsistent covenants. But this does not mean that the parties are prohibited from making contracts for a priority or subordination in so far as they do not impinge upon statutory priorities. Section 65a . . . means no more than that dividends paid to creditors shall be pro rata except when there is a priority given by law or by lawful contractual arrangement between the parties.[35]

In all the cases, no matter what the theory, the court directive that payment of dividends on the subordinated debt be paid to the senior debt holder is made not on the basis of different ranks of claims but on the basis of the recognition of contractual obligations or equitable liens or assignments in the disposition of proceeds of claims of equal statutory rank. In other words, the subordinated debt is proved on a parity with the senior debt.[36]

Second, the would-be senior debt holder will often base his claim for a priority of payment on a written contract to which he is not a party.[37] For example, in the case of publicly issued subordinated debentures, the indenture

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tion 65a of the Bankruptcy Act, [66 Stat. 426 (1952)] 11 U.S.C. § 105(a) [(1958)], which provides: 'Dividends of an equal percentum shall be declared and paid on all allowed claims, except such as have priority or are secured.' Its theory is that the Bankruptcy Act compels equality in the distribution of dividends to general creditors and that section 65a defines and restricts the power of the court. In other words, that when the claim of general creditors has been allowed section 65a establishes an inexorable rule for the distribution of the fund and 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.

. . . [W]e are not persuaded that the powers of the bankruptcy court can be so narrowly limited. The provisions of section 65a for the equal distribution of dividends, when interpreted in the light of the broad equity powers granted the bankruptcy court under sections 1 and 2 of the Bankruptcy Act [64 Stat. 1113 (1950)] 11 U.S.C. §§ 1, 11, [(1958)] do not preclude that court from considering such a contract as was executed by appellant in this case, nor from applying equitable principles to the situation presented. [Citing cases]. By its adjustment of the order of payment the bankruptcy court conformed the distribution of the estate to accord with the rights of the parties, as such rights were fixed by their own contract. The contract violated no public policy nor the spirit of the bankruptcy law, but was entered into by the appellant and relied upon by those who extended credit on the faith of it in the hope that Barney Grosberg, Inc., could be maintained as a going concern.

35. 96 F.2d 768, 770 (2d Cir. 1938).

36. On this point, the holding in *In re* Geo. P. Schinzel & Son, Inc., 16 F.2d 289, 290 (S.D.N.Y. 1926) is instructive: "The order is affirmed, so far as it gives the nonjoining creditor its full dividends, on the basis of allowing all claims at their face without priority."

37. *In re* Aktiebolaget Kreuger & Toll, 96 F.2d 768 (2d Cir. 1938), and *In re* Associated Gas & Elec. Co., 53 F. Supp. 107 (S.D.N.Y. 1943), *aff'd sub nom.* Elias v. Clarke, 143 F.2d 640 (2d Cir.), *cert. denied*, 323 U.S. 778 (1944) are two cases involving subordinated debentures. In the former case the appellant argued that the Bankruptcy Act prohibited contractual agreements for subordination unless the creditor claiming the priority

pursuant to which they are issued will not be executed by the senior creditor. When the senior creditor is not a signatory party, courts have indicated their willingness to utilize the principle of estoppel [38] or that of unilateral contract,[39] while in most states the third party beneficiary doctrine will fill the gap.

The third party beneficiary concept [40] has developed into a rule of law of such consequence as to assure that unilateral subordination agreements, intended to benefit then existing or subsequent senior creditors, will be enforced in virtually all jurisdictions.[41] Nevertheless, in drafting indenture subordina-

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is a party to the contract or is the sole beneficiary or there is an estoppel. The court summarily rejected this argument and applied the contract theory of enforcement.

38. In Londner v. Perlman, 129 App. Div. 93, 95-96, 113 N.Y.S. 420, 422 (1908), it was held:

> It was not necessary that the State Bank . . . should be directly a party to the agreement to subordinate. . . . Upon the plainest principles of equity [the subordinating creditor], or any one claiming under him, is now estopped from repudiating this agreement.

39. As stated in Brooklyn Trust Co. v. Fairfield Gardens, Inc., 260 N.Y. 16, 21, 182 N.E. 231, 233 (1932):

> The covenant contained in the so-called subordination agreement was, perhaps, not enforceable at the time the instrument was executed. Then it was merely a promise made without consideration, to induce Prudence Company, Inc., to make the loan to be secured by a first mortgage. It became enforceable if and when the Prudence Company, Inc., was induced thereby to made [*sic*] the stipulated loan. That is not and cannot be disputed, and it is unnecessary to determine whether it became enforceable upon the theory that a promissory estoppel then arose, or a unilateral contract in which promise to subordinate was given by one party in exchange for the act of making the stipulated building loan by the other party. Such distinctions would carry no consequences in this case, for on either theory the priority of plaintiff's mortgage depends upon proof that the mortgagor did the act which the promise to subordinate called for.

See also 6 REMINGTON, BANKRUPTCY § 2874, at 486 (5th ed. 1952):

> Actually, subordination of the claims of one creditor as against another, whether by contract or on the theory of estoppel in pais, involves no special bankruptcy law but is an application of equity jurisprudence to the facts at hand.

40. The concept has less validity in Massachusetts where it is still anathema to the courts. *E.g.*, Mellen v. Whipple, 67 Mass. (1 Gray) 317 (1854); Cain's Lobster House, Inc. v. Cain, 312 Mass. 512, 45 N.E.2d 397 (1942); Gustafson v. Doyle, 329 Mass. 473, 109 N.E.2d 465 (1952). However, the following clause, when added to the indenture providing for subordinated debentures, is thought to overcome the absence of the third party beneficiary concept in Massachusetts:

> The foregoing provisions constitute a continuing offer to all persons who, in reliance upon such provisions, become the holders of, or continue to hold, Senior Indebtedness; and such provisions are made for the benefit of the holders of Senior Indebtedness, and such holders are hereby made obligees hereunder the same as if their names were written herein as such, and they and/or each of them may proceed to enforce such provisions.

41. See Note, 57 COLUM. L. REV. 406 (1957) for an excellent treatment of the entire concept of contracts for the benefit of third parties. See generally RESTATEMENT, CONTRACTS §§ 133-47 (1932); 2 WILLISTON, CONTRACTS §§ 347-403 (3d ed. 1959); 4 CORBIN, CONTRACTS §§ 772-855 (1951).

tion provisions, counsel usually make explicit that the debenture holders intend the subordination to benefit third parties (the holders of the senior indebtedness).

Drafting Safeguards to Protect the Senior Creditor

Qualification of Senior Debt

The importance of making certain that the senior debt qualifies as such within the limitations provided in the subordination agreement, indenture, or other instrument creating or evidencing the subordinated debt cannot be overemphasized. It is not unusual to find that a subordination agreement contains restrictions of various types as to the amount and nature of senior indebtedness, so that indebtedness maturing more (or less) than, say, nine months from its date, indebtedness arising other than from borrowing, indebtedness to lending institutions other than commercial banks or trust companies, indebtedness in excess of a stated amount, or even indebtedness other than that issued under a specified indenture, would not qualify as senior indebtedness. Only if the senior indebtedness falls within such limitations and conditions would it be entitled to the benefit of the subordination. For example, should an indenture provide for subordination to only $1,000,000 of senior indebtedness, it seems clear that no indebtedness in excess of that amount would qualify as senior indebtedness. It is believed that this would be so even if a senior creditor made a loan in excess of that amount in good faith on the basis of representations of the debtor as to the amount of other senior indebtedness then outstanding.

The senior creditor would not be permitted, while not complying with the express terms of the contract between the subordinator and the debtor, to take advantage of that same contract. Furthermore, the exact wording of the limitation provisions might well determine whether any part of an issue of indebtedness in excess of the prescribed limit, either originally or after subsequently being paid down to the limit, would be entitled to the benefit of the subordination.

Voting Rights

Assuming that the obligation owed to the senior creditor qualifies as a senior debt under the agreement, the senior creditor will also want to protect his position in any proceedings relating to financial distress of the debtor. A provision in a subordination agreement giving the senior creditor the right to express his wishes by voting the full amount of the subordinated debt in any bankruptcy, reorganization, or other proceeding, including any meeting of creditors of the debtor, is therefore an important one, both from the legal and the economic points of view. Further, short of a proceeding under the Bankruptcy Act, the senior creditor might well be outvoted at a creditors' meeting in which the fate of the debtor will be determined. The subordinated debt may be much larger than the senior debt and thus the subordinating creditors may well determine, against the wishes of the senior creditor, whether or not the debtor should be put into a Chapter X or Chapter XI proceeding or otherwise.[42]

In the absence of specific provision, the senior creditor probably would not have the right to vote the subordinated debt. In the somewhat analogous situation of a pledge of stock, it is specifically provided under some state statutes that the right to vote the pledged stock remains in the pledgor unless certain action is taken by the parties. In New York, for example, it is provided that "except in cases of express trust, or in which other provision shall have been made by written agreement between the parties . . ." the record holder pledgee shall, upon demand by the pledgor and payment of the expenses entailed, issue a proxy to vote the stock to the pledgor.[43] Under the Delaware statute, the right to vote pledged stock remains in the pledgor "unless in the transfer by the pledgor on the books of the corporation he has expressly empowered the pledgee to vote thereon . . . ."[44] If the right to vote does not pass to the pledgee of stock when there has been an actual transfer of the stock, it would seem that the mere subordination of debt, involving no present transfer of the debt, would not pass the right to vote such debt to the senior creditor.[45]

Prohibition against Involuntary Bankruptcy Proceedings

A relatively new clause used in subordination agreements (not yet detected in corporate indentures) stipulates that the subordinator will not commence, or join with any other creditor in commencing, any bankruptcy, reorganization, or insolvency proceeding against the debtor. This clause is designed to prevent small subordinating creditors from taking action contrary to the interests of the senior creditor. For example, should the debtor get into financial difficulties and should the senior creditor be willing to carry on some sort of "work-out" or "bailing-out" operation, the senior creditor would not want a subordinator to precipitate a bankruptcy proceeding.

Altering the Senior Debt

The senior creditor may also desire to maintain flexibility by inserting in the subordination agreement a specific provision permitting the senior cred-

42. In a Chapter X reorganization it is likely that the subordinated debt would be put in a separate classification from that of other unsecured debts and would be voted accordingly in adopting or rejecting the plan of reorganization. See 6 COLLIER, BANKRUPTCY § 9.10 (14th ed. 1947).

43. N.Y. STOCK CORP. LAW § 47.

44. DEL. CODE ANN. tit. 8, § 217 (1953).

45. *But cf.* Meinhard, Greeff & Co. v. Brown, 199 F.2d 70 (4th Cir. 1952) (where in a reorganization proceeding the pledgee of a bond of a larger principal amount than the debt it secured was limited to voting the bond only to the extent of the amount secured by the pledge, with the right in the owner of the bond to vote the remainder of the debt evidenced by it).

itor to extend, renew, or alter the terms of the senior debt or of any security therefor and to release, sell, or exchange such security and otherwise to deal freely with the debtor, all without notice to or consent of the subordinator and without affecting the liabilities and obligations of the subordinator under the subordination agreement. It is clear law that a surety or guarantor will be released from his contract by any material alteration of the principal contract, or by the creditor granting the debtor an extension of time for payment or performance of the main obligation;[46] similarly, any voluntary release or surrender of collateral held for the principal obligation would discharge the surety or guarantor at least to the extent of the collateral released.[47] Moreover, the extension of time and the release of collateral operate to decrease the value of the guarantor's equitable right of subrogation to the rights of the creditor. Since in substance the subordinator is a guarantor to the extent of the value of the subordinated debt, it could be argued by analogy to the law of guaranty and suretyship that, at least in this area, the subordinator should be protected in the same manner in which the law protects guarantors. No cases have been found which apply the law of guaranty to subordination problems, but the step would not be illogical. Just as a guarantor would be adversely affected by the creditor's release of collateral security for the indebtedness guaranteed, so, too, would a subordinator be adversely affected by the release by the senior creditor of the collateral security held for the senior debt. To the extent that such collateral is not available to the senior creditor in the event of the bankruptcy of the debtor, dividends on the subordinated debt must be used in making the senior creditor whole. In other words, by giving up his collateral, the senior creditor makes it more likely that if the debtor goes bankrupt, the senior creditor will have to satisfy the obligation owed him by taking the junior creditor's dividends. It would therefore follow, in the absence of a provision permitting the senior creditor to alter the terms of the debt or deal with the security therefor that the senior creditor might be obligated to some extent to the subordinating creditor as to the value of the collateral released.

This view would apply in all cases where the subordination is to a specified senior indebtedness. On the other hand, it could be argued that this rigid rule should not apply when the subordination is to any and all indebtedness, present or future, secured or unsecured, incurred by the debtor. Where the subordinator has given carte blanche, so to speak, to the debtor, and agrees to subordinate no matter what type of contract the debtor makes with the senior creditor, it might well be urged that the subordinator has not asked for the protection of the strict rules applicable to guaranty and suretyship. So, too, if the subordination is to all indebtedness of a particular class, such as indebtedness to banks, insurance companies, and other financing institutions, an alteration of the debt of that class within the limits of the class should not serve as the basis for relieving the subordinator of its liabilities. Nevertheless, in the

46. STEARNS, SURETYSHIP § 6.1 (5th ed. 1951).

47. *Id.* § 6.46.

absence of law on the subject, it would be in order to insert the suggested provision in all subordination agreements, if at all obtainable.

Assignment Versus Subordination

Probably the most misunderstood conceptual element of subordination agreements concerns the question of the necessity of including an assignment of the subordinated debt in the agreement. An examination of the subordination agreement forms used by large banks and trust companies (these forms almost invariably provide for the complete type of subordination) reflects a wide difference of opinion as to the propriety of such an assignment. At least five different approaches to this question are evidenced by such forms: (1) an express present assignment; (2) a covenant by the subordinator to give an assignment on the demand of the senior creditor; (3) a covenant to give an assignment immediately upon the occurrence of certain events; (4) an assignment to take effect at the option of the senior bank creditor in certain events; and (5) no provision as to assignment. Except in situations where both the debtor and the subordinating creditor become bankrupt, no present assignment of the subordinated debt is necessary. In all of the subordination cases, except *Matter of Goodman-Kinstler Cigar Co.*,[48] the subordination agreement was given full force and effect, and in none of them did the agreement contain an assignment of the subordinator's claim. Moreover, in the *Handy-Andy* case[49] the need for an assignment was adverted to and rejected. Indeed, an actual assignment of the subordinated debt as collateral security for the senior debt obviates the need for the subordination itself, or for any of the implementing provisions of the typical complete subordination agreement in so far as existing debt is concerned. If the subordinated debt were so assigned, the holder of the senior debt would have the full benefit of such subordinated debt and any dividends on it. The holder of the senior debt, having been given in the assignment or pledge instrument the power to file proof of claim upon the collateral, could, without benefit of any subordination agreement, take whatever steps are necessary to protect its interests. The only benefit of the subordination agreement in this situation would be to cover any additional subordinated debt which might have arisen after the date of the subordination agreement and which was not specifically assigned.

Only in the rare instance where both the principal debtor and the subordinating creditor become bankrupt would an actual assignment of the subordinated debt be beneficial. A subordination agreement does not constitute a present legal transfer, and in the absence of such a transfer the subordinating creditor's trustee in bankruptcy might be able to take title to the subordinated debt free and clear of all equitable or contractual rights created by the subordination agreement. Under § 70c of the Bankruptcy Act,[50] the so-

48. 32 Am. Bankr. R. 624 (S.D. Cal. 1914).
49. 2 F. Supp. 97 (W.D. La. 1932).
50. 66 Stat. 420 (1952), 11 U.S.C. § 110(c) (1958).

called "strong-arm" clause, the trustee is deemed vested as of the date of bankruptcy with all the rights, remedies, and powers of a creditor then holding a lien on all the bankrupt's property, whether or not such creditor actually exists.[51] The claim of the trustee to the subordinated debt, as a lien creditor, might thus be regarded as superior to the unsecured right of the senior creditor. No cases have been found involving the bankruptcy of the subordinator. There are, however, many cases in which trustees in bankruptcy have prevailed over equitable rights created by bankrupts and running in favor of third persons.[52]

On the other hand, as *Collier* states:[53]

> The trustee generally will take the bankrupt's property subject to such equities or equitable interests as are created by the situations wherein the bankrupt, either expressly, impliedly or constructively, is holding property in trust for others. Where the bankrupt holds funds or other property impressed with a trust, the strong-arm clause of § 70c is usually of no more effect in securing the title thereto for the trustee than are the broader provisions of § 70a(5). The reason is that lien creditors are generally not entitled to prevail against beneficiaries of a trust, and by virtue of § 70c the trustee in bankruptcy has, at most, the rights of a lien creditor under the applicable state law.[54]

Since the matter is not clearly resolved, it seems that the only way to avoid the question is to include a present assignment of the subordinated debt in the subordination agreement. If this is done, a legal transfer of the then existing indebtedness to the subordinator takes place on the date of the subordination agreement. The senior creditor, as a prior assignee, would therefore unquestionably prevail over the trustee.[55] A present assignment would also

51. Section 70(c) of the Bankruptcy Act, 66 Stat. 420 (1952), 11 U.S.C. § 110(c) (1958) provides:

> The trustee may have the benefit of all defenses available to the bankrupt as against third persons, including statutes of limitation, statutes of frauds, usury, and other personal defenses; and a waiver of any such defense by the bankrupt after bankruptcy shall not bind the trustee. The trustee, as to all property, whether or not coming into possession or control of the court, upon which a creditor of the bankrupt could have obtained a lien by legal or equitable proceedings at the date of bankruptcy, shall be deemed vested as of such date with all the rights, remedies, and powers of a creditor then holding a lien thereon by such proceedings, whether or not such a creditor actually exists.

52. Rosenbaum v. Century Indem. Co., 168 F.2d 917 (2d Cir. 1948) (trustee prevailed over equitable lien); Titusville Iron Co. v. City of New York, 207 N.Y. 203, 100 N.E. 806 (1912); Zartman v. First Nat'l Bank, 189 N.Y. 267, 82 N.E. 127 (1907); Corney v. Saltzman, 22 F.2d 268 (2d Cir. 1927) (trustee prevailed over pledgee or mortgagee of after-acquired property); F. & M. Schaefer Brewing Co. v. Amsterdam Tavern, Inc., 171 Misc. 352, 12 N.Y.S.2d 701 (Sup. Ct. 1939); Atlas Advertising Agency, Inc. v. Casa Cubana, Inc., 259 App. Div. 951, 19 N.Y.S.2d 900 (1940) (trustee prevailed over equitable assignment).

53. 4 COLLIER, BANKRUPTCY § 70.62, at 1491 (14th ed. 1959).

54. See, *e.g.*, *In re* Berry, 147 Fed. 208 (2d Cir. 1906).

55. Even if the transfer were fraudulent as to creditors of the subordinator under § 67(d) of the Bankruptcy Act, 66 Stat. 428-29 (1952), 11 U.S.C. § 107(d) (1958), the

serve to protect the assignee from the fraud of the subordinator making a second assignment of the subordinated debt.

In passing, it should be noted that even if an outright assignment is included in a subordination agreement, so that it clearly constitutes a present transfer of assets, such assets are not being transferred to prefer one creditor of the subordinator over other creditors, and, therefore, the assignment will not constitute a preference under § 60a of the Bankruptcy Act.

Whether, in the rare situation involving the bankruptcy of both the debtor and the subordinating creditor, the benefit to the bank in having a present assignment outweighs the reluctance on the part of subordinating creditors to give such an assignment is a matter which individual bankers can best determine for themselves. The following are some of the factors which should be considered in making any such determination:

(1) As a practical matter, many subordinators might well object to an assignment as collateral security, with the concomitant right in the holder of the senior debt, either provided in the instrument itself or by law, to foreclose on the security in the event of default on the senior debt, whereas they might not object to a subordination agreement which leaves the subordinated debt to some extent within their own control.

(2) In many cases an assignment of the subordinated debt as collateral security might contravene the terms of a negative pledge covenant between the subordinating creditor and his creditor, whereas a typical subordination agreement not containing words of present assignment would not.[56]

(3) In the usual complete subordination agreement, where both present and future indebtedness owing by the debtor to the subordinator is subordinated, an assignment would be effective in law only as to the subordinated

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trustee would not prevail if a period of one year had elapsed between the date of the subordination agreement and the bankruptcy of the subordinator. As a practical matter, a fraudulent transfer of the type provided for in § 67(d) would be inapplicable except in very rare instances, for the reason that the subordinator usually has a valid business reason for executing a subordination agreement. However, as a matter of law, there might be a serious question as to whether the subordinator could be said to have received a fair equivalent for such an agreement, and if the subordination agreement should be held to constitute a transfer, the possibility of a fraudulent conveyance within the meaning of § 67(d) might be present.

56. For example, if the subordinator as a borrower under a bank loan or credit agreement has covenanted not to create or suffer to exist any mortgage, pledge, lien, charge, encumbrance, assignment, or transfer upon or of any of its property or assets, an assignment of the subordinated debt would appear to be in violation of such a negative pledge clause. A subordination, without assignment language, would not appear to be such a violation. Query whether the execution of a subordination agreement containing a covenant to give an assignment on the demand of the senior creditor or upon the occurrence of a stated event would violate a negative pledge covenant of the subordinator. There are no known cases on the matters mentioned in this footnote. See generally Kelly v. Central Hanover Bank & Trust Co., 11 F. Supp. 497 (S.D.N.Y. 1935) for an interesting case containing both general and specific observations on a negative pledge clause.

debt actually in existence at the time, and as to future indebtedness would constitute only an equitable assignment. To obtain a legal assignment of the future indebtedness the subordination agreement would have to provide for supplemental assignments of additional debt as such debt comes into existence.[57]

(4) A present assignment would be completely inappropriate in the inchoate subordination which presupposes effectuation at some future date.

(5) If the subordinated debt is presently assigned as collateral security for the senior indebtedness, with power given to the senior creditor to file proof of claim against the estate in bankruptcy of the debtor, the responsibility of performing all acts necessary to file the claim and collect the dividends thereon would devolve on the senior creditor.[58]

(6) There should be no real concern that the assignment will prejudice the senior creditor's rights in bankruptcy. Section 57h of the Bankruptcy Act provides that a secured creditor must deduct the value of his collateral and prove only on the unpaid balance of his claim. But under section 1(28) of the Bankruptcy Act a "secured creditor" is defined as one who has security for his debt "upon the property of the bankrupt." It seems clear that the assignment of the subordinated debt to the senior creditor as security involves security coming from a third person and is not security upon the property of the bankrupt which must be deducted.

Restrictions on the Subordinating Creditor

Amendments to Subordination Agreements. It is usual to find provisions in indentures or other instruments creating or evidencing subordinated debt that they may not be amended so as to affect or impair the provisions providing for the subordination. From the senior creditor's point of view, such a provision is desirable because, in the absence of other controlling considerations, the parties to an agreement may amend it. Although the courts would probably sustain the rights of senior debt created in reliance on the unamended subordination, either on the ground of estoppel or that equities or rights had vested in the holder of the senior debt which would enable him to prevent an amendment injurious to his position, the courts might well have some difficulty in so holding if the indenture itself allowed for amendments. What would be the result if an indenture providing for the subordination of securities issued thereunder was amended by the junior creditor and the debtor to impair or destroy the subordination, new securities were issued which did not refer to the subordination, and such new securities were sold to a bona fide purchaser for value without notice? Such purchaser might well obtain rights equal to those of the senior debt holder.

57. See 2 WILLISTON, CONTRACTS § 413 (rev. ed. 1936). RESTATEMENT, CONTRACTS § 154 (1932).

58. A typical exculpation clause would give the senior creditor some measure of protection in failing to properly perform this responsibility.

Securing Subordinated Debt. Protection of the senior creditor may also require that he prohibit the subordinator from taking any security for the subordinated debt. If security is given for subordinated debt after the senior debt has been created, the subsequent payment of the subordinated debt out of that security might be sustained by the courts, on the theory that an effective lien securing the subordinated debt had been legally created. Since the subordinated debt could then be collected out of the security, rather than out of bankruptcy dividends for unsecured creditors, the senior creditor would lose his contemplated right to the dividends due the subordinator. Accordingly, from the point of view of the senior creditor the only safe procedure is to require a provision prohibiting the giving of such security or, as an alternative, a provision that payments on the subordinated debt out of the proceeds of security are to be treated as if made out of general assets of the debtor. In the latter case it would follow that such payments could not be made without violating the subordination provisions. However, since an inchoate subordination does not usually prohibit payment of principal of the subordinated debt prior to the time that the subordination becomes operative, it is somewhat inconsistent, when dealing with an inchoate agreement, to prohibit the giving of security for the subordinated debt prior to such time.

Converting Subordinated Debt. Senior creditors should also be cognizant of the consequences of provisions permitting conversion of subordinated debt into capital stock. As a result of the exercise by debenture holders, for example, of their options to convert subordinated debentures, the theretofore subordinators would now be stockholders, rather than unsecured creditors, and would not share in the debtor's assets with the senior debt in the event of a distribution to creditors. The senior debt would thus fail to receive the dividends that would have been paid to these subordinating creditors.

Assignment of Subordinated Debt. The senior creditor must also be wary of the junior creditor assigning his claim. A carefully prepared subordination agreement should thus prohibit any transfer, assignment, or pledge of the subordinated debt unless such transfer, assignment, or pledge is made expressly subject to the subordination. This is desirable even though as a matter of law it would seem that any transfer of what is in fact subordinated debt could not affect the subordination.[59] Some subordination agreements prohibit any transfer of the subordinated debt. If the subordinated debt were evidenced by a negotiable instrument which was sold to a bona fide purchaser for value, who purchased without notice of the subordination, the purchaser would take free of the subordination.[60] In the light of these circumstances, it appears to be desirable that a reference to the fact of subordination be made within the body of the subordinated debt instrument or, in the alternative, a legend as to subordination should be typed or stamped on such instrument.

59. See 2 WILLISTON, CONTRACTS § 432 (rev. ed. 1936).
60. See BRITTON, BILLS AND NOTES § 100 (1943).

Subrogation Clauses

While many of the above provisions are necessary to protect the senior creditor, an additional clause is frequently provided to protect the junior creditor. Thus, subordination agreements often contain a provision specifically stating that after payment in full of the senior debt, the subordinator shall be subrogated to the rights of the senior creditor to receive payments or distributions of assets of the debtor made on the senior debt. Such provisions are most usually found in subordinated debenture issues, but apply equally in the typical bank form of subordination agreement. The subordinating creditor should be subrogated to the rights of the senior creditor in respect to that portion of the senior debt which has, in fact, been paid, not from dividends on the senior debt as such, but from dividends on the subordinated debt. For example, assume that the senior creditor is paid 60 per cent of the debt by reason of dividends on its own claim and that the balance of 40 per cent of the senior debt is paid by reason of the application of the dividends on the subordinated debt. The subordinating creditor should then be subrogated to the senior creditor's right to receive payment of that 40 per cent of the senior debt. In other words, although by reason of the subordination the senior debt will receive "double dividends"—the dividends payable on the senior debt and those payable on the subordinated debt—as between the debtor and the senior creditor, only 60 per cent of the senior debt has been paid. Therefore, after the senior debt has thus been paid in full, the subordinated debt will then receive double dividends—dividends on the subordinated debt and dividends on the 40 per cent of the senior debt which was paid by the application thereto of the subordinated debt dividends. Even if a provision specifically covering the point is not used, it is clear that the doctrine of equitable subrogation would apply.[61]

Remaining Legal Problems

Even with careful drafting and inclusion of the suggested provisions for promoting flexibility and protection of both the senior and junior creditors, various legal problems will arise.

One Debt, Two Subordinations

For example, there may come into being two subordinations of the very same debt, in which case it would seem that the first subordination agreement in point of time would prevail over a second subordination agreement, on the theory that the second subordination agreement covers a debt already sub-

61. See Restatement, Restitution § 162 (1937):

Where property of one person is used in discharging an obligation owed by another or a lien upon the property of another, under such circumstances that the other would be unjustly enriched by the retention of the benefit thus conferred, the former is entitled to be subrogated to the position of the obligee or lien-holder.

ordinated. The maxim of equity—"between equal equities the first in order of time prevails"—should also apply to such a situation.[62] Further, one may look to the law of assignments for analogy. Under the law of New York and of many other jurisdictions, the first assignee prevails over a subsequent assignee whether the assignment is regarded as creating a legal or equitable right in the assignee.[63]

Corporate Power to Subordinate

Moreover, because the subordinator may be viewed as a guarantor of the senior debt, where the subordinating creditor is a corporation it would seem that the same *ultra vires* problems which apply in guaranty situations should by analogy apply in the subordination field. Thus, just as it is usually considered that a parent has the power to guarantee the obligation of its subsidiary,[64] so, too, should a parent have the power to subordinate its right to payment as a creditor of the subsidiary. The reverse situation should be the same both as to guaranties and subordinations—that is, just as "upstream" guaranties (the guaranty by a subsidiary of its parent's obligation) may be *ultra vires* [65] so, too, may "upstream" subordinations be *ultra vires.* Similarly, in both fields, "crossstream" guaranties and subordinations (involving commonly owned or affiliated corporations) might well be held *ultra vires.* In the guaranty field, the courts have usually held that if there is a business reason for the execution of a guaranty, a consideration commensurate with the risks involved, the guaranty will be upheld.[66] The entire area concerning adequate consideration, statutory and charter permissions, stockholders' consents and absence of the likelihood of creditor attack as it pertains to the field of guaranty might serve as an analogy in resolving these same problems as they apply in the subordination field.[67]

Subordination by a Partner

A subordination by a partner of indebtedness owing by the partnership (other than for profits or such partner's contribution to capital) would not result in the senior creditor receiving dividends on both the subordinated debt owed to the partner and the senior obligation. This is so because by the

62. 2 POMEROY, EQUITY JURISPRUDENCE §§ 413-15 (5th ed. 1941).

63. See 2 WILLISTON, CONTRACTS § 435 (rev. ed. 1936); RESTATEMENT, CONTRACTS § 173 (1932).

64. 6 FLETCHER, CYCLOPEDIA OF CORPORATIONS § 2593 (rev. ed. 1950).

65. *Cf. In re* John B. Rose Co., 275 Fed. 416 (2d Cir. 1921); Robert Gair Co. v. Columbia Rice Packing Co., 124 La. 193, 50 So. 8 (1909); *In re* Gilchrist Co., 278 Fed. 235 (D.C. Mass. 1922), *aff'd sub nom.*, Wm. Filene's Sons Co. v. Gilchrist Co., 284 Fed. 664 (1st Cir. 1922), *cert. denied*, 260 U.S. 750 (1923); Bayou Drilling Co. v. Baillio, 312 S.W.2d 705 (Tex. Civ. App. 1958).

66. 6 FLETCHER, CYCLOPEDIA OF CORPORATIONS §§ 2591, 2596 (rev. ed. 1950).

67. See 6 FLETCHER, CYCLOPEDIA OF CORPORATIONS ch. 26 (rev. 1950).

specific provisions of the Uniform Partnership Act,[68] after "dissolution" of a general partnership (which could be caused by the bankruptcy of any partner or the partnership or the insolvency of either under any state insolvency act),[69] all claims of nonpartner creditors against the partnership must be paid in full before any distribution will be made on a debt claim of a partner.[70] Thus, the senior creditor would not receive the dividends paid on the junior debt because the senior creditor would already have been paid in full before any dividends could be paid on the partner's claim. However, the usual type of bank subordination agreement (i.e., complete subordination) would benefit the bank because it prohibits payment of the partner's claim prior to payment of the senior indebtedness, and thus keep assets in the partnership which might otherwise be paid out to the partner. Such a subordination agreement would also prohibit the transfer of the partner's claim to a nonpartner, unless the claim transferred remained expressly subject to the subordination agreement. Therefore, even though the claim might be elevated to the rank of a nonpartner claim by reason of the transfer,[71] the bank's right of subordination would continue; indeed the bank's right would become more valuable, for the nonpartner claim would be entitled to dividends which would pass to the bank.

Subordination by a general partner of his debt claim against a limited partnership is much the same, although in this case the statutory rank of the partner's claim is also below the claims of limited partners in respect of their capital contributions.[72]

A limited partner's debt claim against a limited partnership ranks equally with claims of nonpartner creditors,[73] and therefore the subordination of such a claim would entitle the bank to receive "double dividends," assuming that there is nothing in the partnership articles altering the ranking of the limited partner's debt claim.[74]

Trust Indenture Act Disgorging Provision

A bank lender may become both a trustee (on behalf of all holders of subordinated debentures) under the terms of a subordinated indenture and also the holder of senior indebtedness of the obligor. As a result of two separate

68. The Uniform Partnership Act has been adopted in thirty-eight States and the Uniform Limited Partnership Act in thirty-nine. The acts as adopted in certain States contain variations from the uniform act.

69. UNIFORM PARTNERSHIP ACT §§ 2, 31.

70. *Id.* § 40; *In re* Effinger, 184 Fed. 728 (D.C. Md. 1911). See also Brandt & Brandt Printers, Inc. v. Klein, 220 F.2d 935 (2d Cir. 1955).

71. See First Nat'l Bank v. Wood, 128 N.Y. 35, 27 N.E. 1020 (1891).

72. UNIFORM LIMITED PARTNERSHIP ACT §§ 23(1)(c), -(d).

73. *Id.* §§ 13(1), 23(1)(a).

74. In both Missouri and Louisiana, however, a limited partner's debt claim against the limited partnership ranks below claims of nonpartner creditors. See case notes following *id.* § 23.

transactions, with the same debtor, therefore, the bank will be both senior creditor and also trustee for the junior creditors. But to qualify under the Trust Indenture Act of 1939 the indenture must contain the "disgorging" provisions required by section 311(a).[75] Such provisions provide in substance that, when a payment is made by the obligor to the bank in "reduction" of the bank's claim as senior creditor within four months of a default in payment of the senior debt by the obligor, the bank shall set aside an equal amount in a special account for the pro rata benefit of the bank *and* the debenture holders. Put simply, the Trust Indenture Act requires that when the bank acts in this dual capacity of trustee-senior creditor, the money it receives on its claim as creditor during this four month period must be shared with the debenture holders. This provision does not apply to bankruptcy dividends. When bankruptcy of the obligor occurs, the act allows the bank to retain for its own account dividends which it receives on its claim filed as senior creditor. Moreover, the bank will be allowed to assert its right under the subordination agreement to receive dividends paid on the claims of the debenture holders. Dividends to the junior creditors do not constitute a "reduction" of the bank's claim as senior creditor, and thus would not fall within the purview of the disgorging provisions.

A real question might exist, however, as to any payment the bank might receive on its individual claim as senior creditor within the above-mentioned four months' period. The disgorging provisions would clearly seem to require the bank, as the indenture trustee, to set apart the amount received in a special account for the pro rata benefit of the debenture holders and the bank as creditor. A pro rata share of the money set aside by the trustee would then be paid to the debenture holders. In the usual subordinated indenture situation, payments from the debtor to the junior creditors must be turned over to the senior creditor. But the typical subordinated indenture requires only that the debenture holders turn over payments or distributions "of assets of the Company." The amount distributed pro rata to the debenture holders would not, according to strict interpretation of the subordination provisions, constitute a payment or distribution "of assets of the Company." Thus, the debenture holders would retain for their own account amounts which the indenture trustee was required to turn over to them through the operation of the disgorging provisions.

Two arguments could be made against this literal interpretation of the disgorging and subordination provisions. First, such an interpretation would have the practical effect of preventing a bank from being both an individual creditor and an indenture trustee, which is not the purpose of the Trust In-

75. 53 Stat. 1161 (1939), 15 U.S.C. § 77kkk (1958). Section 318 of the Trust Indenture Act of 1939, 53 Stat. 1173 (1939), 15 U.S.C. § 77rrr (1958) further requires that the indenture provide that "if any provision thereof limits, qualifies, or conflicts with another provision which is required to be included in such indenture by any of sections 310 to 317, inclusive, such required provision shall control."

denture Act. Rather, assuming that the bank does act in this dual capacity, the act, through the operation of the disgorging provisions, seeks only to prevent the bank from keeping the advantage of "preferential collection of claims" against the obligor company. Second, if the literal language of the disgorging and subordination provisions is followed, there ensues the somewhat peculiar result that the bank may have to disgorge to the debenture holders an amount received in payment of its individual claim shortly prior to bankruptcy even though it would be permitted to retain such amount if received during bankruptcy. Not only does such a result go far beyond the ostensible intent of the act, but it is contradictory to the express subordination by the debenture holders.

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