

A Conflict Between the Bankruptcy Code and State Law Revisited

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The intersection of federal bankruptcy policy and state law has once again collided. This time, the Rule of Explicitness was the subject. In a recent decision from the First Circuit, Bank of New England Corp. v. Branch (In re Bank of New England Corp.), 364 F.3d 355 (1st Cir. 2004), the Court vacated the lower court's ruling denying a senior debt holder's request that a subordination agreement be construed to allow the senior debt holder to collect postpetition interest ahead of any payments to the junior debt holder. Under generally applicable bankruptcy equitable principles, which had been controlling since well before the passage of the Bankruptcy Code, a subordination agreement was required to be explicit in allowing a senior unsecured creditor to recover postpetition interest at the expense of a subordinated creditor.

In Bank of New England Corp., the bankruptcy court and the district court applied the Rule of Explicitness and determined that the subordination agreement in question was not sufficiently explicit to allow this benefit to the senior creditor. The First Circuit vacated finding that the Rule of Explicitness was no longer applicable. The Court ruled that under the applicable

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state law, the subordination agreement in question was sufficiently ambiguous which required that the matter be remanded to the lower court for determining the intent of the parties. Of particular significance, the holding of the First Circuit provides that no deference should be given to a state-created law that only applies in the context of bankruptcy.

States are Prohibited From Enacting Bankruptcy-Specific Rules

It is black letter law that a state may not enact bankruptcy-specific rules, or otherwise provide additional or auxiliary regulation with respect to bankruptcy matters. See Int'l Shoe Co. v. Pinkus, 278 U.S. 261, 265 (1929). This is consistent with long-standing purposes and policies of bankruptcy jurisprudence. The Bankruptcy Code was enacted pursuant to the authority granted by the Constitution to Congress to enact “uniform laws on the subject of Bankruptcies.” U.S. Const. Art. I, § 8, cl. 4. Congress has used this power to create comprehensive regulations in the area of bankruptcy and has vested exclusive jurisdiction over bankruptcy matters in the federal district courts. See 28 U.S.C. § 1334(a).

The purpose of federal bankruptcy law is to establish uniformity of laws throughout the country, rather than requiring 50 different rules governing insolvencies. The Supreme Court has historically held that a primary function of the bankruptcy laws is “to secure a prompt and effectual administration and settlement of the estate of all bankrupts within a limited period.” In re Christy, 44 U.S. 292 (1845). Speaking to the importance of the federal bankruptcy power, James Madison explained that, “[t]he power of establishing uniform laws of bankruptcy is so intimately connected with the regulation of commerce, and will prevent so many frauds where the parties or their property may lie or be removed into different States, that the expediency of it seems not likely to be drawn into question.” The Federalist No. 42, at 308 (James Madison) (Benjamin Fletcher Wright ed., 1961). Justice Story agreed, writing that, “if the [bankruptcy]

power is exclusively vested in the states, each one will be at liberty to frame such a system of legislation upon the subject of bankruptcy and insolvency, as best suits its own local interests and pursuits.” He explained that the purpose of establishing a uniform system was rooted in “the importance of preserving harmony, promoting justice, and securing equality of rights and remedies among citizens of all the states.” 2 Joseph Story, Commentaries on the Constitution of the United States § 1107 (2d. ed. 1851).

The Rule of Explicitness

The Rule of Explicitness developed under the Bankruptcy Act as an equitable theory of contract interpretation for determining whether a senior creditor may recover postpetition interest under a subordination agreement. It was applied as a matter of federal bankruptcy law.

Subordination agreements are intercreditor agreements that contractually allocate credit risk among two or more creditors of a common debtor. Usually, subordination agreements have specific provisions applicable in a bankruptcy context. A typical subordination agreement attempts to alter the otherwise applicable rules of priority so that a distribution to a junior creditor is diverted to the senior creditor until the senior creditor is satisfied in full.

Under ordinary circumstances, in an insolvent bankruptcy estate, an unsecured creditor does not receive postpetition interest. Courts were, therefore, reluctant to construe subordination agreements in a manner that would allow senior creditors to recover postpetition interest from junior creditors when that interest would not have been recoverable by the senior lender from the debtor. Under the Bankruptcy Act, the right of a senior creditor to receive postpetition interest was not required, but such right was dependent upon the court’s equity powers. The equity powers pursuant to which the contract was interpreted enforced subordination agreements as to postpetition interest only when the subordination agreement was explicit as to the intent of the

parties. The concepts of this equitable principle have been applied since at least 1893. See Thomas v. Western Car Co., 149 U.S. 95 (1983). See also, Heather J. VanMeter, *How Explicit Do You Need to Be? An Analysis of the Rule of Explicitness After Southeast Banking*, 105 COMM. L.J. 35, 36 (2000).

Over time, this equitable doctrine became known as the Rule of Explicitness. The Rule of Explicitness, as the phrase was first coined by the Third Circuit in 1974, generally required that, to overcome the generic bar on recovery of postpetition interest, language in a subordination agreement must be unequivocal. See In re Time Sales Fin. Corp., 491 F.2d 841 (3d Cir. 1974); In re King Resources, Co., 385 F.Supp. 1269 (D. Co. 1974), *aff'd* 528 F.2d 789 (10th Cir. 1976); In re Kingsboro Mortgage Corp., 379 F.Supp. 227 (S.D.N.Y. 1974), *aff'd* 514 F.2d 400 (2d Cir. 1975) (per curiam). The Rule of Explicitness gained wide acceptance as an appropriate use of the bankruptcy court's equity powers.

Section 510(a)

Notwithstanding the wide adoption of the Rule of Explicitness, the Bankruptcy Act itself was silent with respect to subordination agreements. Not surprisingly, courts continued to employ the Rule of Explicitness in interpreting subordination agreements under the Bankruptcy Code as well. Unlike the Bankruptcy Act, however, the Bankruptcy Code contains a provision that specifically deals with subordination agreements. Section 510(a) states that "a subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law." 11 U.S.C. § 510(a). Since the Rule of Explicitness is a federal bankruptcy policy, it does not constitute "applicable nonbankruptcy law" as contemplated under Section 510(a). As noted by the district court in First Fidelity Bank v. Midlantic Nat'l Bank (In re Ionosphere Clubs, Inc.), after the enactment of Section 510(a),

“enforcement of subordination provisions [was] no longer solely an application of the court’s equitable powers.” First Fidelity Bank v. Midlantic Nat’l Bank (In re Ionosphere Clubs, Inc.), 134 B.R. 528, 533 (S.D.N.Y. 1991).

Until the Eleventh Circuit’s decision in Chemical Bank v. First Trust of New York (In re Southeast Banking Corp.), 156 F.3d 1114 (11th Cir. 1998), courts had apparently continued to recognize the viability of the Rule of Explicitness, regardless of Section 510(a). See In re Ionosphere, 134 B.R. at 533-34 (holding that the Rule of Explicitness survived the enactment of the Code).

Death and Revival of the Rule of Explicitness: In re Southeast Banking Corp.

In Southeast Banking, the Eleventh Circuit appeared to resolve the issue once and for all in holding that Section 510(a) of the Code abrogated the Rule of Explicitness. Southeast Banking Corporation filed a Chapter 7 petition. Thereafter, the junior indenture trustee argued that the subordination language in its trust indenture lacked sufficient explicitness to give the junior bondholders notice that their claim would be subrogated to the senior creditors’ claims for postpetition interest. The bankruptcy court denied payment of postpetition interest from junior bondholders based on the Rule of Explicitness and stated that the Rule of Explicitness was a principle of contract interpretation and was not overruled by the enactment of Section 510(a). Chemical Bank v. First Trust (In re Southeast Banking Corp.), 188 B.R. 452, 461-62 (Bankr. S.D. Fla. 1995). The district court upheld the lower court and held that the agreement failed to meet the Rule of Explicitness and that Section 510(a) was not meant to overturn the practice of following the Rule. Chemical Bank v. First Trust (In re Southeast Banking Corp.), 212 B.R. 682, 686 (D. Ct. S.D. Fla. 1997).

On appeal, the Eleventh Circuit initially agreed that the subordination provisions at issue in Southeast Banking failed to satisfy the Rule of Explicitness. The court in Southeast Banking found, however, that the Rule of Explicitness was no longer a controlling federal bankruptcy principle because it was abrogated by the enactment of Section 510(a). The Court held that New York state law, rather than federal common law, controlled the issue.

The court certified the question to the New York Court of Appeals to determine what language had to be included in subordination agreements to alert junior debenture holders that they were subordinating their claims to senior debenture holders' claims for interest and whether New York followed the Rule of Explicitness. The New York Court of Appeals responded by adopting the Rule of Explicitness as a "guiding interpretive principle of State contract dispute resolution" in bankruptcy cases. Chemical Bank v. First Trust of New York (In re Southeast Banking Corp.), 710 N.E.2d 1083, 1086 (N.Y. 1999).

Bank of New England Corp. v. Branch

In Bank of New England Corp. v. Branch, 364 F.3d 355 (1st Cir. 2004), the First Circuit was likewise faced with deciding whether a senior lender was entitled to postpetition interest at the expense of a junior creditor. Both the litigants and the lower courts assumed that the Rule of Explicitness continued to be valid and, therefore, framed the issue before the Court as whether or not the subordination provisions at issue complied with the equitable rule. In its holding, the Court contradicted that portion of the Southeast Banking opinion which authorized the New York state court to adopt the Rule of Explicitness as a matter of New York state law.

Bank of New England is in accord with the Southeast Banking court in holding that the Rule of Explicitness was abrogated by Section 510(a), pointing to the language of the statute and reasoning that "applicable nonbankruptcy law" refers to state law and that the federal interest in

uniform application of the bankruptcy law does not justify a resort to federal common law in the area of subordination agreements. Bank of New England, 364 F.3d at 363. The court cited the Supreme Court's decision in Butner v. United States, 440 U.S. 48 (1979) for the proposition that "property interests should not be analyzed differently as a result of a party's involvement in a bankruptcy case." Bank of New England, 364 F.3d at 363.

Bank of New England sharply disagreed with the Eleventh Circuit's decision in Southeast Banking for permitting the New York state court to fashion a bankruptcy-specific rule. The Court pointed out that the question put to the New York Court of Appeals by the Eleventh Circuit was beyond the New York state court's ability to determine because Section 510(a) "does not vest in the states any power to make bankruptcy-specific rules: the statute's clear directive for the use of applicable nonbankruptcy law leaves no room for state legislatures or state courts to create special rules pertaining strictly and solely to bankruptcy matters." Bank of New England, 364 F.3d at 364 (citing Int'l Shoe Co. v. Pinkus, 278 U.S. 261, 265 (1929)).

The Court concluded that the Rule of Explicitness, as a matter of federal equity principle, no longer has application in the context of bankruptcy. Because of the requirements of Section 510(a), a subordination agreement must be interpreted in accordance with otherwise applicable law, which the court determined was state law. State law may not adopt a rule consistent with the Rule of Explicitness that is solely applicable in a bankruptcy context, because "states are not free to adopt rules of contract interpretation that apply only in bankruptcy." Bank of New England, 364 F.3d at 359. In the Bank of New England case, the Court refused to apply what it viewed as an attempt by the New York courts to establish a rule applicable only in a bankruptcy context.

Consequently, the Court required an analysis of New York state law to interpret the contractual provisions at issue. Applying those principles, the Court found that the subordination provisions were sufficiently ambiguous as to whether they provided for the priority payment of postpetition interest. The Court remanded the case to determine the intent of the parties on the issue of whether the senior lender would receive postpetition interest at the expense of the junior lender.

Broader Implications?

The holding in Bank of New England, which provides that states may not regulate bankruptcy proceedings by providing bankruptcy-specific rules, may have far-reaching implications. It is common for drafters of contracts to consider bankruptcy implications. By the same token, state legislators are well aware of the Bankruptcy Code when promulgating new law. If that new law is bankruptcy specific, it clearly would violate the holdings of cases like Bank of New England and International Shoe. What happens, though, when a state legislature promulgates new law, which appears on its face to be of general applicability, but is in fact designed primarily to impact bankruptcy policy?

An interesting example of this gray area is the recent passage of revised Article 9, which makes significant changes in state law, and to the extent the Bankruptcy Code depends upon state law, it affects significant changes in results under the Bankruptcy Code. Revised Article 9 broadened the manner in which a secured party can perfect its interest in certain collateral, such as instruments. Under old Article 9, a party perfected its security interest in an instrument only by control. Now, under revised Article 9, a party may perfect its security interest in an instrument either by control or through filing a financing statement. This change has specific implications to a trustee in a bankruptcy.

Under Bankruptcy Code § 544, a bankruptcy trustee, in certain circumstances, has the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by a judgment lien creditor. These so-called, “strong-arm” powers allow a trustee to avoid certain transactions and as enacted in the Bankruptcy Code were similar to the strong-arm powers under the Bankruptcy Act.

Prior to the passage of revised Article 9, a secured creditor who filed a financing statement but did not have possession of the instrument would not have priority over a judgment lien creditor or a trustee in bankruptcy, because a trustee in a bankruptcy has the same rights as a judgment lien creditor. Under revised Article 9, if the secured creditor filed a financing statement, but does not have possession of the instrument, it will have priority over a judgment lien creditor. It is informative that the rules as between two secured parties were not changed under revised Article 9, only the rights of a judgment lien creditor were diminished. Because a trustee in a bankruptcy has the same rights as a judgment lien creditor, the trustee’s strong-arm powers were similarly diminished. This leaves the question whether the changes to revised Article 9, which in certain circumstances alter the long-standing rules of priority in bankruptcy, are rules of general applicability, or bankruptcy-specific rules in violation of Bank of New England?

In *The Anti-Bankruptcy Act: Revised Article 9 and Bankruptcy*, professor Ray Warner argues that revised Article 9 was drafted to alter the distribution scheme under the Bankruptcy Code because many of the changes in revised Article 9 do little to enhance a state’s non-bankruptcy objectives, but rather have a significant impact upon the bankruptcy rights of a secured creditor. See generally, Ray G. Warner, *The Anti-Bankruptcy Act: Revised Article 9 and Bankruptcy*, 9 AM. BANKR. INST. L. REV. 3 (2001).

On the other hand, Professors Steven L. Harris and Charles W. Mooney, Jr. who served as Reporters for the Drafting Committee to revised Article 9, disagree with Warner's proposition that Revised Article 9 is inconsistent with or adverse to federal bankruptcy policies. See Steven L. Harris and Charles W. Mooney, Jr., *Revised Article 9 Meets the Bankruptcy Code: Policy and Impact*, 9 AM. BANKR. INST. L. REV. 85 (2001). The professors counter that the new rules impacting distributions and power to secured creditors and unsecured creditors will operate in contexts other than bankruptcy and even if they do not, "there would be no presumptive conflict with bankruptcy policy." Id. at 94-95.

The discourse raised by professors Warner, Harris and Mooney suggest to the Authors that the holding of Bank of New England may implicate significant issues in terms of the interplay between state law and bankruptcy policy. This juxtaposition will likely be considered in future cases and may have a critical impact on the future administration of bankruptcy cases.

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