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A Theory of Contractual Debt Subordination and Lien Priority

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I. INTRODUCTION

Creditors distrust debtors and other creditors. Some of this insecurity is dispelled by the two basic priority rules—"first in time" for secured credit and pro rata sharing for general credit. These priorities, however, are merely suppletive rules that replicate what most creditors want.[1] Individual creditors can have different objectives that call for different priorities. For that reason, creditors vary their rights by contract.[2]

Two motives exist for subordination agreements. First, a creditor may wish to subordinate its priority to induce another creditor

1. Some commentators believe that liquidation priorities duplicate what the creditors would agree to if preliquidation bargaining were possible. *See* Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 871 (1982); Jackson & Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1157 (1979); Rogers, *The Impairment of Secured Creditor's Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 HARV. L. REV. 973, 994 (1983). The most typical priority rule in consensual lien systems—first in time is first in right—is explained as an attempt to protect the creditor from the debtor's misbehavior in dissipating his wealth. Jackson & Kronman, *supra*, at 1162-63. When the creditor is comparatively unskilled in preventing this misbehavior by monitoring and policing, creditors efficiently may take security under a "first in time" regime, leaving the general task of policing the debtor to those better able to do it. *Id.* at 1158-61. *But see* Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49 (1983) (arguing that the *most* efficient monitors take security).

2. 11 U.S.C. § 510(a) (1982); U.C.C. § 9-316 (1977).

to advance new funds. Second, a junior creditor may wish to advance credit, but the resulting increased leverage of the debtor would violate a covenant in a loan agreement between the debtor and some other creditor. A subordinated debt may be the only kind of debt that does not violate the covenant of a senior creditor.[3]

Governance of remote contingencies within the remote contingency of the debtor's liquidation is often too costly. Hence, subordination agreements are often vague and incomplete. When financial disaster strikes, courts are called upon to fill in the omissions left by the contract. The best way for courts to fill in these contractual gaps is by reference to the economics of the basic subordination relationship among creditors.[4]

This subordination analysis currently does not exist. The seminal article in the field[5] has stated that a theory of subordination does not matter, providing the agreement is enforced.[6] The disdain for exploring the structure of the subordination relationship in that article may have deterred the courts from making this inquiry.[7] As a result courts have not been solving interpretation dis-

3. The basic priority in bankruptcy is pro rata sharing between general creditors. This priority also is described as a suppletive rule based on what most creditors want. Pro rata sharing guarantees that no single creditor will attempt to collect its debt from an insolvent debtor at the expense of other creditors. Jackson, *supra* note 1, at 869.

4. *See generally* Farnsworth, *Disputes over Omission in Contracts*, 68 COLUM. L. REV. 860 (1968) (commenting on filling in terms omitted from the text of contracts).

5. Calligar, *Subordination Agreements*, 70 YALE L.J. 376 (1961).

6. Calligar stated that four different theories have been advanced to explain why bankruptcy courts are willing to enforce collateral agreements between creditors: subordination agreements create equitable assignments, equitable liens, or constructive trusts; or are merely contractual obligations enforced by a bankruptcy court on no particular theory. Of these theories, Calligar stated: "Each . . . is conclusionary; they are ways of rationalizing, rather than reaching, a desired result. In total, they show a general willingness on the part of the courts to find a legal reason to enforce subordination agreements." *Id.* at 389.

7. *E.g.*, First Nat'l Bank v. American Foam Rubber Corp., 530 F.2d 450, 454 (2d Cir.), *cert. denied*, 429 U.S. 858 (1976); *In re* Credit Indus. Corp., 366 F.2d 402, 407 (2d Cir. 1966). Congress has underscored the need for an examination of the structure of subordination relationships in § 510(a) of the Bankruptcy Reform Act, which provides, "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) (1982). Professor Gilmore, who wrote with his usual intelligence on subordination, predicted in 1965 "that the focus of litigation will shift to the 'true nature' of the senior-subordinator relationship." 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 37.3, at 995 (1965); *see also* Chase Manhattan Bank v. First Marion Bank, 437 F.2d 1040, 1047 (5th Cir. 1971) ("Until the trier of fact characterizes the subordination agreement executed by these parties, he cannot begin to answer the questions posed by . . . the written agreement."). The *Chase Manhattan* court confessed that it was perplexed by the distinction between subordination and assignments for security. *Id.*

putes consistently with the dynamics of subordination.

This Article examines the nature of voluntary subordination of lien and bankruptcy priorities. Part II briefly addresses the judicial role in determining the meaning of subordination agreements. Part III will demonstrate that all aspects of the agreement to subordinate debt (but not agreements to subordinate lien priority) derive from the junior creditor's simple core promise. The junior creditor promises that, after a point in time, he will receive no payment from the debtor on the junior claim until the senior creditors are paid. From this core promise, courts can build a jurisprudence that is consistent with the economics of consensual subordination.

Part IV will show that every promise not to receive payment on the junior debt is a transfer of ownership (an "assignment") of the junior claim from the subordinated lender to the senior creditors. Subordination of debt (but not of lien priority) bridges the gap between the junior creditor's personal obligation and the encumbrance of the junior creditor's property. The shift from the junior creditor's personal obligation to the transfer of the junior creditor's property protects senior creditors from the junior creditor's bankruptcy or other misbehavior. This is an important consideration because the junior creditor is frequently an insider of the common debtor. Recognition that subordination of the junior claim is an assignment by a nonrecourse guarantor in order to secure the senior claim[8] will permit courts to expropriate many useful doctrines pertaining to assignment of choses in action.

While a creditor that subordinates its debt transfers ownership of the debt, the secured creditor that subordinates lien priority (without the core promise not to receive payment on the debt itself) transfers no property. Contractual lien subordination is like any junior lien priority—the obligation to stand aside from the trough while senior creditors drink their fill according to their priorities.[9]

The above propositions run contrary to the vast weight of authority. The Second Circuit, the nation's preeminent commercial

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8. The Second Circuit recently described the nonrecourse guarantor relationship:

> A non-recourse clause normally is intended to reduce the risks to the party granting the security interest if the secured party is later forced to foreclose on the security. By precluding the secured party from getting a deficiency judgment against him, the debtor contains the risk of loss to the security alone . . . .

Vintero Corp. v. Corporacion Venezolana de Fomento, 735 F.2d 740, 742 (2d Cir. 1984) (citation omitted).

9. Lien subordination can be equated with waiver of the right to repossess and sell the collateral. *See infra* text accompanying notes 166-81.

forum, has reached opposite conclusions: subordination of debt is not an assignment,[10] and subordination of lien priority is an assignment of the security interest held by the junior creditor.[11] Because assignees of secured debt usually can rely on the perfecting acts of the assignor,[12] the categorization of lien subordination as assignment permits an assignee that has not itself perfected its security interest to survive the debtor's bankruptcy. Two prestigious works on subordination concur that debt subordination is not an assignment of the debt[13] and that lien subordination is an assignment.[14] This Article will argue that these authorities have a mistaken view of subordination.

Finally, part V will show that, contrary to the assumptions of the blue chip bar, contingent debt subordination is substantially worthless. At least in the American Bar Association (ABA) standard forms, unvested subordination rights can be amended away if the junior creditors and the common debtor choose to do so. Thus, the ABA form provides an opportunity for instant wealth transfer from the seniors to the juniors that senior creditors can prevent only by enforceable refunding prohibitions. A weird corollary is that, providing subordination rights are still contingent, the junior creditor may receive security for its subordinated loan. This leaves the loan simultaneously secured and subordinated. This anomaly is appropriate, provided the junior creditor receives security at a time when its claim could have been prepaid.

II. THE JUDICIAL ROLE IN DETERMINING THE MEANING OF SUBORDINATION AGREEMENTS

In the reported cases on subordination agreements courts usually are asked to fill in omitted terms. This should be no surprise. The cost of negotiating these agreements often will outweigh the benefits of formulating rules for remote contingencies.

The parties can reduce these costs by recourse to standard forms.[15] Since invention costs for these forms are now sunk, their

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10. *See* First Nat'l Bank v. American Foam Rubber Corp., 530 F.2d 450, 454 (2d Cir.), *cert. denied*, 429 U.S. 858 (1976); Cherno v. Dutch Am. Mercantile Corp., 353 F.2d 147, 150-51 (2d Cir. 1965).

11. *See* Citibank, N.A. v. Tele/Resources, Inc., 724 F.2d 266 (2d Cir. 1983).

12. U.C.C. § 9-302(2) (1977).

13. *See* Calligar, *supra* note 5, at 395-96.

14. *See* Coogan, Kripke & Weiss, *The Outer Fringes of Article 9: Subordination Agreements, Security Interests in Money and Deposits, Negative Pledge Clauses and Participation Agreements*, 79 HARV. L. REV. 229, 234 n.20, 259-61 (1965).

15. *See, e.g., Model Simplified Indenture*, § 11.01-.08, 38 BUS. LAW. 741, 769-70 (1983)

use in future deals is highly efficient. Lawyers also can use forms to overrule disfavored judicial opinions interpreting prior language. This greatly reduces the long term judicial damage done by courts to stylized and repetitive loan agreements.[16]

The standardization of forms for large loans does not absolve courts from the need to understand the basic relation between junior and senior creditors. The large number of recent subordination cases suggests new disputes unanticipated by the investment industry can spring up even when the parties use these forms. Judges who decide wrongly may be unable to cause long term damage, but, even in the short term, no judge wants to impose a loss unfairly on the individual parties to an agreement. Moreover, a judicial decision concerning one standard-form loan could affect the market value of all similar debt instruments.[17] In addition, as the size of the deal shrinks, the parties become less sophisticated regarding the standard forms.[18] Under time pressure, even sophisticated lawyers can draft poor agreements.[19] The advance sheets include enough of these events to justify a more satisfactory theory of consensual subordination relations between senior and junior creditors.

The role of the courts in settling subordination agreement disputes does not differ from the courts' general role in interpreting contracts. If the parties have formed an expectation about the meaning of an agreement, the court's role is to find and to effect that expectation. Because of expense, negotiators cannot form expectations on every conceivable event. Failure to form an expectation is especially common in subordination agreements in which the subject of the agreement is the "remote contingency" of the

(§ 11.01-.08).

16. One author, writing on convertible bonds, documented how lawyers overruled disfavored judicial opinions with revised boilerplate language in standard forms. Bratton, *The Economics and Jurisprudence of Convertible Bonds*, 1984 WIS. L. REV. 667, 718-19. The tendency of the financial bar to engage in this practice is evidence that the original judicial decisions misperceived the allocation of risks assumed at the marketplace. *Id.* at 723; *see also* Bratton, *The Interpretation of Contracts Governing Corporate Debt Relationships*, 5 CARDOZO L. REV. 371, 378-79 (1984) [hereinafter cited as *Interpretation of Contracts*].

17. Bratton, *supra* note 16, at 708-10.

18. For a truly incomprehensible agreement, see Peoples Bank & Trust v. Reiff, 256 N.W.2d 336 (N.D. 1977). In this case, the trial and appellate courts disagreed on which party was the junior creditor and which was the senior creditor.

19. For a Wall Street associate's nightmare, see Chase Manhattan Bank v. First Marion Bank, 437 F.2d 1040 (5th Cir. 1971), in which lawyers for the senior creditors inserted subordination clause into an intracreditor preference agreement that was limited to 12 months.

debtor's liquidation.[20]

When the parties form no expectations, courts resort to many different methods to decide cases. Courts investigate the relations between the parties and develop rules that comport with the purpose of the relationship. If such inquiries fail to suggest an answer, then courts often resort to "rules of thumb," or place the drafting burden on the plaintiff. These crude methods do not purport to find the parties' expectations, nor do they explore the purpose of the relationship, but they effectively dispose of cases.

Courts should use this last type of method only when the exploration of the relations between the litigants fails to suggest an answer. In cases concerning subordination agreements, however, courts have resorted to these methods without making a proper exploration of the litigants' relations. In *First National Bank v. American Foam Rubber Corp.*,[21] the junior creditor deprived the senior creditor of the junior creditor's dividends in bankruptcy by exchanging debt for stock. The Second Circuit decided the case without exploring the nature of subordination. Instead, the court imposed the drafting burden on the senior creditor. The court held the action taken by the junior creditor and debtor to be consistent with the contract because the agreement expressly did not bar such action. If the court had understood the nature of the subordination agreement, a different result would have been reached.[22]

A description of the basic contractual subordination relation follows. Individual creditor's expectations may differ, but the purposes of subordination should be the same in a majority of cases. There should be a presumption in favor of using the suppletive rules that will be developed, rebuttable only if it is very clear that the parties have developed contrary expectations.

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20. *See* First Nat'l Bank v. American Foam Rubber Corp., 530 F.2d 450, 456 (2d Cir.), *cert. denied*, 429 U.S. 858 (1976).

21. *Id.*

22. The court characterized the *First National Bank* case as a "discharge" case, but the junior debt was traded for stock. The court should have determined that the senior creditor became the owner of the stock. In addition, to the extent the stock was not a fair exchange (*i.e.*, to the extent the transaction was a true discharge), the junior creditors should have been liable in damages to the senior creditor for breach of the assignor's duty to take no action to defeat a presently effective assignment of the junior debt. *See infra* note 195.

III. The Fundamental Promise in a Debt Subordination Agreement

The subordination clause in the ABA Model Simplified Indenture[23] imposes the following obligation on junior creditors: (1) After a certain point,[24] the junior creditor promises not to receive payment from the debtor until the senior creditors are paid. (2) If the junior creditor does receive payment after that point—"an improper payment"—the model indenture deems the junior creditor to hold it "in trust" for the senior creditor.[25] (3) In the common debtor's bankruptcy proceeding, any dividends payable to the junior creditor instead should be payable to the senior creditors—the assignment idea.[26] The senior creditors receive "double dividends"[27] because, in addition to the usual dividends allocable to the senior claim against the debtor, the senior creditors receive the junior creditor's dividends as well. (4) After the senior creditors recover their claims against the debtor, the right to receive junior dividends reverts back to the junior creditor. In addition, the jun-

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23. *Model Simplified Indenture*, *supra* note 15, at 769-70 (§ 11.01-.08).

24. The critical point is the time the junior creditor is notified of default on the senior debt. *Id.* (§ 11.04).

25. *Id.* at 770 (§ 11.06). The word "trust" should mean only that the senior creditor is to have a proprietary interest in the improper payment. Use of the term "trust" should not mean that the senior creditor has an "equitable" property interest in the improper payment. For the meaning of "equitable" as applied to property concepts, see text accompanying notes 96-104.

26. *Id.* at 769 (§ 11.03).

27. First Nat'l Bank v. American Foam Rubber Corp., 306 F. Supp. 593, 601 (S.D.N.Y. 1969), *rev'd on other grounds*, 530 F.2d 450 (2d Cir.), *cert. denied*, 429 U.S. 858 (1976); *In re* Associated Gas & Elec. Co., 53 F. Supp. 107, 114 (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); 2 G. Gilmore, *supra* note 7, at 985-86; Calligar, *supra* note 5, at 377; *see also* Cohn, *Subordinated Claims: Their Classification and Voting Under Chapter 11 of the Bankruptcy Code*, 56 Am. Bankr. L.J. 293, 295-96 (1982).

The phrase "double dividends" must not be taken literally. Double dividends will be exactly double only when the junior and senior claims are equal in size and priority.

Double dividends can be a valuable right. *See* Citibank, N.A. v. Baer, 651 F.2d 1341, 1345 n.2 (10th Cir. 1980) (reorganization securities worth $6,000,000 given to supplement senior creditors' share); *In re* W.T. Grant Co., 4 Bankr. 53, 58-59 (Bankr. S.D.N.Y. 1980) (double dividends of $95,378,373), *aff'd*, 20 Bankr. 186 (S.D.N.Y. 1982), *aff'd*, 699 F.2d 599 (2d Cir.), *cert. denied*, 104 S. Ct. 89 (1983). In *W.T. Grant* the dividend amount was equal to the face value of all subordinated debentures. Meanwhile, other creditors were receiving dividends of less than 50%. *In re* W.T. Grant Co., 4 Bankr. Ct. Dec. (CRR) 596, 607 (Bankr. S.D.N.Y. 1978). One would have thought that ratio of junior dividend to face value of junior debt would have equated with the ratio of general dividend to the total general debt. According to the bankruptcy court the 100% junior dividend was designed to protect the junior debenture holders from the compromise and settlement of all nonjunior claims. *Id.* at 605.

ior creditors become subrogated to any further bankruptcy dividends that the senior creditors are entitled to receive. This subrogation clause guarantees that the junior creditor will receive double dividends after the senior creditors are paid out.[28]

The above obligations make subordination agreements relatively easy for a bankruptcy court to administer—providing the parties do not try some unusual ploy to increase their take or avoid their obligations. Courts, however, have gone awry when some of the above promises are not expressly set forth. This Article posits that the above contractual clauses from the Model Simplified Indenture all derive from the core promise not to receive payment on the junior debt until the senior creditors are paid. When these clauses are not explicitly set forth in a subordination agreement, courts should infer them because they are consistent with the economic purposes of subordination.

A. *The Promise to Receive No Payment as an Assignment of Bankruptcy Dividends*

A junior creditor may make its promise to receive no payment immediately effective, or it may defer effectiveness until some contingency occurs. When a subordination promise is immediately effective, it is a "complete subordination"—a term that suggests a complete lack of contingencies regarding the core promise.[29] When a subordination promise not to receive payment is contingent on a future event of default—such as violation of a net capital ratio or the common debtor's bankruptcy—it is a contingent subordination.[30]

The simple promise to receive no payment before senior credi-

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28. *Model Simplified Indenture*, *supra* note 15, at 770 (§ 11.08).

29. *See* Calligar, *supra* note 5, at 381.

30. Calligar termed any subordination duty contingent on the debter's bankruptcy to be an "inchoate" subordination. Calligar, *supra* note 5, at 377. The term "incboate" inappropriately suggests that the agreement creates no rights before the contingency occurs. Coogan, Kripke & Weiss, *supra* note 14, at 234 n.20 ("this term is misleading because it suggests tbat something further bas to be done in order to make the subordination good against the [junior] creditors"); Everett, *Subordinated Debt—Nature, Objectives and Enforcement*, 44 B.U.L. Rev. 487, 491 n.9 (1965); *see* Charles W. & Ruby W. Norton, Inc., v. Leadville Corp., 570 F.2d 911, 912 (10th Cir. 1978) ("inchoatcness" equated with unenforceability).

Calligar bad no term for a subordination agreement in which the promise to receive no payment was not immediatcly effective but was effective earlier than the debtor's bankruptcy. In this Article, these agreements are called "contingent subordinations." This new terminology is consistent with the Article's empbasis on the junior creditor's promise not to receive payment until the senior creditors are paid as the essence of debt subordination.

tors, regardless of whether it is a complete or contingent subordination, translates into the double dividend system described in the Model Simplified Indenture, a proposition that courts generally have recognized.[31] The superiority of the double dividend system becomes apparent upon consideration of the effect of withholding bankruptcy dividends from the junior creditor without assigning them to the senior creditor.[32]

When the debtor's estate is liquidated, all further opportunity for creditors to obtain repayment from the debtor disappears. If subordination means only that the junior creditor is denied a share of the bankrupt's estate until the senior creditors are paid, consistent with the literal words of the core promise, more of the estate is available to satisfy the senior creditor's claim. But more also is available to satisfy nonsenior claims. Absent an assignment of dividends to the senior creditor, ordinary creditors benefit to exactly the same extent as the senior creditors, and the contractual language identifying specific senior creditors is superfluous. For the senior creditor to get any *special* benefit in bankruptcy from the subordination clause, an assignment of double dividends, barring unusual contractual language, must be presumed.[33]

While double dividends provide the senior creditors with more, these dividends actually cost the junior creditors less. For example, in a large bankruptcy with numerous creditors and fifty

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31. *See In re* Credit Indus. Corp., 366 F.2d 402, 412 (2d Cir. 1966) ("Any reference to bankruptcy proceedings would have been superfluous in view of the broad terms of the [complete] subordination provisions."); Cherno v. Dutch Am. Mercantile Corp., 353 F.2d 147, 154 (2d Cir. 1965); *In re* Geo. P. Schinzel & Son, Inc., 16 F.2d 289 (S.D.N.Y. 1926) (what appeared to be a complete subordination translated into an "equitable lien" on the junior creditor's bankruptcy dividends); First Nat'l Bank v. American Foam Rubber Corp., 306 F. Supp. 593, 601 (S.D.N.Y. 1969), *rev'd on other grounds*, 530 F.2d 450 (2d Cir.), *cert. denied*, 429 U.S. 858 (1976); *In re* Handy-Andy Community Stores, Inc., 2 F. Supp. 97 (W.D. La. 1932). Only one older case held a contrary position. *See In re* Goodman-Kinstler Cigar Co., 32 Am. Bankr. Rep. 624 (Bankr. S.D. Cal. 1914).

32. Withholding dividends shall be termed the "demotion" theory. The "demotion" theory is in the nature of a waiver of rights and is the alternative to an assignment theory. While the demotion theory is inappropriate for debt subordination, it should be the operative theory for lien subordination. *See infra* text accompanying notes 171-81.

33. *See* Wyse v. Pioneer-Cafeteria Feeds, Ltd., 340 F.2d 719, 723 (6th Cir. 1965) ("It is to be noted, however, that the enforcement of subordination agreements between creditors of the same bankrupt affects only their rights and does not interfere with or change the rights of other creditors."); *In re* Geo. P. Schinzel & Son, Inc., 16 F.2d 289 (S.D.N.Y 1926); *In re* Associated Gas & Elec. Co., 53 F. Supp. 107, 114 (S.D.N.Y 1943) (double dividends approved specifically to exclude nonsenior creditors), *aff'd sub nom.* Elias v. Clarke, 143 F.2d 640 (2d Cir.), *cert. denied*, 323 U.S. 778 (1944). In one case, the court noted that there ought to be a difference between senior and nonsenior debt and asked the referee to take evidence on the matter. *See In re* Discon Corp., 346 F. Supp. 839, 845 (S.D. Fla. 1971).

percent dividends or more, a general demotion of a junior creditor guarantees no return on its claim and perhaps only the slightest increase on the return of all the other creditors. A double dividend system, however, will provide the junior creditor partial repayment when the senior debt is less than half the size of the junior debt. Double dividends are lucrative for the senior creditor, cheaper for the junior creditor, and essentially free for the common debtor, and thus should be an important element in all debt subordinations.

Double dividends are also more efficient than general demotion because they lower the aggregate cost of credit to the common debtor. When the purpose of subordination is to induce new credit,[34] double dividends provide security to the senior creditor. Security lowers the risk of the loan and hence lowers the price that the senior creditor will charge.[35] A general demotion theory provides less security. The price of a senior loan under such a rule must reflect the risk that subsequent creditors can expropriate the subordination benefit. A general demotion theory, therefore, does not have the favorable effect on the price of senior credit that double dividends would have.[36]

A general demotion theory probably will not lower the cost of nonsenior credit enough to counterbalance the above costs imposed upon the senior and junior creditors. Preexisting nonsenior creditors have no opportunity to lower the cost of new credit. Hence, general demotion transfers wealth to preexisting creditors for free. Furthermore, postsubordination creditors will have no incentive to lower the price of their loans to the common debtor in light of existing subordination benefits. Each creditor extending credit under a general demotion theory of subordination must discount the subordination benefit by the probability that its value will be diluted by the issuance of subsequent debt. Hence, a general demotion theory of subordination will have only a fraction of the cost reducing effect that double dividends would have. A double dividend theory limits the security to creditors that can lower the cost of

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34. On the two motives for subordinating a debt claim, see *supra* text accompanying notes 2-3.

35. On the relation between risk and price of a loan, see Carlson & Shupack, *Judicial Lien Priorities Under Article 9 of the Uniform Commercial Code: Part 1*, 5 CARDOZO L. REV. 287, 307-09 (1984).

36. The threat of future expropriation of collateral by subsequent creditors is the justification for the "first in time first in right" rule that prevails in commercial law. *See* Jackson & Kronman, *supra* note 1, at 1161-64.

their loans. A general demotion theory forces a division of the security with free riders and provides no protection against subsequent debtor misbehavior.

In addition to the inducement of new senior credit, the desire to avoid debt restrictions imposed by preexisting debt covenants also can motivate junior creditors to subordinate their claims. Double dividends for those entitled to enforce preexisting debt covenants can be characterized as a benefit not anticipated in setting the price of the senior loan. As such, double dividends are a benefit for which the senior creditor did not pay.[37] The free ride for senior creditors, however, is less costly to the junior creditor than the free ride under a general demotion theory.[38] Therefore, junior creditors would prefer an interpretation of subordination agreements that requires double dividends instead of general demotion.

Every promise not to receive payment before the senior creditors are paid should result in double dividends and should prevent general creditors from receiving a windfall in the debtor's bankruptcy. The promise not to receive *prebankruptcy* payment until specified senior debts are paid, however, benefits all general creditors because the senior creditor takes no immediate rights to payment. Only the debtor's liquidation—when junior dividends must be disposed of one way or another—activates the senior creditor's rights. The promise of the junior creditor to forego prebankruptcy payment merely enhances the debtor's estate to the equal benefit of senior and nonsenior creditors. In this respect, the junior creditor's promise to receive no payment is like a covenant by the debtor against further debt. Each type of promise renders the debtor's credit less risky. Preexisting creditors receive a windfall because these covenants render their claims less risky, but subsequent creditors may perceive less risk and may tend to offer lower interest rates.

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37. The creditor with a debt restriction covenant cannot always count on the issuance of subordinated debt to generate double dividends. Later issuance of the debt is, therefore, frequently a windfall. The restrictive covenant itself, however, tends to reduce the price of the senior claim. But the basis for the lower price—reduced risk of a dissipating asset base—is served as well by a general demotion theory as by a double dividends theory.

The senior creditor with a covenant to enforce also suffers an increased risk because subordinated debt makes the debtor more highly leveraged. Arguably double dividends are not a free ride because they are paid for by permission to increase the leverage of the common debtor. If double dividends do not create a free rider problem in this context, the argument for preferring double dividends over general demotion is even stronger.

38. *See supra* text accompanying notes 33-34.

B. Derivation of the Subrogation Clause

The subrogation clause in the standard form subrogates the junior creditor to the right to future senior dividends after the senior claims have been satisfied by senior and junior dividends. The junior creditor then receives "double dividends,"[39] arising from the senior creditor's subrogation rights. This allows the junior claim to catch up with the nonsenior claims that have continued to receive bankruptcy dividends at an even rate.

The basic subordination relation demands that a subrogation right be inferred even when such a right is not explicit in the agreement.[40] The consequences of not awarding the junior creditor double dividends after the satifaction of senior claims illustrates why.

After a bankruptcy court fully pays a senior creditor from double dividends, it has three choices regarding the remaining dividends payable on the senior debt. The court can: (a) Overpay the senior creditor; (b) dismiss the senior creditor and retain the dividends in the bankrupt's estate for the general creditors; or (c) pay excess dividends to the junior creditor, thus providing the junior creditor with double dividends. Further enrichment of the senior creditor as in alternative (a) would violate the probable expectations of the parties. Generally the parties contemplate assignment of bankruptcy dividends as security for the senior debt, not as an outright "sale" of the junior debt. The core promise not to receive payment until the senior creditors are paid directly contradicts the first of these three options.[41] Alternative (b) calls for the bank-

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39. *See* Allegaert v. Chemical Bank, 657 F.2d 495, 498-99 n.2 (2d Cir. 1980); *Model Simplified Indenture, supra* note 15, at 770 (§ 11.08).

40. Although few bankruptcies result in general creditors receiving 100% satisfaction of their claims, the phenomenon is not unknown. *In re* Nova Real Estate Inv. Trust, 30 Bankr. 347 (Bankr. E.D. Va. 1983); Meckling, *Financial Markets, Default, and Bankruptcy: The Role of the State*, 41 LAW & CONTEMP. PROBS., Autumn 1977, at 13, 32-33. The remote possibility of complete satisfaction is not the only reason a comprehensive subrogation theory for subordination agreements is necessary. Subrogation could arise when the senior debt is small and the junior debt is large. For example, if $1000 in junior debt is subordinated to $100 of senior debt, and each creditor receives 50% on its claim, the junior creditor initially receives a $500 dividend. The senior creditor initially receives a $50 dividend. Sufficient junior dividends would be assigned over to the senior creditor ($50) in order to satisfy the senior claim. Thus, after the first distribution, the senior creditor receives $100, while the junior creditor receives $450. If there is a subsequent distribution of 10% on all general claims, the junior creditor would receive an additional $100. It also is subrogated to the five dollars the senior creditor would have received if the senior creditor had not been paid fully. Thus, in the second distribution, the junior creditor would receive $105—a higher pro rata amount than other general creditors would receive.

41. A different issue on the size of the senior claim is whether the senior debt includes

ruptcy court to retain all future dividends on the senior debt for the benefit of all general creditors. When the subordination agreement names specific senior creditors, however, the junior creditor that consents to the double dividend system ordinarily will intend no benefit to the nonsenior creditors.[42] The junior creditor's purpose is to induce new credit or to steer clear of senior covenants against new debt. Avoidance of free rides dictated creation of the double dividend system.[43] The same reason dictates the creation of a subrogation right after the senior creditor is paid. Under alternative (c), the only choice left, the bankruptcy court pays back senior

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the senior creditor's postbankruptcy interest claims against the common debtor. Postbankruptcy interest is not an allowable claim in bankruptcy. 11 U.S.C. § 502(b) (1982). *But see id.* § 726(a)(5) (creditors receive postbankruptcy intcrest at the legal rate if all other creditors bave been paid). Junior creditors can agree that the senior creditors should receive compensation for loss of senior postbankruptcy interest from junior bankruptcy dividends. *See* Bankers Life Co. v. Manufacturers Hanover Trust Co., 514 F.2d 400, 401 n.2 (2d Cir. 1975).

In the three leading cases on this issue, the subordination agreements indicatcd that the junior creditor could not receive payment until principal *and interest* on the senior claim were paid in full. *In re* King Resources Co., 528 F.2d 789, 791 (10th Cir. 1976); Bankers Life Co. v. Manufacturers Hanover Trust Co., 514 F.2d 400, 401 (2d Cir. 1975); *In re* Time Sales Fin. Corp., 491 F.2d 841, 842 (3d Cir. 1974). But these courts concluded that the senior creditors had not been sufficiently clear in defining the senior debt to include postbankruptcy interest. *Cf. In re* Aktiebolaget Kreuger & Toll, 96 F.2d 768, 770 (2d Cir. 1938) (placing drafting burden on junior creditor regarding intent to exclude interest from junior claim). The reasoning of these courts is associational, not logical. The senior creditor cannot recover postbankruptcy interest against the common debtor on a general unsecured claim, but it is not the debtor who pays postbankruptcy interest in this case. It is the junior crediotr who pays with junior creditor property. Also, a senior creditor can recover its secured postbankruptcy interest to tbe extent of the collateral. 11 U.S.C. § 506(b) (1982). The junior debt itself is collateral for the senior debt. *See infra* tcxt accompanying notes 72-153. If the junior creditor were bankrupt at the same time as the common debtor, the junior creditor's trustee would have to award postbankruptcy interest to the senior creditor out of the collateral. *Id.* Why should the rule be different when the junior creditor is solvent?

Subordination is the assigument of a chose in action by a nonrecourse guarantor. The usual motivation in suretyship is to guarantee the repayment of the *entire* senior claim. The motivation to guarantce the entire senior claim also motivates parties to a subordination agreement. Placing the drafting burden on the senior creditors is less likely to replicate the parties' expectations, especially when the senior claim broadly includes *all* interest claims. *Cf.* Citibank, N.A. v. Smith Jones, Inc., 17 Bankr. 128 (Bankr. D. Minn. 1982) (broadly phrased subordination agreement covered senior creditor's postbankruptcy advances).

Further evidence against tbe proposed solution of the above cited cases is the inclusion of postbankruptcy interest in the standard forms definition of the senior debt. *Model Simplified Indenture, supra* note 15, at 1169 (§ 11.03(1)). The standard forms represent typical market expectations of debt covenants. Bratton, *supra* note 16, at 718-19. Therefore, in a future case when the parties do not follow the standard forn but do not specifically reject it, the better view of the parties' agreement is a definition of senior claim that includes postbankruptcy interest.

42. *See supra* text accompanying notes 31-35.

43. *See id.*

dividends to the junior creditor. This subrogation cuts out free-riding nonsenior creditors and is, therefore, consistent with efficiency considerations and with the purpose of the contracting parties.

The theory propounded in alternative (c) can be used to justify the implication of subrogation into every surety relationship.[44] If subrogation were not implied, the surety not only would benefit the assured creditor, but also would enrich the debtor's estate and hence the general creditors. The removal of any creditor from a pro rata distribution increases the share of the remaining creditors. Subrogation allows the surety to take the place of the assured creditor and recover the dividend otherwise payable to the assured party. Subrogation does not prejudice the general creditors in comparison to their presurety position and reduces the cost of the arrangement to the surety. All of these reasons exist in the context of surety as well as subordination.[45]

C. Assignments and Subrogation in Analogous Subordination Systems

Both the assignment and subrogation portions of the double dividend system should become a part of the federal doctrine of equitable subordination. Section 510(c)(1) of the Bankruptcy Code states that a court may "subordinate for purposes of distribution all or part of an allowed claim to . . . all or part of an allowed interest to all or part of another allowed interest . . . ."[46] Significantly, Congress has drawn a distinction between equitable subordination to *all* claims and subordination to a *subset* of claims. This distinction has meaning only if double dividends are awarded to the subset. Otherwise, the court only can institute a general demotion of a claim to a position below that of general creditors,[47] which

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44. *See* Bankruptcy Act of 1898 § 57(i), ch. 541, 30 Stat. 544 (creditor that has received its full claim partly from dividends and partly from surety must hold additional dividends in trust for surety).

45. The Trust Indenture Act, 15 U.S.C. § 177kkk (1982), sets up a double dividend system whenever the indenture trustee, as independent creditor, accepts a preference four months before bankruptcy. *See infra* note 71. The indenture trustee is subrogated to that part of the senior creditors' (*i.e.*, debenture holders') claim that is satisfied from the proceeds of the indenture trustee's preference. Caplin v. Marine Midland Grace Trust Co., 439 F.2d 118 (2d Cir. 1971). Thus, subrogation rights fit naturally into subordination regimes.

46. 11 U.S.C. § 510(c)(1) (1982).

47. *See In re* Pat Freeman, Inc., 42 Bankr. 224 (Bankr. S.D. Ohio 1984) (using demotion theory, even though the guilty creditor had harmed only one person); *In re* Osborne, 42 Bankr. 988 (Bankr. W.D. Wis. 1984) (remanding case to determine proper standard for equitable subordination to a single harmed creditor).

would not give special benefit to the subset of claims.[48]

Congress also invites a double dividend system in section 509(c), which subrogates a guarantor to the rights of the benefited creditor to the extent that the guarantor has paid the creditor.[49] An obvious problem arises when the guarantor pays only half the guaranteed claim. If it enters the bankruptcy proceeding along with the half-paid creditor, both parties are entitled to bankruptcy dividends. The presence of the guarantor is prejudicial to the guaranteed creditor but not to the nonguaranteed creditors.[50] Congress has solved this dilemma by providing:

> The court shall subordinate to the claim of a creditor and for the benefit of such creditor an allowed claim, by way of subrogation under section 509 of this title, or for reimbursement or contribution, of an entity that is liable with the debtor on, or that has secured, such creditor's claim, until such creditor's claim is paid in full, either through payments under this title or otherwise.[51]

A full double dividend system best effects this statutory language. Such a system removes the prejudice to the guaranteed creditor caused by a partially performing guarantor making subrogation claims in bankruptcy and prevents a windfall to general creditors. The double dividend system pays the guaranteed creditor at the same rate as if it had made its full claim in bankruptcy and as if there had been no partial satisfaction of the guarantor.[52]

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48. The suggested approach for both contractual and equitable subordination is punishment to fit the crime. *See In re* W.T. Grant Co., 699 F.2d 599, 604 n.7 (2d Cir.), *cert. denied*, 104 S. Ct. 89 (1983). Subordination to a specific creditor should not adhere to the benefit of *all* creditors. Professor Clark has urged sculpting equitable subordination to match fault in a different context. Professor Clark believes that an important goal of equitable subordination is punishment of insider creditors for taking fraudulent conveyances. He believes that recovery of the fraudulent conveyance is the fairest remedy, but if a court uses equitable subordination, the amount of the fraudulent conveyance should be offset against the bankruptcy dividend otherwise due to the subordinated creditor. This rule would succeed in avoiding the overcompensation or undercompensation of the general creditors. *See* Clark, *The Duties of the Corporate Debtor to its Creditors*, 90 HARV. L. REV. 505, 518-25 (1977).

Analogously, the rules proposed for § 510(c) and for contractual subordination try to achieve the distributional fairness that concerns Professor Clark.

49. 11 U.S.C. § 509(c) (1982).

50. Nonguaranteed creditors must expect that a full dividend is allocable to the guaranteed debt. Whether the dividend goes to the guarantor or to the benefited creditor, however, is a matter of indifference to the general creditors.

51. 11 U.S.C. § 509(c) (1982).

52. A numerical example might help illustrate the beneficial effects of double dividends as applied to suretyship. Suppose *A* guarantees *B*'s loan of $100 to *D*. *D* defaults and files in bankruptcy. *B* demands payment from *A*, but *A* pays only $50. *B* then seeks the deficit in *D*'s bankruptcy proceeding. Meanwhile *A* also seeks to recover $50 from *D* on the grounds that *A* is subrogated to *B*'s claim for that $50. Assume that *D*'s trustee can pay

D. *The Meaning Accorded to the Word "Subordinated"*

The preceding analysis gives meaning to the subordination agreement that contains no express promise to forego payment or to assign bankruptcy dividends. In *In re Joe Newcomer Finance Co.*[53] the court ruled that the term "subordinated" had no inherent meaning. Two leading authors also have demurred on what meaning to give the simple statement that a debt is "subordinated."[54] More should be done with the term than these authors or the *Newcomer* court were willing to do.

The analysis of a subordination clause unaccompanied by any explicit promise is best divided into two parts. First, does a creditor intend to change its position when it uses the term "subordinated"? Second, in what respect does a creditor intend to change its position?

As to the first point, a typical creditor should understand that subordination pertains to bankruptcy priority, and that subordinated debt falls behind other debt in that priority.[55] The diction-

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50% of all claims.

If *A* is allowed to make a subrogation claim for $50, the estate is depleted by $25, to *B*'s detriment. Section 509(c) therefore requires that *A* be demoted. The issue addressed in the text is the disposition of the $25 that *A* would have received from *D*'s trustee, but for the operation of § 509(c).

If the $25 is distributed to all the creditors, *B* takes only a pro rata share of it. On the other hand, if the $25 is given entirely to *B*, the other creditors are not harmed because *B* is receiving $50 on a claim that was initially $100.

53. 226 F. Supp. 387, 392 (D. Colo. 1964). The ambiguous clause read: "The interest on these notes shall be payable only out of earnings of the corporation and the principal represented hereby, and interest thereon, shall be subordinated to the claims of all other general creditors, secured or unsecured, including banks [sic]." *Id.* at 389. A semicolon between "corporation" and "and" would have rendered clear the intent to subordinate. The court noted that the clause reads as if the debtor promised to pay interest out of the principal of the debenture, an absurd notion, except that the debtor, in Ponzi-like fashion, apparently did just that.

Placement of semicolons seems to be a major issue in subordination cases. *See In re* W.T. Grant Co., 4 Bankr. 53, 71 (Bankr. S.D.N.Y. 1980), *aff'd*, 20 Bankr. 186 (Bankr. S.D.N.Y. 1982), *aff'd*, 699 F.2d 599 (2d Cir.), *cert. denied*, 104 S. Ct. 89 (1983).

54. "A subordination clause may provide merely that [the] debt is 'hereby subordinated.' . . . [T]here have . . . been no decisions on whether a clause so inartistically drawn is to be construed as effecting a complete subordination . . . or an inchoate subordination . . . ." 2 G. GILMORE, *supra* note 7, § 37.1, at 986. "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." Calligar, *supra* note 5, at 383.

55. Aldrich v. Redington, 605 F.2d 590, 597 (2d Cir. 1978); *In re* Eaton Factors Co., 3 Bankr. 20 (Bankr. S.D.N.Y. 1980). In these cases, junior creditors unsuccessfully asserted that they did not understand the meaning of the word "subordinated" because they were unsopbisticated.

ary definition of subordination compels this conclusion. A creditor should not be able to deny that a "subordinated" claim is less valuable than an ordinary claim.[56] Second, the vague promise to be subordinated, without more, implies assent to the double dividends system. The alternatives are unacceptable. A general demotion specific senior creditors are the beneficiaries grants an expensive free ride to unnamed general creditors.[57] Of course, if the vague promise does not specify senior creditors, or if it is for the benefit of *all* creditors, the effect of double dividends is indistinguishable from a general demotion.[58] Thus, in the *Newcomer* case, the vague promise to be "subordinated to all other general creditors,"[59] would not produce double dividends for any specific senior creditor. The promise should have resulted in the general demotion of the unfortunate holders of the "subordinated debenture notes."[60]

Complete subordination also should be rejected as the basic meaning of the word "subordinated." Complete subordination is inconsistent with provisions in loan agreements that stipulate a specific maturity. Under a complete subordination, the junior creditor promises that it will not exercise its right to collect on its debt

56. *Newcomer*, 226 F. Supp. at 391. The court in *Newcomer* said that the subordinated debenture holders "were not sophisticated in the sense that they would be likely to give accurate legal scrutiny to the rather ambivalent wording of their documents." *Id.* at 391. A difference exists, however, between inability to describe all the legal ramifications of subordination—an inability upon which publication of this Article is premised—and an inability to understand that subordinated debt is not as good as ordinary debt.

57. *See supra* note 36 and accompanying text.

58. *In re* Aktiebolaget Kreuger & Toll, 96 F.2d 768, 770 (2d Cir. 1938).

59. *See supra* note 53.

60. If the objective is to eliminate free riders, a division of junior dividends other than that envisioned in the double dividends system also might suffice. For example, instead of giving all junior dividends to the senior creditor, subordination might allow the transfer of just enough dividends to "hold the senior creditor harmless" in preserving the senior creditor's prior position. Suppose there are nine claims on the debtor. The junior debt is the tenth claim. The junior creditor could give enough dividends to ensure the senior creditor a one-ninth share of the estate. The junior creditor then would retain the rest, even though the senior creditor was not paid fully. Although this system eliminates free riders (as would any other division of junior dividends between junior and senior creditors), it does not comport with the meaning of the word "subordination" as used in commercial law. Subordination is tied integrally with the termination of the transferor's rights in his former property. Carlson, *Death and Subordination Under Article 9 of the Uniform Commercial Code: Senior Buyers and Senior Lien Creditors*, 5 CARDOZO L. REV. 547, 558-62 (1984). Subordination implies a hierarchy of secured creditors that give way completely to the senior party before the junior can receive any payment. Thus, subordination is less suited to the above "hold harmless" interpretation, under which the junior creditor may retain a large percentage of his dividends. Of course, this alternative construction is even less supportable when the parties set forth the core subordination promise—that the junior creditor will receive no payment until the senior creditor is paid. *See supra* text accompanying notes 29-30.

when the debt matures, even if the common debtor is solvent and completely able to pay the senior debt. On the other hand, subordination contingent on liquidation allows the junior creditor to receive periodic payments at maturity providing the debtor is not bankrupt.[61]

E. Payments Wrongfully Received by the Junior Creditor in Breach of the Subordination Promise

The principle of excluding nonsenior creditors from the benefits of subordination has led to a full double dividend system, including subrogation of the junior creditor to the senior creditor's future dividends after the senior creditor is paid fully. The same principle permits a similar interpretation of the "trust clause" that appears in standard form subordination agreements. In addition, this principle suggests that a trust clause should be implied into every subordination relation, unless a contrary intent clearly exists.

In support of the junior creditor's promise not to receive payment from the common debtor, the trust clause provides that any payments actually received by the junior creditor, in violation of the subordination agreement, should be held in trust for the senior creditors.[62] The trust clause presents an issue that is sure to arise in bankruptcy court: what are the trustee's rights when the junior creditor has received a wrongful payment immediately before bankruptcy?

As a preliminary matter, if the payment is voidable by the trustee as a preference, the trustee should recover it for the benefit of all the creditors. Afterwards, the senior creditors should receive their double dividends based on the junior creditor's share of the enhanced estate.[63] The senior creditors alone, however, should reap subordination benefits to the exclusion of nonsenior creditors when payment received by the junior creditor is not a voidable preference. If the trustee is allowed to recover the trust property, general creditors that were not parties to the subordination agreement

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61. *Cf.* Allegaert v. Chemical Bank, 454 F. Supp. 341, 347 n.2 (E.D.N.Y. 1978), *rev'd on other grounds*, 657 F.2d 495 (2d Cir. 1980). While the decision is not clear, apparently the court interpreted an ambiguous subordination clause to be a "complete" subordination, despite a schedule of payments that was rendered ineffectual by such a construction.

62. *See In re* Credit Indus. Corp., 366 F.2d 402, 408 (2d Cir. 1966); *Model Simplified Indenture*, *supra* note 15, at 770 (§ 11.06).

63. *Cf.* Clark, *supra* note 48, at 518. Professor Clark generally prefers avoidance of transfers to any attempt to set off or adjust bankruptcy dividends to account for the illegal transfer.

would benefit. The senior creditors, therefore, should be the sole beneficiaries of trust property, provided the payment to the junior creditor was not otherwise generally fraudulent or preferential.

A trustee may use section 544(b) of the Bankruptcy Code[64] to argue that an express or implied trust clause subrogates it to the senior creditors' rights. The trustee then would claim the amount recoverable by the senior creditors for the benefit of the estate.[65] Furthermore, under the rule of *Moore v. Bay*,[66] the trustee would be able to recover the entire improper payment even if the amount of the senior claim is less than the amount of the payment. Use of section 544(b) provides an unjustifiable windfall to general creditors, while depriving senior creditors of the benefit of their "paid-for" status. Nevertheless, the historical evidence undeniably shows that section 70(e) of the 1898 Act, predecessor to section 544(b) of the Bankruptcy Code, was used to achieve this result. Prior to adoption of the Uniform Commercial Code (UCC), chattel mortgage statutes frequently provided that unrecorded interests were voidable by creditors that extended their credit during the unperfected life of the security interest. Those creditors that extended credit after the filing had no such rights. Under chattel mortgage statutes, the security interest was voidable by some, but not all creditors.[67] If an actual creditor with avoidance rights existed, then the trustee could use section 70(e) to recover all the property for the benefit of *all* creditors.[68] Hence, section 70(e) pro-

64. Section 544(b) provides: "The trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim . . . ." 11 U.S.C. § 544(b) (1982).

65. *See* Blanck v. Young, FED. SEC. L. REP. (CCH) ¶ 96,756, at 94,963 (D. Utah 1979).

66. 284 U.S. 4 (1931). Under the rule of *Moore v. Bay*, if trustee can subrogate herself to a claim of one dollar against which a large transfer is voidable, the entire transfer is recoverable for the estate, not just the dollar's worth. *See In re* Plonta, 311 F.2d 44 (6th Cir. 1962). Congress specifically endorsed *Moore v. Bay* in § 544(b), Report of Committee on the Judiciary, S. REP. No. 989, 95th Cong., 2d. Sess. 61 (1978), *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5787, 5847 [hereinafter cited as S. REP. No. 989], after Professor Countryman argued that, absent *Moore v. Bay*, the trustee would have to waste valuable resources locating unsecured creditors with enough claims to avoid an entire transfer. With *Moore v. Bay*, the trustee need only locate one such creditor. *See The Bankruptcy Reform Act, 1975 (Part II): Hearings on S. 235 and S. 236 Before the Subcomm. on Improvements in Judicial Machinery*, 94th Cong., 1st Sess. 521-55 (1975).

67. *See* G. GILMORE, *supra* note 7, § 16.3, at 486-87.

68. *See* Buchman v. American Foam Rubber Corp., 250 F. Supp. 60 (1965). *Moore v. Bay*, discussed *supra* note 66, thus makes two controversial points. First, the trustee may recover all the transferred property, even if it is worth more than the claims of the creditors to whom the trustee is subrogated. Second, the proceeds of the recovery should go to all the creditors, not just to those to whom the trustee was subrogated. For the view that Justice Holmes in *Moore v. Bay* intended only to establish the second rule, see Jackson, *Avoiding*

vided a windfall to postperfection creditors that were beyond the scope of the recording statute's protection.

A distinction exists between contractual subordination and the chattel mortgage decisions just described. A creditor with the right to set aside an unrecorded chattel mortgage only had the standard fraudulent conveyance remedy. That is, the creditor could obtain a judicial lien that was enforceable against the debtor's property and any property that the debtor has conveyed away in a voidable chattel mortgage. Roughly speaking, the creditor could only force the holder of the chattel mortgage to return the collateral to the debtor so that it could be susceptible to judicial liens. The creditor had no property interest in the fraudulently conveyed property until the judicial lien attached to it. In the trust clause circumstance, the senior creditor does not seek the return of the trust property to the debtor, but rather claims a property interest in the payment and seeks to obtain it directly from the junior creditor. This transaction is not "voidable" within the meaning of section 544(b). Following this reasoning, a trustee may not subrogate itself to a senior creditor's right to recover improper payments made to the junior creditor. Indeed, to the extent of the improper payment, the senior creditor is secured. Under section 544(b), a trustee can subrogate itself only to the rights of an *unsecured* creditor.

When a subordination agreement is silent, trust clauses should be implied. When no trust clause has been set forth expressly, the bankruptcy court must decide the appropriate remedies for payments received in violation of a subordination agreement. The choice is to give the proceeds to all creditors or to the named senior creditors only. When a class of senior creditors has been singled out, it alone should receive subordination benefits.[69] Other creditors are free riders with no persuasive claim to relief.[70] Therefore,

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Powers in Bankruptcy, 36 STAN. L. REV. 725, 742-50 (1984).

69. *Supra* notes 31-35 and accompanying text.

70. For those states not exempting subordination agreements from Article 9 of the UCC, a second strong justification exists for finding that junior creditors should hold all illegal payments for the senior creditors and therefore should not return them to the debtor. As will become clear later, *see infra* text accompanying notes 121-41, subordination agreements amount to Article 9 security interests in the junior debt granted by the junior creditor to the senior creditor. Because the junior debt is collateral, any amounts collected by the junior creditor are proceeds of the collateral. Under § 9-306, the senior creditor has an automatic security interest in proceeds.

This security interest does not prove, however, that the junior creditor has an immediate duty to hand over proceeds. Generally, the secured party has no right to possess the collateral until default occurs. The parties, however, are free to decide among themselves which of them has the present right to possess collateral. U.C.C. § 9-501(2) (1977). A junior improper payments should be recoverable for the benefit of senior creditors only.[71]

IV. Subordination as an Ownership Transfer of the Junior Debt

A. Subordination of Debt

The fundamental subordination promise—the promise by a junior creditor to receive no payment on its claim until the senior creditors are paid—is an assignment of the junior claim for security by a nonrecourse guarantor. The consequence of this statement is not merely a matter of terminology. Application of the term "assignment" implies a bridging of the gap between a junior creditor's personal obligation enforceable by money judgment and a property claim on the junior creditor's asset—the junior claim against the

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creditor that has promised not to receive prebankruptcy payments specifically has agreed *not* to possess collateral. Because the senior creditor is superior to the common debtor as possessor of the proceeds, it is an easy step to the conclusion that the senior creditor should have the immediate right to proceeds held by the junior creditor. Once the senior creditor obtains the illegal payments it may use the money to reduce the senior claim. *Id.* § 9-207(2)(c).

71. The Trust Indenture Act of 1939 presents an interesting context in which to test the interpretation of the trust clause. The Trust Indenture Act permits the indenture trustee to be a creditor of the issuer in competition with its indenture beneficiaries. But when the trustee, as a senior creditor, receives payment on or reduction of its claim from the issuer in the four month period before bankruptcy, it must set apart and hold the value it has received for the benefit of the debenture holders, regardless of whether they are subordinated to its claim. 15 U.S.C. § 77kkk(a) (1982); *see also id.* § 77kkk(b)(1) (indenture may exempt short term debt from this rule). The indenture trustee is also a pro rata beneficiary of this fund. *Id.* § 77kkk(a).

These rules create a "trust fund" to which the debenture holders are senior creditors. The fund guarantees that the debenture holders will receive double dividends. Because the indenture trustee is often a senior creditor under the subordination clause of the debenture, Morris v. Cantor, 390 F. Supp. 817, 823 (S.D.N.Y. 1975), it is necessary to determine whether the trustee can recapture by contract part of what debenture holders have received from the indenture trustee by statute. *See* United States Trust Co. v. First Nat'l City Bank, 57 A.D. 2d 285, 394 N.Y.S.2d 653, 656 (1977) (issue raised but not resolved), *aff'd*, 45 N.Y.2d 869, 382 N.E.2d 1355, 410 N.Y.S.2d 580 (1978).

Applying the analysis from the text, the special fund for the debenture holders should exist only when the preference received by the indenture trustee is not generally voidable. Only preferences received between three months (the bankruptcy preference period) and four months (the Trust Indenture Act period) of bankruptcy go into the special fund, although other eligible payments are conceivable. This amount should benefit only the debenture holders. Other creditors should not benefit. Receipt of these extra dividends by the subordinated debenture holders, however, is an improper payment and, hence, trust property for senior creditors under the debenture. *See Model Simplified Indenture*, *supra* note 15, at 770 (§ 11.06). Therefore, the senior creditors under the debenture must receive these contributions from the fund. If the indenture trustee is within this class, it can recapture part of the fund that it earlier had donated to the junior creditor debenture holders.

debtor. If the junior creditor has transferred its claim against the debtor, the junior claim is no longer part of the junior creditor's estate, and the senior creditor's legal rights are protected from the junior creditor's bankruptcy. This is important because inside creditors frequently subordinate their claims to induce new credit, simultaneous bankruptcy of the debtor and junior creditor is not therefore uncommon.

A second benefit of establishing subordination as an assignment of the junior claim is that assignments of choses in action are understood far better than subordination of general debt. Recognition that subordinations are assignments would allow courts to borrow the rules of assignments to decide subordination cases.[72]

An assignment is defined in the *Restatement (Second) of Contracts* as the "manifestation of the assignor's intention to transfer [rights against the obligor] by virtue of which the assignor's right to performance by the obligor is extinguished in whole or in part and the assignee acquires a right to such performance."[73] An assignment is, therefore, in the nature of a transfer of "title"[74] to a chose in action. Once an assigument is made known to the debtor, it has an obligation to pay the assignee. Payment to the assignor after notification no longer discharges the debt.[75] When the circumstances of the assignment are in dispute, the debtor, at its risk, must determine which party is the true owner of the contractual rights against it.[76]

The infusion of a contingency into an assigument is a sure formula for judicial consternation. "[T]o some courts," commented Professor Gilmore, "words of condition and futurity are like red

72. Synonymity of subordination and assignment has an unpleasant side effect—assignments of choses in action to secure debt are security interests under Article 9 of the UCC. While some have defended UCC coverage as beneficial—senior creditors would have to alert the junior creditor's creditors that an asset is encumbered—other features of Article 9 coverage are disastrous. Discussion of the impact of the UCC will be deferred pending a more general examination of assignments of choses in action and subordination of debt. *See infra* text accompanying notes 121-53.

73. RESTATEMENT (SECOND) OF CONTRACTS § 317(1) (1979).

74. The common law imposed great formalities on the transfer of the land but never required nearly as much formality for assignment of contractual rights. It is sufficient if the assignor manifests its intention to assign "without further action or manifestation of intention by the [assignor]." RESTATEMENT (SECOND) OF CONTRACTS § 324 (1979). Unless forbidden by the Statute of Frauds, an assignment may be oral. *Id.* The assignor need not manifest its intent to assign to the assignee but may manifest it to a third person. *Id.* In most subordinated debentures, an assignor manifests its intent to assign bankruptcy dividends to the common debtor, not the assignee-senior creditor.

75. *Id.* § 338(1).

76. *Id.* §§ 322, 329.

rags to a bull."[77] Yet it is exactly these red rags that are of most concern because the common debtor's bankruptcy is both a contingency and a futurity regarding the junior creditor's assignment of bankruptcy dividends.[78]

In order to render the equation of assignments and subordination persuasive, three tricky aspects of assignments, contingency, and futurity must be understood. The following comments will show that subordination is a present assignment of a chose in action, with the right to collect deferred to the debtor's bankruptcy.

1. Assignments Versus Promises to Assign in the Future

A present assignment divests the assignor of title and places title in the assignee. A promise to assign does not transfer title. It presupposes some future "livery of seisin" by the assignor before title is transferred.[79] The consequences are important. The breach of a mere promise to assign gives the promisee only a breach of contract action against the assignor. The wronged promisee generally cannot recover the property in dispute.[80] In contrast, a present assignment followed by a *second* assignment gives rise to a classic priority dispute between assignees. If the assignment is a security interest, Article 9 will provide the rules for deciding who wins. If the assignment is not for security or is exempted from Article 9,[81] the common law of assignments establishes the priorities.[82]

Subordination is not a mere promise to assign in the future.

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77. 1 G. GILMORE, *supra* note 7, § 7.5, at 209.

78. Henson, *The Problem of Uniformity*, 20 BUS. LAW. 689, 693 (1965) ("We really are dealing with the contingent assignment of a potential future claim which in the normal course of events will never become enforceable.").

79. RESTATEMENT (SECOND) OF CONTRACTS § 330 (1979).

80. Under some circumstances, promises to assign might give rise to a right to specific performance by the potential assignee, in which case the assignee has "equitable property" good against all third parties except bona fide purchasers for value. *See infra* note 84.

81. *E.g.*, U.C.C. § 9-104(d) (1977) (assignment of wages excluded); *id.* § 9-104(f) (assignment of a single account in satisfaction of antecedent debt excluded). Article 9 covers an assignment of a single account in exchange for present value but deems it automatically perfected under § 9-302(1)(e). As an automatically perfected security interest, the common-law priority rules pertaining to assignments, *infra* note 82, would not apply.

82. RESTATEMENT (SECOND) OF CONTRACTS § 342 (1979). The three variants are the New York rule (first in time is first in right), the English rule (first to notify the obligor), and the Four Horseman rule. The *Restatement* adopts this last rule and follows "first in time is first in right" with four exceptions: the subsequent assignee wins if, in good faith and without knowledge of the prior assignment, (a) it has been paid first, (b) it obtains a judgment first, (c) it and the obligor enter into a novation first, or (d) it has obtained commercial paper, and the first assignee has not. These rules are discussed in 2 G. GILMORE, *supra* note 7, § 25.6 at 670.

Subordination agreements frequently specify that the senior creditor is to receive bankruptcy dividends if and when bankruptcy occurs. The senior creditor will become the owner of bankruptcy dividends without any further act by the junior creditor. This is just as true when the parties manifest nothing explicitly about bankruptcy dividends. Courts universally have recognized that the non-contingent promise not to receive payment until the senior claims are paid eventually evolves into the double dividend system.[83] The junior creditor need only assent to the subordination for the senior creditor to receive dividend rights.[84]

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83. *See supra* note 31 and accompanying text.

84. *But see* SEC v. Charles Plohn & Co., 448 F.2d 546 (2d Cir. 1971). In *Plohn* the junior creditor had promised to sign a standard form subordination agreement of the New York Stock Exchange. The facts do not indicate that the parties signed the agreement. The opinion deals with whether the common debtor's receiver should sell collateral in which the junior creditor had an interest. The assumption of the case is that the promise to subordinate was the equivalent of actual subordination and that the proceeds of the collateral would adhere to the benefit the senior creditors.

Promises to assign frequently were termed "equitable assignments." *See* 1 G. GILMORE, *supra* note 7, § 7.2, at 198. Their status in bankruptcy has a long and painful history. *See* Breitowitz, *Article 9 Security Interest as Voidable Preferences,* 3 CARDOZO L. REV. 357, 378-84 (1982). The nature of an equitable assignment was far from clear, but, if a person had an equitable assignment, he had a property interest that frequently was good against the assignor's creditors. Only bona fide purchasers of the assignod intangible took free of the equitable interest of the assignee. The 1898 Bankruptcy Act included a major attempt to curb the equitable assignment. Section 60(a)(6) stated that if (1) a transfer was for security and (2) applicable law required a writing, delivery of possession, or recording as a condition to its full validity against third persons *other* than buyers in the ordinary course of trade, and (3) such transfer resulted only in an equitable lien, such transfer was not deemed made, notwithstanding its state law priority over a subsequent lien creditor. *Id.* at 378. Under the 1898 Act the equitable subordination in *Plohn* probably would have been a voidable preference, that is, a transfer on antecedent debt, in the junior creditor's bankruptcy. Under the present Bankruptey Code, however, the preference statute makes no special attempt to destroy equitable assignments. *See id.* at 384.

Whether state law should recognize an equitable assignment must relate in some degree to whether an adequate legal remedy exists. Failure to execute an assignment is compensable by damages, whicb, under traditional doctrine, precludes the equitable remedy of specific performance. The rules may differ when the junior creditor assignor is insolvent. *See* RESTATEMENT (SECOND) OF CONTRACTS § 360 (1979) (supporting specific performance in these cases).

Applying these assignment rules to subordinations is treacherous. When the junior creditor is insolvent, it is defensible to find an equitable interest in the junior claim. But the rationale disappears when the junior creditor is solvent. If the junior creditor does not honor his promise to subordinate, the senior creditors incur huge transaction costs and must bring a state contract action against the junior creditor. This cost is unacceptable in the context of *Plohn,* which concerned protection of stockbroker customers by a regulatory agency. On the other hand, any attempt to broaden proprietary interests created by contractual promises may have pernicious effects on commercial law. *See generally* Oesterle, *Deficiencies of the Restitutionary Right to Trace Misappropriated Property in Equity and in UCC § 9-306,* 68 CORNELL L. REV. 172 (1983).

Notwithstanding the above, three courts have found that the core subordination promise alone does not constitute an assignment.[85] Calligar, in an extreme position, states that a subordination promise does not protect the senior creditors from the junior creditor's bankruptcy because the junior creditor still owns the junior claim. Calligar, however, believes the totemistic words "I assign bankruptcy dividends" protect the senior creditors completely.[86] These views defeat a major purpose of subordination—security for the senior debt. Requiring the magic words of *express* assignment is a trap for the unwary. Everyone agrees that the promise not to receive payment before the senior creditors are paid results in double dividends—the heart of the assignment idea.[87] Consequently, the "no payment" promise should be seen to transfer ownership of the junior claim.

2. The Assignment of Property Presently Owned Versus Property Not Yet Owned (After-Acquired Property)

A basic tenet of commercial law is that a person may not assign a right that he does not own. In primitive times, an attempt to assign nonexistent property was a mere *promise* to assign. After the property came into existence, the parties had to remanifest their intent to assign.[88] Modern thinking, as embodied in Article 9, is more enlightened.[89] It is still impossible to transfer property not

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My recommendation is to make a sui generis rule for subordination that would equate the promise to subordinate with the actual subordination. This rule would avoid wasting the resources of the senior creditors. *Cf.* Aldrich v. Redington, 605 F.2d 590 (2d Cir. 1978) (senior creditors absolved from proving reliance to estop junior creditors from rescinding suhordination). Courts should be given stern warning against expanding the "equitable assignment" doctrine beyond the subordination context.

85. First Nat'l Bank v. American Foam Rubber Corp., 530 F.2d 450 (2d Cir.), *cert. denied*, 429 U.S. 858 (1976); Cherno v. Dutch Mercantile Corp., 353 F.2d 147 (2d Cir. 1965); *In re* Dodge-Freedman Poultry Co., 148 F. Supp. 647 (D.N.H. 1956), *aff'd per curiam*, 244 F.2d 314 (1st Cir. 1957).

86. Calligar, *supra* note 5, at 395. A similar issue arises in more standard security interest cases. In American Card Co. v. H.M.H. Co., 97 R.I. 59, 196 A.2d 150 (1963), the court held that a security agreement that does not include words of grant fails to create a security interest. The *American Card* view has been criticized as needlessly interfering with the intent of the parties to create a security interest. *See In re* Bollinger Corp., 614 F.2d 924 (3d Cir. 1980); *see also* Nickles, *Rethinking Some U.C.C. Article 9 Problems—Subrogation; Equitable Liens; Actual Knowledge; Waiver of Security Interests; Secured Party Liability for Conversion Under Part 5*, 34 ARK. L. REV. 1, 50-71 (1980) (defending the requirement of words of grant, if coupled with the existence of equitable liens outside the UCC).

87. *See supra* note 27.

88. 1 G. GILMORE, *supra* note 7, § 2.4, at 33. The *Restatement (Second) of Contracts*, still adheres to this rule. *See* RESTATEMENT (SECOND) OF CONTRACTS § 327(2) (1979).

89. *See* U.C.C. § 9-204 comment 1 (1977).

yet acquired.[90] But when the debtor acquires the property, Article 9 deems the assignment effective immediately, which automatically gives the assignee rights in the property.

Subordination of debt is not an assignment of after-acquired property, but is the assignment of the existing junior debt itself. The right to receive bankruptcy dividends is not different from the simple right of the junior creditor to be repaid in general. Subordination of existing debt is, therefore, not an effective attempt to convey a property right that the assignor does not yet have.[91]

3. Assignments with Present Rights to Collect Versus Assignments with Contingent Rights to Collect

A third tricky distinction is between an assignment that gives an immediate right to receive an income stream from the obligor and an assignment that gives the right to receive payments only after a contingency has occurred. Both transactions are present assignments.[92] When the collateral is an income stream owed by a third party, courts become confused by this distinction.[93] An exam-

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90. *See* 11 U.S.C. §§ 547(e)(3), 552(a) (1982); U.C.C. § 9-203(1)(c) (1977).

91. One commentator suggests that assignments of bankruptcy dividends are not assignments of the debt itself. *See* Zinman, *Under the Spreading U.C.C.—Subordinations and Article 9*, 7 B.C. INDUS. & COM. L. REV. 1, 10-12 (1965). Coogan, Kripke & Weiss, *supra* note 14, at 244, sort this out correctly early in their article, but later fall into error by equating the right to bankruptcy dividends with a claim on after-acquired property. *Id.* at 253.

92. RESTATEMENT (SECOND) OF CONTRACTS § 331 comment b (1979); *see* Segal v. Rochelle, 382 U.S. 375, 379-81 (1966) ("Postponed enjoyment does not disqualify an interest as 'property.' ").

93. An excellent example of a district court judge falling afoul of this distinction is Allegaert v. Chemical Bank, 454 F. Supp. 341 (E.D.N.Y. 1978), *rev'd*, 657 F.2d 495 (2d Cir. 1980). In *Allegaert* the collateral was a debenture. The pledge agreement covering tbe collateral permitted the debtor to receive payments until default on the debtor's loan obligations. 454 F. Supp. at 344-45. The security interest in the debenture was perfected in July 1973, 657 F.2d at 500, default occurred some time in January 1974, *id.* at 501, and the obligor on the pledged debenture paid the debenture to the secured party on March 26, 1974. The next day, tbe debtor filed for bankruptcy. *Id.* The trustee sued the secured party to recover the Marcb 26 payment on the theory that it was a voidable preference.

The secured party argued that the payments were not voidable preferences because they emanated from the pledged debenture, which had been transferred well before the preference period. The district court judge, however, reasoned tbat the parties to the pledge agreements must have agreed that no security interest existed until default because the debtor could receive debenture payments until then. Thus, the district court judge determined that the debenture was not transferred until. 454 F. Supp. at 349-50.

The Second Circuit did not make the same analytical error. It ruled the pledge perfected in July 1973. Thus, the creation of the security interest was not a voidable preference. 657 F.2d at 511.

Allegaert was more complicated because the secured party had subordinated itself to a ple in which a television set is substituted for the income stream should clarify the principle. When the television set is Article 9 collateral, the debtor usually is entitled to possess the television until default. After default, the secured party is entitled to repossess. Clearly the secured party has a property interest in the television set before the debtor defaults. The secured party's right to the income stream in the above example is similar to the right to the television set. In both cases the secured party has a property interest in the collateral before default.

A subordination agreement is an assignment in which the senior creditor has no right to receive payment on the junior debt until the contingency of the common debtor's liquidation occurs. At that point, the right to future payments reverts to the senior creditor. In this regard, subordination is analogous to nonnotification accounts receivable financing,[94] which allows the debtor to collect and retain proceeds of encumbered accounts provided it has not defaulted.[95]

4. Equitable Assignments and Equitable Liens

Some courts have been willing to categorize subordination agreements as "equitable" assignments.[96] "Equitable assignment" and "equitable lien,"[97] according to Professor Gilmore, are terms that have "long plagued this field of law, obfuscated discussion and

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class of senior creditors. No doubt the district court judge was suspicious that a junior creditor also could be a secured creditor. His decision may have been a misguided effort to do rough justice. As to whether creditors can be junior under a subordination agreement and secured under a pledge agreement, see *infra* text accompanying notes 198-209.

94. For a description of nonnotification accounts receivable financing, see 1 G. GILMORE, *supra* note 7, § 8.1.

95. In First Nat'l Bank v. American Foam Rubber Corp., 530 F.2d 450, 455 (2d Cir.), *cert. denied*, 429 U.S. 858 (1976), the Second Circuit confused the time when the senior creditor is entitled to receive payment on the junior debt—after bankruptcy—with the time the assignment is made. The court compounded the error in a highly original way when it assumed not that the assignment was deferred, but that any arrangement that involves futurity or contingency must not be an assignment at all. Nevertheless, in *American Foam Rubber*, the Second Circuit conceded that the senior creditor could receive bankruptcy dividends, even when not "assigned" to it.

96. *In re* Alda Commercial Corp., 300 F. Supp. 294, 296 (S.D.N.Y. 1969); *In re* Itemlab, Inc., 197 F. Supp. 194, 197-98 (E.D.N.Y. 1961); *In re* Handy-Andy Community Stores, Inc., 2 F. Supp. 97, 98-99 (W.D. La. 1932).

97. Various courts have referred to subordination assignments as equitable liens. Searle v. Mechanics' Loan & Trust Co., 249 F.2d 942, 945 (9th Cir.), *cert. denied*, 248 U.S. 592 (1918); *In re* Geo. P. Schinzel & Son, Inc., 16 F.2d 289 (S.D.N.Y. 1926). I understand "equitable lien" to be synonymous with "equitable assignment" for security. Calligar, *supra* note 5, at 384-85, assumes they are separate theories of subordination.

made clear analysis almost an impossibility."[98] Gilmore identified five meanings to the adjective equitable:

> "Equitable" is used in at least tbe following senses. (1) A right which was at one time . . . enforced only in courts of equity and not in courts of law. (2) A right in some kind of property which is thought or felt to be "essentially" equitable in nature (such as trust property), without regard to whether the right has been enforced in courts of law or equity or both. (3) A security interest which is ineffective as to creditors of the borrower or purchasers of the collateral without notice because [the security agreement was defective or unperfected]. (4) [After-acquired property.] (5) An interest which, because of some rule of substantive law, cannot be made effective against some other type . . . of interest in the property.[99]

Most of these definitions cannot apply to subordination. Gilmore's definition (3) cannot apply because perfection is relevant only in the junior creditor's bankruptcy, not the debtor's. The debtor's creditors have no right to the bankruptcy dividends that the junior creditor receives under federal law. Definition (4) is inapplicable because subordination of present debt does not involve any after-acquired property concepts.[100] Definition (5) is similarly unhelpful.[101] The first two definitions might fit because subordinations are enforceable in bankruptcy, which is a province of equity. But bankruptcy courts also recognize and enforce "legal" assignments. The adjective "equitable" adds nothing.

Some commentators have suggested that the consequence of the adjective "equitable" is the imposition of different priority rules. If subordination is an equitable assignment, good faith purchasers of the junior debt might take free of the subordination because they take free of equitable interests generally.[102] In compari-

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98. 1 G. GILMORE, *supra* note 7, § 7.2, at 198.

99. *Id.* § 7, at 198-99 (footnotes omitted).

100. *See supra* text accompanying notes 88-91.

101. In definition (5) Professor Gilmore simply meant that in a priority contest the party with the "equitahle" assignment would lose on the facts. Gilmore thought this definition was applicable "nine times out of ten." 1 G. GILMORE, *supra* note 7, § 7.2, at 199.

102. *See* Calligar, *supra* note 5, at 395-96; Heileson & Hirsch, *Private Subordination Agreements and the U.C.C.: Is Section 1-209 an Un-*Wyse *Solution*, 38 BUS. LAW. 555, 564-65 (1983); Zinman, *supra* note 91, at 24 n.72.

Some commentators have thought that subordination creates a constructive trust in which the junior creditor is the trustee, the senior creditor is the beneficiary, and the junior claim is the *res* of the trust. *See* Calligar, *supra* note 5, at 386-88. The *Restatement* favors protection of bona fide purchasers of a debt that is the *res* of a trust, and under this rule no distinction exists between calling subordination an equitable assignment or constructive trust. *See* RESTATEMENT (SECOND) OF CONTRACTS § 343 (1979). But the *Restatement* rule seems to have been an innovation. Early cases refused to apply the bona fide purchaser rule to constructive trusts when the *res* was a general intangible. *See* Glenn, *The Assignment of Choses in Action; Rights of Bona Fide Purchaser*, 20 VA. L. REV. 621, 627-28 (1934). If these older cases are followed, the label "constructive trust" produces priorities identical to those son, legal assignments are subject to ordinary principles of "first in time is first in right," the New York version, or "first to notify the obligor," the English rule.[103]

Since there is no logical distinction between subordination and the assignment of junior debt,[104] changing the priority rules for subordinations because they are "equitable" would serve little purpose. The principle of good faith purchaser protection, has merit, but there is no rational reason to limit the benefits of that policy to subordinations when that doctrine could apply with equal benefit to all assignments of debt.

5. Benefits of the Equation

Equation of subordination with assignment solves problems that have perplexed courts. First, this equation explains why bankruptcy courts concern themselves in what essentially is a collateral contract between creditors.[105] Calligar proposed four theories to explain bankruptcy court jurisdiction over such contracts,[106] but the equation of assignment and subordination provides an easier answer. Subordination is an assignment. The trustee must honor subordination agreements because it stands in the shoes of the debtor which must always determine, at its risk, the true owner of a claim.[107] This simpler answer[108] has an important implication.

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applicable to "legal" assignments—first in time is first in right—assuming the obligor already is notified.

103. *See supra* note 82.

104. *See supra* notes 72-103 and accompanying text.

105. Only one court has refused to determine the rightful recipient of junior dividends. *See* J. Henry Schroder Banking Corp. v. L.S. Brach Mfg. Corp., 78 F.2d 530 (7th Cir. 1935). The Seventh Circuit termed the subordination agreement "collateral" and held that the bankruptcy referee had discretion to avoid the issue. *Id.* at 532.

106. Calligar's often repeated four theories for collateral contracts are: (1) equitable assignment, (2) equitable lien, (3) constructive trust, and (4) contractual promise with no property overtones. Calligar, *supra* note 5, at 384. The first three theories are different ways of expressing the same idea of equitable property defeasible by bona fide purchasers. This idea has been criticized previously. *See supra* text accompanying notes 96-104. The fourth theory is criticized, *supra* note 84 and accompanying text, for defeating a purpose of subordination—security for the senior creditor.

107. 1 G. GILMORE, *supra* note 7, § 7.7, at 214.

108. Doubt about the proper "theory" of enforcing subordination agreements led Congress to provide for explicit jurisdiction over subordination agreements in § 510(a) of the Bankruptcy Code. *See* 11 U.S.C. § 510(a) (1982) ("A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law."). Section 510(a) overrules *J. Henry Schroder v. L.S. Brach Mfg. Corp.*, 78 F.2d 530 (7th Cir. 1935), which held that courts have discretion to abstain from hearing disputed subordination claims. Section 510(a) also suggests that bankruptcy courts must hear intercreditor suits for damages or property not in the bankrupt estate, a result

Suppose the junior creditor fails to file in bankruptcy in the hope of defeating the senior creditor's double dividends.[109] Although the bankruptcy trustee has the power to file the junior claim on behalf of the senior creditors,[110] it has a major disincentive against doing so. If subordinations are assignments, the senior creditors will be able to file for the junior creditor.[111]

Another useful doctrine pertains to the assignment of secured debt. The standard rule is that the security interest travels with the debt when the terms of the assignment are silent.[112] If subordinations are assignments, then a subordination of debt by a junior secured creditor should transfer the security interest to the senior creditor. All of the reasons for inferring an assignment from a promise not to receive payment dictate that the senior creditor should obtain the junior creditor's security interest.[113] The Second

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that need not follow. In Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416 (1972), the Supreme Court held that the liability of an indenture trustee to its debenture holders was beyond the jurisdiction of the bankruptcy court. On this analogy, suits to recover damages or improper payments from the junior creditor directly should be brought in state court. Thus, in First Nat'l Bank v. American Foam Rubber Corp., 530 F.2d 450 (2d Cir.), *cert. denied*, 429 U.S. 858 (1976), the senior creditor brought his suit for damages stemming from discharge of the junior debt under federal diversity jurisdiction.

109. This failure to file could occur when the junior creditor has an equity stake in the debtor. *See In re* Dodge-Freeman Poultry Co., 148 F. Supp. 647 (D.N.H. 1956), *aff'd mem.* 244 F.2d 314 (1st Cir. 1957). Waiver of the junior claim would increase the value of the equity.

110. 11 U.S.C. § 501(c) (1982). The purpose of this provision is to strengthen the discharge provisions applicable to individual bankruptcies. S. REP. No. 989, *supra* note 66, at 61.

111. The trustee's filing on behalf of a junior creditor would benefit senior creditors with double dividends, but it would deplete the bankrupt estate to the detriment of general creditors.

Incidentally, the legislative history reflects the notion that junior creditors ordinarily will not file a claim. S. REP. No. 989, *supra* note 66, at 5787, 5847 ("in situations where the claim asserted would be subordinated and the creditor would not recover from the estate in any event, filing of a proof of claim may simply not be necessary"). This remark overlooks the possibility of double dividends for the senior creditors.

112. RESTATEMENT OF SECURITY §§ 29-34 (1941); Epstein, *Security Transfers by Secured Parties*, 4 GA. L. REV. 527, 533-39 (1970) (discussing the rationale for such a rule); Jackson, *Embodiment of Rights in Goods and the Concept of Chattel Paper*, 50 U. CHI. L. REV. 1051, 1058 (1983) (same).

113. If the junior claim is secured and the entire debt is subordinated to the senior creditor's claim, a court has three choices in disposing of the collateral. The court can keep the collateral in the debtor's estate, can give the collateral to the senior creditor, or can let the junior creditor have the collateral. The efficiency reasons discussed earlier eliminate the option of keeping the collateral in the debtor's estate. *See supra* text accompanying notes 32-38. *But see In re* Pat Freeman, Inc., 42 Bankr. 224 (Bankr. S.D. Ohio 1984) (choosing this option in an equitable case). The choice between giving the collateral to the senior creditor or letting the junior creditor keep it is not simple. This choice will depend on whether the debtor gave the security interest to the junior creditor at a time when payment

Circuit failed to recognize this logic, although it reached a fair result on other grounds.[114]

The subordination equation also suggests who should vote junior claims in reorganizations. Treatment of junior creditor voting rights should be identical to the rules governing a claim against a debtor that the owner pledges to a secured party. The secured party is entitled to vote the debt provided the pledgor has defaulted. The pledgor also has a claim against the debtor for any surplus to which the secured party is not entitled is and so should have voting rights commensurate with this surplus.[115] These rules can be adapted to subordination without difficulty.[116]

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of the junior claim would have been proper. *See infra* text accompanying notes 198-208. If security is an improper payment, the collateral goes to the senior creditor.

114. Cherno v. Dutch Am. Mercantile Corp., 353 F.2d 147 (2d Cir. 1965). In *Cherno* the junior creditor subordinated a secured claim and then falsely filed a statement of satisfaction. Essentially, this action rendered the security interest unperfected and hence void in bankruptcy. *Id.* at 152-53. On this score the Second Circuit was correct. The court also ruled that subordination is not assignment, *id.* at 151, which creates the inefficiencies alluded to in *supra* note 113.

115. Bankr. Rule 3001(e)(7), 11 U.S.C.A. 1984. One possible criticism of the assignment theory is the effect of assigning stock in satisfaction of debt pursuant to a Chapter 11 reorganization, which the junior creditors must assign over to the senior creditors. Some may fear that loading up the senior creditors with stock pursuant to an assignment theory might force the debtor to report as income the discharge of debt that occurs in a cbapter 11 reorganization. Chapter 11 forgiveness is not reportable income, unlike many other types of debt forgiveness. I.R.C. § 108(e)(10)(B). This exemption is made contingent upon no unsecured creditor being more than twice as bad off as other unsecured creditors. *Id.* § 108(e)(8)(B) *See* Bergquist & Groff, *Reorganizing the Fiancially Troubled Corporation After the Bankruptcy Tax Act of 1980*, 36 TAX L. REV. 517 (1981) (discussing the meaning of § 108(e)(8)(B)).

When stock is assigned over to the senior creditors as a replacement for double dividends, it is in satisfaction of the junior debt. The proper calculation for the purposes of § 108(e)(8) requires that the percentage of stock allocated to the junior debt be compared with the percentage of stock allocated to all other unsecured debt (without regard to the effect of the subordination agreement). The fact that the senior creditors are entitled to receive both types of stock does not prove there is discrimination in violation of § 108(e)(8)(B). The junior creditor's position is equivalent to a debenture holder who pledges the instrument to a secured lender. The lender then becomes entitled to receive at least some of the stock (up to the lender's secured claim against the debenture holder) if the debenture holder is in default. No one would argue that the debenture owner is being discriminated against for the purpose of § 108(e)(8)(B).

116. A tricky aspect of senior creditor claims is that the difference between tbe face amount of the senior claim and the eventual senior dividend defines tbe claim secured by the junior dividends. Therefore, this amount defines the senior creditor's right to vote the junior claim. The junior creditor should vote the surplus. As a result, the face amount of the junior claim for voting purposes never can be calculated without also calculating the result of a hypothetical liquidation. This hypothetical exercise will be done eventually because a court must determine whether a reorganization supplies each general creditor with at least as much present value as it would have received in a liquidation. 11 U.S.C. § 1129(a)(7)(A) (1982). The need to make the liquidation calculation for the purposes of determining the

Finally, the equation of assignment and subordination solves the problem of multiple subordinations[117] or subordination followed by a more typical assignment. If Article 9 applies, the first senior creditor to perfect or file a financing statement against the junior creditor prevails.[118] In the states that have exempted subordination from Article 9, the usual assignment rules dictate that the first in time always prevails.[119] The second in time will receive only the junior creditor's subrogation rights.[120]

All of the solutions inspired by the rules for assignments accord with the purposes of subordination: to secure the senior claim at the lowest cost to the junior creditor and the debtor and to cut out free riding general creditors that have not paid for their subordination rights.

B. *The Junior Creditor as Article 9 Debtor*

If subordination of debt is an assignment for security of a general intangible by a nonrecourse gnarantor, it falls within the Article 9 definition of a security interest.[121] Under Article 9 senior

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amount of the junior vote, *see id.* § 1126(c) (providing for class voting by amount of claim), undoubtedly will cause some administrative complexities. Nevertheless, bankruptcy courts make summary estimations of value in other situations, 3 W. COLLIER, BANKRUPTCY ¶ 56.07 (14th ed. 1984), and can do so here.

A more subtle issue is the classification of junior creditors for voting purposes. One commentator, Cohn, *supra* note 27, has shown that junior creditors have an economic stake that differs from other creditors. If junior creditors are not separately classified, they either will dominate the voting or will be unfairly outvoted by creditors with different interests. Separate classification for voting purposes does give junior creditors extra leverage when a plan proposes to give shareholders some compensation without fully paying more senior classes. Each dissenting class is entitled to full compensation before any lower class is paid. 11 U.S.C. § 1129(b)(2)(B) (1982) (absolute priority rule for cram-downs). The absolute priority rule dictates this tactical advantage, and bankruptcy policy against unfair discrimination demands separate classification except in de minimis cases.

117. Successive subordination of the same debt to competing senior creditors occurred in First Nat'l Bank v. American Foam Rubber Corp., 306 F. Supp. 593, 600 n.24 (S.D.N.Y. 1969), *rev'd*, 530 F.2d 450 (2d Cir.), *cert. denied*, 429 U.S. 858 (1976), although the court had no occasion to determine priorities.

118. U.C.C. § 9-312(5) (1977). For a discussion of whether the UCC governs subordinations, see *infra* text accompanying notes 121-53.

119. *See supra* note 82. Under the English rule, the first assignee to notify the debtor has priority. In subordinations, however, the debtor usually will have notice of the subordinated status of the debt.

120. Once the senior creditor that was first in time has been paid out, the second senior creditor is a better recipient for subrogation rights than the junior creditor.

121. Article 9 applies "to any transaction (regardless of its form) which is intended to create a security in personal property . . . . U.C.C. § 9-102(1)(a) (1977). A security interest is "an interest in personal property . . . which secures payment or performance of an obligation." *Id.* § 1-201(37). Both the principal obligor and junior creditor guarantor qualify under

creditors must perfect their rights if they are to survive the junior creditor's bankruptcy. Commentators widely acknowledge that Article 9 perfection rules create difficulties for subordination agreements. Nevertheless, leading commentators have urged the adoption of new perfection rules and the continuation of Article 9 coverage in other respects. This section will show that the side effects of Article 9 are sufficiently disruptive of the subordination relation to justify passage of proposed section 1-209, which takes subordinations out of UCC coverage. In addition, when section 1-209 is not in effect, the courts should ignore the literal words of the UCC and rule that subordinated debt is not within the jurisdiction of Article 9.

1. The Argument for UCC Coverage

Although noted coauthors Coogan, Kripke, and Weiss fully recognized the difficulty of perfecting subordination rights under existing Article 9 rules,[122] they nevertheless believed Article 9 should govern subordination because otherwise subordinations would be vulnerable in the junior creditor's bankruptcy under non-UCC rules.[123] Their fear was based upon the much analyzed case of *Pioneer-Cafeteria Feeds, Ltd. v. Mack*.[124] In *Mack* the senior creditor had the right to pursue the junior creditor personally on the guaranteed senior debt. Both the debtor and junior creditor filed for bankruptcy. In the first bankruptcy, the senior and junior creditors received double dividends. The senior creditor then made a claim for the balance of the senior debt in the junior creditor's bankruptcy. The Sixth Circuit affirmed a ruling that equitably subordinated the senior creditor to all other creditors of the junior creditor until they had received the amount that the senior creditor had received in the first bankruptcy. To justify this view, the

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the Article 9 definition of "debtor." *Id.* § 9-105(1)(d). In a subordination agreement the debtor is not only an Article 9 debtor under § 9-105(1)(d), but is also the account debtor under § 9-105(1)(a).

122. These authors point out that the secured party must perfect by possession when the junior claim is represented by an instrument. Perfection by possession is difficult when many junior creditors share the same claim. In addition, the Article 9 definition of instrument excludes writings that are security agreements. U.C.C. § 9-105(1)(i) (1977). Hence, a subordinated debenture with the subordination clause set forth cannot be an instrument and must he perfected by filing.

Perfection by filing is complicated when there is a class of junior creditors. The debtor must sign the financing statement. If an indenture trustee does not represent the class of junior creditors, they all must sign. *See* Coogan, Kripke, & Weiss, *supra* note 14, at 242-47.

123. *Id.* at 253-55.

124. 340 F.2d 719 (6th Cir. 1965).

court relied upon vague equitable grounds related to ostensible ownership concerns regarding the subordination.[125]

Coogan, Kripke, and Weiss were justified in finding ways to circumvent the holding of *Mack*. Their solution was to amend the UCC to provide more sensible perfection rules for subordinations.[126] Apparently they hoped that if state law viewed perfected subordinations as adequately public, then the federal courts would not proclaim subordinations to be frauds on creditors.[127]

The Bankruptcy Code, however, has changed subordination law considerably. Section 510(a) now provides that subordination agreements are enforceable in bankruptcy to the same extent they are enforceable under applicable nonbankruptcy law. To the extent *Mack* represented a federal bankruptcy rule, section 510(a) has repealed it.[128] Hence, the need for perfection at the state level has disappeared, at least insofar as the need to appease federal policy. The more general question remains whether subordination really does create an ostensible ownership problem.

The equation of subordination to assignment is again instructive. Courts applying the New York rule[129] never have avoided assignments of debt on the grounds of ostensible ownership problems. Courts applying the English or Massachusetts rule have never done so once the debtor is notified of the assignment.[130] Notice to the debtor serves as notice to the world because the debtor always can be consulted on the existence of a prior assignment.

One argument why subordinations, as opposed to assignments, might create ostensible ownership problems is that under many contingent subordinations the junior creditor retains the right to receive payments from the debtor. The typical common-law assign-

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125. *See* Coogan, Kripke, & Weiss, *supra* note 14, at 248-49.

126. The suggested perfection rule for subordination would include the subordination clause on the face of or in the title of an instrument or an Article 9 financing statement when no instrument is involved. *Id.* at 258-59.

127. *See* Glenn, *supra* note 102, at 645-46. Under the New York rule, an assignment is unassailable even before the obligor is notified. *See supra* note 82.

128. *But see* Heileson & Hirsch, *supra* note 102, at 557-59. Heileson and Hirsch assert that *Wyse* lives on to threaten subordinations in the junior creditor's bankruptcy. They do not justify their views in light of § 510(a), which explicitly overrules bankruptcy equities.

129. Under the New York rule, priorities are decided strictly according to the principle of "first in time is first in right." *See supra* note 103. *See* text accompanying *supra* note 103 and *supra* note 82.

130. Under the English and Four Horsemen rule, the assignor retains a power to create good title in a second assignee until the debtor is notified of the assignment. These rules therefore establish a sort of perfection requirement for assignees. *See supra* note 103. *See* text accompanying *supra* note 103 and *supra* note 82.

ment contemplates an immediate right in the assignee to collect. Retention of the right to collect by the assignor has made assignments for security suspect.[131] Assignments for security and debt subordinations are fundamentally different, however. In subordinations the debtor is usually aware of the subordination and can be consulted as to its existence. In the typical assignment for security, as in nonnotification accounts financing, usually the debtor is unaware that a secured party is in the picture. The debtor's lack of notice is what gives rise to ostensible ownership problems. Ostensible ownership concerns never have sunk an assignment of a chose in action when the debtor has notice.[132]

Much of the incentive for bringing subordinations under Article 9 disappears if one concedes that subordination does not give rise to significiant ostensible ownership concerns. In addition, three undesirable side effects of continued Article 9 coverage indicate that the common law of assignments provides a much better source of rules.

First, the priority rules of Article 9 are different from assignment priorities. Under Article 9, if the second senior creditor is the first to perfect,[133] it has priority to the bankruptcy dividends when the distribution occurs. Furthermore, this priority holds true when it has knowledge of the subordination to the first senior creditor, or when the subordination language is printed on the face of the instrument. Priorities under Article 9 favor the first party to perfect regardless of the second secured party's knowledge.[134] Under

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131. The assignor's retention of the right to collect destroyed the assignment under the infamous rule of Benedict v. Ratner, 268 U.S. 353, 360 (1925) ("Under the law of New York [sic] a transfer of property as security which reserves to the transferor the right to dispose of the same, or to apply the proceeds thereof, for his own uses is, as to creditors, fraudulent in law and void.").

In Professor Gilmore's chapter discussing *Benedict v. Ratner*, he develops the point that the above-quoted rule was based not merely upon secrecy, but upon the requirement that the accounts financier closely police the debtor by controlling the payments received from credit customers. 1 G. GILMORE, *supra* note 7, § 8.3, at 257-61. Thus, a decision by the accounts financier to take a bigger risk by not policing meant that the assignment for security was void against creditors, even when the assignment was highly public. The second branch of *Benedict v. Ratner* (overruled in UCC § 9-205), was limited to accounts and inventory cases. 1 G. GILMORE, *supra* note 7, § 8.4, at 265.

132. Rockmore v. Lehman, 129 F.2d 892 (2d Cir.), *cert. denied*, 317 U.S. 700 (1942); *In re* New York, N.H. & H.R.R., 25 F. Supp. 874, 877 (D. Conn. 1938). These cases both upheld assignments for security when the assignor could collect until default.

133. On Article 9 perfection rules, see *supra* note 123. Under Article 9, an assignee for security of an account or general intangible cannot perfect by notifying the obligor, as it could under the English rule for assignment priorities. *See supra* note 85.

134. *See* U.C.C. § 9-312(5) (1977). Professor Nickles believes that the second secured

Article 9, senior creditors usually must perfect to save their right to double dividends. This problem is especially acute when the junior claim is an Article 8 security. Section 8-321(1) states that an unperfected security interest in an Article 8 security is no security interest at all.[135] Under Article 8 buyers of the subordinated debenture technically take free of the subordination rights of the senior creditors. At least under Article 9, initial buyers of the junior claim would be subject to unperfected security interests of which they had knowledge.[136] In contrast, the common-law assignment priorities always protect the original senior creditor. No subsequent assignee can take priority[137] once the obligor has notice of the assignment.

Second, under Article 9 senior creditors face an alarming limitation on their rights against buyers of the junior instrument. Section 9-307(3) prevents senior creditors from making future advances forty-five days after the sale of the junior instrument.[138] Subordination agreements frequently contemplate expandable classes of senior creditors and unlimited ability of individual senior creditors to advance more funds on a senior basis, but section 9-307(3) may bring this practice to a halt. The administrative burdens on both a bankruptcy trustee and an indenture trustee would be prodigious if section 9-307(3) applied in these situations. The trustees would have to disallow future advances at different times for each subordinated instrument traded.[139]

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party's knowledge is always relevant. Nickles, *supra* note 86, at 72-103. These views deserve more attention.

135. *See* U.C.C. § 8-321(1) (1977).

136. *See id.* § 9-301(1)(c) & (d). Under these provisions, subordination clauses set forth in the instrument should put buyers on notice. These sections assume that the sale is out of the ordinary course of business. Section 9-307(1) covers sales in the ordinary course of business. In § 9-307(1) the buyer's knowledge is once again irrelevant. *Id.* This provision might apply when the underwriter sells the subordinated debenture. Only security interests "created by [the] seller" are destroyed by § 9-307(1). The underwriter may be a party to the creation of a security interest when an indenture created the interest. Hence, public issue of subordinated debentures might come under § 9-307(1) making the buyer's knowledge of a prior interest irrelevant.

Application of § 9-301(1)(c) to subordination cases is subject to two problems. First, § 9-301(1)(c) does not explicitly cover sales in the ordinary course of business. Second, § 9-301(1)(c) does not explicitly kill security interests but merely subordinates them to the rights of the buyer. These drafting glitches should be ignored, and § 9-301(1)(c) should be viewed as a provision that kills unperfected security interests. *See* Carlson, *Death and Subordination Under Article 9 of the Uniform Commercial Code: Senior Buyers and Senior Lien Creditors*, 5 CARDOZO L. REV. 547 (1984).

137. *See supra* note 82.

138. *See* U.C.C. § 9-307(3) (1977).

139. This Code analysis presumes that the rule against future advances in § 9-307(3)

Third, if junior creditors sell their subordinated debentures, the sales price they receive technically constitutes proceeds under section 9-306(1).[140] Application of Article 9 suggests that these proceeds become available to senior creditors after default. Most investors in subordinated debt instruments would be quite shocked to learn that, years after they sold out, the money proceeds they received must be surrendered to senior creditors. The expansive proceeds rule of Article 9 is the most compelling reason why subordinations should be taken out of Article 9.

To summarize, some scholars have defended applying Article 9 to subordinations on the theory that subordinations are secret liens that the junior creditor's bankruptcy should destroy.[141] But the side effects of Article 9 coverage—priorities against subsequent creditors and buyers, future advance rules, and encumbrances upon sales proceeds—should be avoided. Moreover, the ability of creditors of junior creditors to inquire of the common debtor concerning the nature and value of a general intangible diminishes ostensible ownership problems.

2. The Solution

The legislative exemption recommended in 1966 by the Permanent Editorial Board offers the best solution to the side effects of Article 9 coverage of subordinations. The recommended section 1-209 reads:

> An obligation may be issued as subordinated to payment of another obligation of the person obligated, or a creditor may subordinate his right to payment of an obligation by agreement with either the person obligated or another creditor of the person obligated. Such a subordination does not create a security interest as against either the common debtor or a subordinated creditor. This section shall be construed as declaring the law as it existed prior to the enactment of this section and not as modifying it.[142]

Only seventeen states have passed section 1-209,[143] but they include commercially important jurisdictions. Knowledgeable lawyers often can use choice of law clauses to guarantee that section 1-

applies to Article 8 securities as well as to security interests covered only by Article 9. *See id.* § 8-321(3).

140. *Id.* § 9-306(1).

141. *E.g.*, 2 G. Gilmore, *supra* note 7, § 37.3, at 997-98.

142. U.C.C. § 1-209 (1977).

143. States adopting § 1-209 include: Arizona, Arkansas, California, Illinois, Iowa, Kansas, Massachusetts, Michigan, Minnesota, Montana, New Jersey, New York, Oklahoma, North Carolina, North Dakota, Wisconsin, and Wyoming. *Id.* § 1-209, 1 U.L.A. 50 (Supp. 1984).

209 applies to their loan agreement. This solution, however, requires a reasonable connection between the transaction and the choice of law.[144] In any case, commercial law ought to supply rules that most creditors want. A commercial rule that requires lawyers to stipulate out of it imposes wasteful negotiation costs.

Two nonstatutory suggestions may solve the problem of Article 9 coverage of subordination. First, some commentators have alleged that certain subordination transactions do not fit within the UCC definition of security interests.[145] This argument is that when the debtor issues the debt in subordinated form, the junior creditor "grants" no rights when it first creates a subordination. *Ab initio*, the junior creditor enters into a "limited debt." *Ab initio* subordinations therefore do not constitute proprietary transfers—only subsequently created subordinations do. The limited debt argument succeeds in excluding subordinated debentures from Article 9 coverage, which eliminates the most severe disruption that the UCC imposes on the credit market.

The limited debt solution, however, cannot withstand scrutiny. All subordination agreements, whether *ab initio* or subsequent, fit within the UCC definition of security interest. A junior creditor holding a subordinated debenture is analogous to the debtor in purchase money financing or nonnotification accounts receivable financing concerning after-acquired property. As soon as the debtor obtains collateral, his rights are subject to the secured creditor's superior rights. No one would argue that after-acquired accounts are subject only to a limitation on the account debtor's obligation to pay and therefore are not encumbered by any security interest. The instantaneous encumbrance of newly obtained property is a common Article 9 concept and therefore cannot be used to exempt *ab initio* subordinations from the UCC definitions of security interests.

If courts must do violence to the literal words of the UCC, it would be simpler to declare that Article 9 does not apply to subordination of debt. No reason exists to apply Article 9 priorities out of blind adherence to statutory words when the result is bad policy that the legislature would not endorse.[146] Nevertheless, this sugges-

144. U.C.C. § 1-105 (1977).

145. The distinction between original and subsequent subordinations is developed in Coogan, Kripke, & Weiss, *supra* note 14, at 238-47 and Zinman, *supra* note 91, at 7.

146. For a good essay on ignoring the express words of the UCC to achieve broad commercial law purposes, see Hillman, *Construction of the Uniform Commercial Code: UCC Section 1-103 and "Code" Methodology*, 18 B.C. INDUS. & COM. L. REV. 655, 685-86

tion runs counter to the notion that Article 9 applies to any transaction, "regardless of its form," that creates a security interest.[147] The real thrust of this rhetoric is aimed at the parties to specific transactions. Original parties should not be able to defeat third parties by changing the form of their relation. The rhetoric should not discourage courts from interpreting the statute in a reasonable manner.[148]

Exempting subordination from Article 9 coverage, whether by section 1-209 or judicial fiat, does not eliminate completely the threat of the junior creditor's bankruptcy. A subsequent subordination still could be a fraudulent transfer. A failing junior creditor should not be able to subordinate a claim upon the common debtor without receiving fair consideration from the senior creditors.[149] In

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(1977). An interesting description of "hermeneutics" and their use in finding legislative intent appears in Tushnet, *Following the Rules Laid Down: A Critique of Interpretivism and Neutral Principles*, 96 HARV. L. REV. 781, 798-804 (1983).

147. U.C.C. § 9-102 (1977). *See* Serf v. Leff, 38 Bankr. 571, 575 (Bankr. S.D.N.Y. 1984); Coogan, Kripke, & Weiss, *supra* note 14, at 246 ("[E]ven if there is no explicit agreement between the parties that a security interest is to be created, the law will infer this result from what they did intend."); *see also* 2 G. GILMORE, *supra* note 7, § 37.3, at 996-97. Gilmore asserts that

> The whole point and purpose of Article 9 was to bring to an end the pre-Code proliferation of "independent" security devices. A creditor who wants to claim priority over other creditors in specific assets should no more be able to avoid the perfection requirements of the Article by calling his arrangement "subordination agreement" than he could be calling it "consignment," "lease," "trust" or whatnot.

Id.

148. *Cf.* Serf v. Leff, 38 Bankr. 571, 576 (Bankr. S.D.N.Y. 1984).

149. A subordination is the transfer of rights by a junior creditor to a senior creditor. Transfers for the benefit of third parties are not always made for "fair consideration" under the fraudulent transfer provisions of the bankruptcy laws. Smiley Professional Ass'n v. Phelps, 484 F.2d 864 (10th Cir. 1973); Bullard v. Aluminum Co. of Am., 468 F.2d 11 (7th Cir. 1972). *Compare In re* W.T. Grant Co., 699 F.2d 599, 609 (2d Cir.) (guaranty of loan to subsidiary "probably" not a fraudulent conveyance by parent, for purposes of fairness of class action settlement), *cert. denied*, 104 S. Ct. 89 (1983), *with In re* Associated Gas & Elec. Co., 61 F. Supp. 11, 34 (S.D.N.Y.) (subordination probably a fraudulent conveyance for purposes of settlement), *aff'd*, 149 F.2d 996 (2d Cir. 1944), *cert. denied*, 326 U.S. 736 (1945).

Ordinarily, extension of credit by senior creditors to an entity in which the junior creditor has a claim should constitute consideration. Whether it is "fair" consideration will depend on the circumstances. When the class of senior creditors includes those that extended credit before subordination and when the issuance of the debt itself did not supply consideration—that is, it was an *ab initio* subordination, fair consideration becomes problematic. The junior creditor receives nothing from preexisting creditors.

Aldrich v. Redington, 605 F.2d 590 (2d Cir. 1978), might be used by preexisting senior creditors to avoid fraudulent conveyance liability. In that case the Second Circuit refused to let a subordinated junior creditor rescind for fraud. Senior creditors could have estopped the junior creditors from rescinding if they could have proved reliance. The Second Circuit ruled that imposing a burden of proving reliance on a large class of senior creditors was tantamount to denying the subordination right altogether. It noted that the purpose of the addition, subordination might be a preference[150] or a violation of negative pledge convenants that the junior creditor might have made in unrelated loan agreements.[151] The bankruptcy of the junior creditor may be consolidated with the bankruptcy of an affiliated common debtor—in which case the junior debt and double dividends would disappear.[152] Nevertheless, with Article 9 out of the picture, at least subordination should stand up against the hypothetical lien creditor status of the junior creditor's bankruptcy

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net capital rules of the New York Stock Exchange, pursuant to which the subordination agreement had been signed, was to protect stockbroker customers. The junior creditors knew this. Hence, reliance was not required, even for senior creditors that were not customers within the statute. This same analysis could be used in response to a fraudulent conveyance claim by a junior creditor's trustee.

The Second Circuit's opinion is based squarely on the customer-protective purposes of the Securities Exchange Act. The Ninth Circuit applied the same analysis outside the context of tbe Act. *In re* Holiday Mart, Inc., 715 F.2d 430 (9th Cir. 1983). *But see* Federal Deposit Ins. Corp. v. United States Nat'l Bank, 685 F.2d 270 (9th Cir. 1982) (refusing to follow *Weis* when no regulatory goal was at stake).

The presence of fair consideration removes the risk of fraudulent transfer liability of the senior creditors. Although subordinations in exchange for fair consideration still could be a fraudulent conveyance if the junior and senior creditors intend to deceive nonsenior creditors, 11 U.S.C. 548 (a)(1) (1982), no ostensible ownership concerns exist to cause a bankruptcy court to disallow subordination rights. *See supra* text accompanying notes 122-32.

150. Difficult preference issues exist when the class of senior creditors is large. Creditors preexisting the subordination all have received a transfer of the junior creditor's property on antecedent debt. The subordination may constitute a voidable preference if made when the junior creditor was insolvent and within 90 days of bankruptcy. *See* 11 U.S.C. § 547(b) (1982). A different preference risk is imposed when the subordination is made contingent on regulatory approval. Verace v. New York Stock Exch., 478 F. Supp. 1061, 1065 (S.D.N.Y. 1979). Such a clause creates a "springing lien" that transfers ownership of the junior claim only when approval is obtained. A preference risk is created for senior creditors whose claims are approved by the Exchange while the junior creditor is insolvent. From the senior creditor's point of view, the better practice is to have the subordination immediately effective but to defer permission to the stockbroker to exclude the subordinated claim from debt for net capital purposes.

151. Coogan, Kripke, & Weiss, *supra* note 14, at 256-57; *cf. In re* Associated Gas & Elec. Co., 61 F. Supp. 11, 29 (S.D.N.Y. 1944) (downstream guaranty thought to violate negative pledge covenants), *aff'd*, 149 F.2d 996 (2d Cir.), *cert. denied sub nom.* Elias v. Clarke, 326 U.S. 736 (1945). Some authorities have asserted that when the secured party knows of the negative pledge covenant at the time of the security agreement, the security interest is voidable at the behest of the creditors to whom the covenant was made. 2 G. GILMORE, *supra* note 7, § 38.2. Under this theory creditors with enforcement rights would be able to recover double dividends from the senior creditors.

152. *Cf. In re* Gulfco Inv. Corp., 593 F.2d 921, 927-28 (10th Cir. 1979) (consolidation would eliminate intracorporate guarantees). Elimination of gnarantees was sufficient to convince the *Gulfco* court to reverse the lower court's consolidation order, but the court hinted that even the elimination of the guaranty should not justify a rejection of consolidation under some circumstances, including the hopeless commingling of assets. *Id.* at 929-30. *See generally* Conti, *An Analytical Model for Substantial Consolidation of Bankruptcy Cases*, 38 BUS. LAW. 855 (1983) (discussing the standards for consolidation).

trustee.[153]

C. *The Suretyship Aspects of Subordination*

Subordination resembles a specialized assignment of a nonrecourse variety in which the junior creditor guarantor puts up collateral to secure the debt of the principal obligor, but does not agree to be personally liable.[154] The equation of subordination and nonrecourse suretyship is acceptable provided courts use suretyship rules with great care in order to preserve the precise benefits and burdens of the subordination relation.

One important suretyship doctrine prohibits the benefited creditor from increasing the risk by enlarging the size of its debt[155] or by lengthening the maturity of the loan.[156] This rule is unrealistic for subordinations with an open class of senior creditors. These classes can expand as new senior creditors extend credit to the common debtor. It would be highly anomalous to permit new senior creditors to enter the class, but prohibit old creditors from extending new credit on a senior basis.[157]

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153. The common law of assignment dictates that the trustee, as hypothetical lien creditor, cannot prevail. Courts usually hold that a subsequent lien creditor loses to a prior assignee unless the obligor pays the lien creditor without knowledge of the previous assignment. RESTATEMENT (SECOND) OF CONTRACTS § 341 (1979). Because the common debtor almost certainly will know of the subordination, this theory seldom will help the junior creditor's trustee avoid the subordination agreement.

Two authors, assuming that Calligar's four theories of subordination might be viable, *see supra* note 106, argue that if the "contractual" theory of subordination is adopted, then senior creditors might have no property interest in double dividends that could be senior to a hypothetical lien. At best, the senior creditor would have an unsecured claim against the junior creditor for the amount of the dividends. Hieleson & Hirsh, *supra* note 102, at 565. This point suggests that the true nature of subordination does matter. A casual attitude about the theories of subordination has harmful results.

154. Coogan, Kripke, & Weiss, *supra* note 14, at 236 n.25. *See* Vintero Corp. v. Corporacion Venezolana de Fomento, 735 F.2d 740, 742 (2d Cir. 1984) (describing security interests granted by nonrecourse guarantors); Cohn, *supra* note 27, at 313 (suggesting this analogy for purposes of classifying claims in reorganization).

155. Atterbury v. Carpenter, 321 F.2d 921 (9th Cir. 1963); RESTATEMENT OF SECURITY § 128 (1941).

156. RESTATEMENT OF SECURITY § 129 (1941).

157. Both Gilmore and Calligar believe that if the senior creditor has a security interest that he later releases, there should be a "pro tanto release [of] the unsecured subordinator from his duties under the subordination agreement just as it would release a surety." 2 G. GILMORE, *supra* note 7, at 985-86 n.10; Calligar, *supra* note 5, at 383-84; *see also* First Nat'l Bank v. American Foam Rubber Corp., 306 F. Supp. 593, 605 n.47 (S.D.N.Y. 1969), *rev'd*, 530 F.2d 450 (2d Cir.), *cert. denied*, 429 U.S. 858 (1976). Release of the security interest by the benefited creditor in a suretyship agreement increases the risk to the surety and is therefore not permitted. Application of this surety rule to subordination also suggests that senior creditors must be debarred from increasing the size of the senior debt. Such

A junior creditor that subordinates to a single senior creditor, however, may intend to accept a much smaller risk than the junior creditor that subordinates to a class of senior creditors.[158] This intent is particularly likely with complete subordinations, in which the junior creditor agrees to not receive any payment until a specific designated senior claim disappears. In this case, it is important to limit the power of the debtor and senior creditor to increase the risk to the junior creditor.[159]

One of the traditional remedies for unauthorized increase of risk to the surety is discharge of the suretyship contract. This rule is harsh even in a suretyship context. In *Atterbury v. Carpenter*[160] a surety guaranteed a bank loan for $45,000. In order to save the failing business, the bank advanced an additional $50,000. The court ruled that the entire surety contract was discharged because the benefited creditor's claim was increased. The court should have held that the guaranteed claim continued to be $45,000. The new $50,000 loan should have had no effect on the suretyship contract. An unrelated bank could have advanced the $50,000 without discharging the surety. That the benefited creditor made the advance did not affect the risk actually undertaken by the surety, provided the surety was not liable on the new advance.

Application of the rule of *Atterbury v. Carpenter* to subordination agreements would be as illogical as it is in more familiar suretyship contexts. Unless the debtor covenants against further

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rules make no sense when the junior creditor has accepted the risk that senior debt could be expanded. Release of security by senior creditors was found to be permissible in *In re* W.T. Grant Co., 3 Bankr. Ct. Dec. (CRR) 54, 58-59 (Bankr. S.D.N.Y. 1977); *see also In re* W.T. Grant Co., 699 F.2d 599, 613-14 (2d Cir.) (senior creditors had right to increase size of senior debt), *cert. denied*, 104 S. Ct. 89 (1983); Briggs v. Southern Bakeries Co., 227 Ga. 663, 182 S.E.2d 459 (1971) (hinting, however, that extended maturity would have been wrongful to junior creditors in a complete subordination).

158. A major theme of subordination of real estate mortgages is limitation of risk. A line of California cases holds that a lien subordination agreement is unconscionable unless the junior claim specifically is limited in risk. *See, e.g.*, Handy v. Gordon, 65 Cal. 2d 578, 422 P.2d 329, 55 Cal. Rptr. 769 (1967); Lambe, *Enforceability of Subordination Agreements*, 19 REAL PROP., PROB. & TR. J. 631, 636-38 (1984).

159. Authority may exist in opposition to the principle that subordination to specified debt inherently is limited. In First Nat'l Bank v. American Foam Rubber Corp., 530 F.2d 450, 456 (2d Cir.), *cert. denied*, 429 U.S. 858 (1976), the Second Circuit required the senior creditor to protect itself with an express contractual provision against discharge of the junior debt. The refusal of the court to imply prebankruptcy duties on the junior creditor suggests that it would refuse to imply duties on senior creditors as well. But this wooden resort to drafting burdens is tantamount to the court's abdication of its role to explore the purposes and expectation of the parties to tbe subordination agreement. *See* Bratton, *Interpretation of Contracts*, *supra* note 16, at 390.

160. 321 F.2d 921 (9th Cir. 1963).

nonsenior debt, a senior creditor should be allowed to advance nonsenior credit without discharging the subordination or any other suretyship contract.[161]

Extension of maturity has posed great difficulties for suretyship doctrine. The basic principle is still the same: the benefited creditor may not increase the risk to the surety by extending the maturity of the assured claim.[162] Extended maturities also pose a challenge when junior creditors intend to limit their subordination obligations to specific senior claims. Most complete subordinations will fall into this category. Extending the maturity of a senior claim prejudices the junior creditor by prolonging its inability to collect its own claim. Some limits on the powers of senior creditors to extend the maturity of their claim should exist.

Suretyship rules do provide some useful suggestions to sort out abusive and permissible maturity extensions. First, a distinction exists between genuine extension of maturity and mere collection delays. By extension of maturity, the courts contemplate a legal disability of the benefited creditor to collect from the common debtor until the new maturity date. Simple delay in collecting does not discharge the surety. A surety always may pay off the benefited creditor and pursue the debtor in a more diligent fashion.[163]

The purpose behind an extension of maturity should be material.[164] Any purpose to prevent the junior creditor from collecting should make the extension a breach of the senior creditor's duty to the junior creditor. An extension with the purpose and effect of increasing the chances of the debtor to survive—for instance, a loan workout—should not discharge the subordination agreement. The chief aim in this factual inquiry should be to determine whether the risk to the junior creditor is increased.[165]

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161. *See* Aetna Cas. & Sur. Co. v. Giesow, 412 F.2d 468, 470-71 (2d Cir. 1969) (senior claim was a performance bond; payments to subcontractors that need not have been made were not part of the senior claim but did not discharge the subordination agreement); Miller v. Citizens Sav. & Loan Ass'n, 248 Cal. App. 2d 655, 56 Cal. Rptr. 844 (1967) (in a lien subordination agreement, nonsenior advance did not discharge junior creditor's obligation).

162. 10 S. WILLISTON, CONTRACTS § 1222 (3d ed. 1967).

163. *Id.* § 1231.

164. Once again, a modification of suretyship case law is necessary before even this modest statement can be accepted. Traditionally, courts have cancelled suretyship contracts when the maturity is extended regardless of the reason. *Id.* § 1222. The rule for compensated sureties is different. The compensated surety must show that the extension is actually prejudicial. *Id.* By compensated sureties, usually courts contemplated an insurance company in the business of giving guaranties. *Id.* § 1213. The discussion in the text presupposes that courts will apply the rules for compensated sureties to subordinations.

165. Gluskin v. Atlantic Savs. & Loan Ass'n, 32 Cal. App. 3d 307, 314, 108 Cal. Rptr.

D. *Lien Subordination Contrasted*

Strong justifications for an assignment theory of debt subordination exist, but they do not apply to lien subordinations. A general demotion theory is more appropriate when the junior creditor is a secured party and does no more than concede priority to another secured party as to collateral supplied by the debtor.

The Second Circuit has assumed the opposite is true for both debt and lien subordinations. It has proclaimed that, without an express grant of bankruptcy dividends, a promise to receive no payment on the junior claim is not an assignment of the claim.[166] In addition, it has characterized subordination of lien priority as an assignment.[167] Because assignees can rely upon the perfecting acts of assignors to establish their priority,[168] the Second Circuit permitted an unperfected security interest to survive the debtor's bankruptcy. Coogan, Kripke, and Weiss support the Second Circuit in this latter regard. They believe that subordination agreements under section 9-316 of the UCC come within the definition of a security interest.[169] For this to be true, lien subordination

318, 323 (1973). For a case following the approach suggested in the text, see Briggs v. Southern Bakeries Co., 227 Ga. 663, 182 S.E.2d 459 (1971). In *Briggs* a class of junior creditors promised not to receive payment until a bank was paid on its secured loan. The senior claim matured in 1972, but the senior creditor had the right to insist that the debtor use the proceeds of collateral to pay the senior claim early. The senior creditor, however, permitted the sale of collateral without reducing the senior claim. Instead, the debtor was permitted to maintain a compensating balance with the senior creditor.

The junior creditor claimed that the subordination agreement should be cancelled. The junior creditor argued that the debtor would have paid the senior debt early if the senior creditor had exercised its rights over the collateral. The court properly ruled that the junior creditors accepted a risk of an outstanding senior claim until 1972. The actions of the senior creditor and debtor did not materially affect that risk.

If an extension of time is found to be wrongful, the remedy might be discharge of the subordination obligation. Here, the increased risk cannot be segregated out, as it could be when the senior creditor made an unauthorized future advance.

166. *See supra* notes 72-95 and accompanying text.

167. Citibank, N.A. v. Tele/Resources, Inc., 724 F.2d 266 (2d Cir. 1983), *rev'g on other grounds* 21 Bankr. 358, 364 (Bankr. S.D.N.Y. 1982) ("[The senior creditor's] failure to file a . . . financing statement to perfect its claim . . . is not fatal to its position in this case . . . . What is lacking in this case is a writing signed by [the junior creditor] to prove the existence of an assignment or subordination.").

To add to the irony, another court held that lien subordination should not be deemed an assignment, *In re* Henzler, 36 Bankr. 303 (Bankr. N.D. Ohio 1984), but relied on the Second Circuit's view of *debt* subordination to conclude that *lien* subordinations are never assignments under any circumstances. *Id.* at 305-06 (citing Cherno v. Dutch Am. Mercantile Corp., 353 F.2d 147 (2d Cir. 1965)).

168. U.C.C. § 9-302(2) (1977).

169. Coogan, Kripke, & Weiss, *supra* note 14, at 259-61. This view is supported by Professor Osborne in the context of subordinated real estate mortgages. 4 AMERICAN LAW OF

must be synonymous with assignment of the underlying debt.[170]

There are three reasons why contractual lien subordination should be a demotion or waiver instead of an assignment. First, contractual lien subordination cannot be reconciled with traditional doctrines pertaining to assignments. Although this is the least satisfactory of the reasons, it is presented first in order to illustrate more clearly the policy reasons that follow. Second, the economic justifications that militated for an assignment theory of debt subordination do not militate for a similar view of lien subordination. Third, a demotion theory best comports with the bankruptcy policy against permitting unperfected security interests from surviving the debtor's bankruptcy.

1. Lien Subordination Cannot Be Reconciled Easily With Assignment Doctrine

In a lien subordination agreement, the only collateral for either the senior or junior claims is the property that the debtor has offered both parties as collateral. The junior claim, which is property of the junior secured party, is not collateral for the senior claim. The junior secured party does not promise to receive no payment on the junior claim. It may receive unencumbered cash from the debtor without violating any rights of the senior secured party. If the collateral were to disappear, the senior and junior secured parties would be equal general creditors of the debtor. In these respects, lien subordination differs from debt subordination.

It is difficult to reconcile the two familiar assignment doctrines with lien subordination agreements. First, liens cannot be assigned separately from the underlying debt.[171] Second, once the debtor has been notified that a chose in action has been assigned, only payments to the assignee will extinguish the debt.[172] If the junior secured party's claim is not itself collateral for the senior claim, then the lien subordination agreement separates the lien from the underlying debt. This is an impossibility under traditional assignment theory. Furthermore, payments made by the debtor to the senior secured party do not extinguish the junior claim. After the

PROPERTY § 16.106D, at 215-16 (1952).

170. Coogan, Kripke, & Weiss, *supra* note 14, at 260 (lien subordination "appears to be a transfer and, unless perfected, potentially vulnerable in the subordinator's bankruptcy"). The authors proposed to make lien subordination automatically perfected security interests in order to avoid this alleged problem. *See id.* at 258.

171. *See* RESTATEMENT OF SECURITY § 29 Comment (1941).

172. *See* RESTATEMENT (SECOND) OF CONTRACTS § 338 (1979).

senior claim is satisfied from the proceeds of the collateral, the junior claim survives as an unsecured claim against the debtor.

The problem with these observations is that it is possible to imagine a complicated interpretation of lien subordination that satisfies the doctrinal requirements of assignment without violating the expectations of the parties. For instance, lien subordination could mean that the junior secured creditor could make a partial assignment of its entire secured claim (both debt and lien) so that the senior secured party is completely paid off. Meanwhile, the junior secured party is subrogated to an equivalent amount of the senior creditor's claim (both lien and debt). But the forthcoming policy reasons strongly suggest the adoption of a demotion theory, not a complicated assignment-plus-subrogation theory, for lien subordinations.

2. The Economics of Lien Subordination Militate for a Demotion Theory

If debt subordination is an assignment of the junior claim, subordination benefits are denied to free-riding, nonsenior creditors. Accordingly, the assignment theory is more lucrative for the senior creditors and cheaper for the junior creditors.[173]

None of these statements is true for lien subordination. If the junior secured party is demoted, so that it collects from the collateral after the senior secured party, general creditors receive no benefits because the general creditors have no right to the collateral. Demotion in this context creates no free-rider effect.

The demotion theory also does not increase the cost of the lien subordination, as it would increase the cost of debt subordination. To the contrary, the assignment theory would increase the cost if used to permit the senior creditor to obtain rights to the junior claim. The ability of a junior creditor to pursue the debtor personally, in spite of a lien subordination agreement, makes lien subordination less expensive than debt subordination. Loss of the right through an assignment theory would increase the cost of lien subordination.

Once again, it is possible to interpret lien subordination agreements consistently with assignment doctrine without also entitling the senior creditor to the junior creditor's personal rights against the debtor. The lien subordination could be a swap of the junior creditor's entire claim with the senior creditor's claim, limited to

173. *See supra* text accompanying notes 29-52.

the value of the security. In other words, if the junior creditor's lien claim is more than the value of the collateral, the junior claim would be divided into a secured and unsecured portion, with only the secured portion assigned to the senior creditor. In exchange, the junior creditor becomes subrogated to the senior creditor's claim, which would be unsecured. Such a complicated theory would preserve the junior secured party's personal rights against the debtor while remaining true to assignment doctrine. Assignment doctrine, however, was partially justified by cutting out nonsenior creditors from subordination benefits. No such justification exists for lien subordination. Thus, the complicated assignment-subrogation theory serves no purpose. In addition, the theory would interfere with bankruptcy policy against the survival of unperfected security interests, which is the subject of the next section.[174]

3. A Demotion Theory of Lien Subordination Fits Better with Bankruptcy Policy Against Unperfected Liens

A key difference between debt subordination and lien subordination is that lien subordination presupposes that both the senior and junior creditors have liens.[175] The parties to a debt subordina-

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174. A subordination agreement between two mortgagees should not be viewed as an assignment, but when the junior creditor is a lessor, not a mortgagee, an assignment of property does exist.

In Lambe, *supra* note 159, at 633, the author describes the typical real estate subordination agreement as follows. The owner of undeveloped land either sells or leases the land to a developer. If the land is sold, the seller retains a purchase money mortgage. If the land is leased, the lessor retains a reversion. In either case, the developer commonly needs construction financing. The landowner, therefore, agrees to subordinate the mortgage or the reversion to the rights of the construction mortgagee. Mr. Lambe assumes that the same theory of subordination is applicable whether the retained interest is a mortgage or a reversion. Characterization of lien subordination as waiver in this Article, however, works only for intermortgage agreements. When the landowner retains a reversion, it does more than merely cede administrative control of the sale to the senior creditor. It essentially agrees to sell the reversion, not otherwise susceptible to foreclosure, to satisfy the senior claim. This agreement appears to be the grant of a mortgage by a nonrecourse guarantor. Accordingly, the "subordination agreement" pertaining to the reversion should be recorded against the landlord to preserve the senior creditor's mortgage on the reversion.

175. The case may arise in which a secured party agrees to subordinate his lien to the lien of another creditor when the second creditor neglects to get a security interest. In this case, the second creditor has not performed the minimal acts necessary to take advantage of the subordination agreement. That is, the second creditor's right to priority is contingent upon the second creditor's getting security from the common debtor. An example will demonstrate why this is so.

Suppose *JC* promises to subordinate his \$50 lien in the \$100 collateral to *SC*, in order to induce *SC* to lend \$50 to *D*, the debtor. *SC* makes the loan but neglects to obtain a security interest from *D*. *D* defaults on *JC*'s loan, and *JC* repossesses and liquidates the collateral. *SC* may try to claim that *JC* is estopped from asserting *JC*'s priority to the \$100, tion need not hold secured claims. When a secured party promises to subordinate his debt, however, the entire junior claim, together with the accompanying lien, is assigned to the senior creditor as security for the senior claim.[176]

If subordination is an assignment, then the senior creditor should be able to rely on the perfecting acts of the junior creditor.[177] When a secured party subordinates its debt, the perfecting acts of the junior creditor serve to put the world on notice that one security interest exists. There is no reason for the senior creditor to perfect a second time. Although the identity of the secured party will not be apparent from the records, creditors of the debtor will know at least that an encumbrance exists.

The senior secured party in a lien subordination should perfect separately so that the creditors will know that two encumbrances exist. This is perhaps the most important reason why consensual lien subordination should not be an assignment. If the senior secured party has neglected to perfect its security interest, the debtor's bankruptcy trustee should be able to avoid the unperfected lien by use of the strong-arm power in section 544(a). In contrast, an assignment theory could be used to excuse the senior secured party from putting creditors on notice that a second encumbrance exists.

The alternative to the demotion theory proposed here is the assignment-plus-subrogation theory in which the two secured parties simply trade claims. Under this view, the junior secured party might give up its perfected lien to the senior secured party and might receive the unperfected lien in return by subrogation. This approach would protect the general creditors of the debtor because only one of the two security interests would survive the trustee's avoidance powers. But it is probably unfair to the junior creditor. The rule puts the burden of failing to perfect on the junior creditor and holds the senior creditor harmless from errors made in the

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but *JC* has not promised to waive his security interest altogether. He has promised only that *SC* has the first drink at the trough. If *JC* gives *SC* the first $50 and retains the second $50 for himself, *D* justifiably will complain that *JC* is giving away *D*'s property without *D*'s consent. The only answer is that *SC* has no rights to the collateral because *D* never transferred a security interest. *See* Wilmot v. Central Okla. Gravel Corp., 620 P.2d 1350, 1355 (Okla. App. 1980).

176. This statement applies to security interests received at a time when prepayment of the junior claim was not allowed. If the junior creditor may accept precontingency payments from the debtor, it may also receive security. This distinction is developed *infra* in the text accompanying notes 203-10.

177. U.C.C. § 9-302(2) (1977).

perfecting process. An assignment theory would therefore make the junior creditor the guarantor of the senior creditor's perfecting steps. The only defense of this result is if each and every party to a lien subordination knew the rules. But this assumption of knowledge cannot be made. In addition, it puts extra duties upon the junior secured party that are probably not useful or cost-effective.

Instead, when the senior secured party has failed to perfect the rule should be as follows: The senior security interest should be avoided, and the senior secured party should be demoted to a general creditor of the debtor.[178] The avoided lien should be preserved for the bankrupt estate, so that the trustee can assert the lien's priority under the subordination agreement.[179] The amount recovered from the collateral by the preserved senior lien is added to the debtor's estate. The junior creditor receives exactly what it would have received if the senior creditor had perfected its lien.[180] Meanwhile, the duty to perfect stays with each individual secured party. Under such a rule, the junior secured party has no need to look over the senior secured party's shoulder to ascertain the state of perfection of the senior lien.[181]

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178. 11 U.S.C. § 544(a) (1982).

179. *Id.* § 551.

180. This should have been the result in *In re* Tele/Resources, Inc., 724 F.2d 266 (2d Cir. 1983). Instead, the Second Circuit permitted the senior secured party's unperfected security interest to survive the debtor's bankruptcy. The bankruptcy court opinion sets forth a more explicit equation of lien subordination and assignment. 21 Bankr. 358, 363-64 (Bankr. S.D.N.Y. (1982).

181. When only the junior and senior secured parties hold liens, lien subordination looks much like waiver by the junior creditor, without any derivation of senior rights from the junior security agreement. But what happens when a third lien creditor that is not the beneficiary of the lien subordination agreement is in the picture? For example, suppose *A*, a secured party, is senior to *B*, a lien creditor. To induce *C* to make a new secured loan, *A* subordinates his lien to a new lien for *C* created by the debtor. Now *A* is senior to *B*, *B* is senior to *C*, and *C* is senior to *A*. *See* Grise v. White, 247 N.E.2d 385 (Mass. 1969).

The standard solution to this circular priority is for *C* to take priority first over *B*, but only to the extent of *A*'s priority over *B*. 2 G. GILMORE, *supra* note 7, § 39.1, at 1021. But allowing *C* to assert *A*'s priority is still a waiver by *A*, not an assignment of *A*'s rights to *C*. *A* stands aside for *C*, but *A* continues to screen out *B* until *C* has satisfied its claim, up to *A*'s priority. When *A* can stand aside no longer, *B*'s turn comes to satisfy its claim. The point is that *C* enforces its own security interest granted by the debtor and does not step into *A*'s shoes.

In *Grise v. White* the court was able to award priority to *C* over *B* without analyzing the lien subordination agreement as an assignment. 247 N.E.2d at 390.

V. The Junior Creditor's Duty To Preserve the Junior Debt

A. Destruction of the Junior Debt by Payment or Discharge

Complete subordination of debt equates with assignment of bankruptcy dividends. The converse also follows. Every express assignment of bankruptcy dividends includes the promise not to receive payment after the debtor's bankruptcy. After the debtor has notice of an assignment, only payments to the senior creditor assignee extinguish the debt. The rule that an assignor impliedly promises to do nothing to defeat the assignment supports this rule.[182] If the junior debt could be extinguished with surreptitious postbankruptcy payments, the double dividends disappear, and the junior creditor will have violated its duty to do nothing to defeat the assignment.

In the above discussion, bankruptcy triggered the junior creditor's implied duty not to receive payments. The question arises whether courts should imply a duty on the junior creditor not to receive prebankruptcy payments.

Initially, the Second Circuit did imply a duty not to receive prebankruptcy payments. In *Cherno v. Dutch American Mercantile Corp.*[183] a secured creditor promised a prospective new creditor (a) to subordinate its lien to the lien of the junior creditor, and (b) to receive no payment on the junior debt until the senior debt was paid fully. The senior creditor never took a lien of its own, and never filed notice of an assignment of the junior creditor's chattel mortgage. The junior creditor then dishonestly filed a statement of satisfaction, which led a third secured creditor to extend credit in exchange for a chattel mortgage. The senior creditor maintained that the false statement of satisfaction was void because the security interest already had been assigned by the time of the false statement. The court properly held that the senior creditor's assignment was unperfected and ineffective against the third secured creditor.[184]

The Second Circuit's dictum suggested that the junior creditor breached some kind of duty to the senior creditor when it filed the

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182. Restatement (Second) of Contracts § 333(1)(a) (1979).

183. 353 F.2d 147 (2d Cir. 1965). *Cherno* has been discussed for its alternate holding that subordinations are not assignments. *See supra* text accompanying note 85.

184. 353 F.2d at 154. *Cherno* concerned precode law. Article 9 does not govern fraudulent statements of satisfaction, but Professor Epstein has urged the same result under the UCC. Epstein, *supra* note 112, at 528-29.

false statement of satisfaction.[185] Although the court did not justify this statement, the court appeared to believe that the senior creditor had a right to the preservation of the security interest. This view is consistent with the principle that junior creditors should hold improper payments before bankruptcy for the benefit of the senior creditor.[186] Thus, the *Cherno* court must have viewed the chattel mortgage as already held "in trust" for the senior creditor.[187] Incidentally, this dictum undermines the court's insistence that subordinations are not assignments.[188]

The prebankruptcy duty to preserve the collateral arose from the complete subordination, not the assignment of bankruptcy dividends implied by the complete subordination. That is, the complete subordination, effective by its terms before bankruptcy, implied a duty to hold the security interest in trust for the senior creditor. This duty does not arise when there is no promise to forego prebankruptcy payment.

The issue whether a duty to preserve collateral should be implied in the absence of a promise to forego prebankruptcy payments arose obliquely in *First National Bank v. American Foam Rubber Corp.*[189] The case concerned complete subordination similar to *Cherno*. The junior creditors had promised to receive no principal or interest payments on their debentures until the senior creditors' debentures were paid in full. The junior creditors had agreed to surrender such improper payments to the senior creditors.[190] The court's holding—against any implied duty to preserve the senior debt—related to the implied assignment of bankruptcy dividends, not the promise to forego prebankruptcy payment.

In 1958, after the complete subordination agreement went into effect, the American Foam Rubber Corporation decided to exchange shares of its stock for a junior creditor's subordinated debentures. Three years later, American Foam Rubber became bank-

185. "[The senior creditor] at no time had an interest in or lien upon the chattels. Its so-called 'security' was nothing more than a promise by [the junior creditor] to apply no payment against the mortgage debt until [the senior creditor] was paid in full. [The junior creditor] breached this agreement . . . ." 353 F.2d at 154.

186. At one point, the Second Circuit stated that the junior creditor holds the entire junior debt in trust for the senior creditor—that is, the junior debt is the property of the senior creditor. *Id.* The court does not say expressly that the security interest is held in trust as if it were an "improper payment." *See supra* text accompanying notes 62-71.

187. *See supra* note 85 and accompanying text.

188. 353 F.2d at 151.

189. 306 F. Supp. 593 (S.D.N.Y. 1969), *rev'd in part*, 530 F.2d 450 (2d Cir.), *cert. denied*, 429 U.S. 858 (1976).

190. 306 F. Supp. at 599-601.

rupt. The senior creditor received some dividends in bankruptcy, but did not receive the "double dividends" he would have received if the junior creditor had remained a subordinated lender instead of becoming a shareholder. The senior creditor alleged that the junior creditor had breached her contract by discharging a subordinated loan in exchange for stock. The district court ruled that the junior creditor would be liable for wrongfully depriving the senior creditor of double dividends in bankruptcy. The court analyzed the transaction as a "complete subordination" so that any "payment" was a breach of the contract for which the senior creditor had the right to recover damages. But, the trade of the junior creditor's subordinated debentures for the preferred stock was *not* considered a payment in violation of the complete subordination agreement because no assets left the firm as a result of the trade.[191]

The district court and the court of appeals disagreed on the effect of discharging the subordinated loan. The district court ruled that the subordination agreement included not only an implied assignment of bankruptcy dividends to the senior creditor, but also an implied promise not to discharge the subordinated debt. The district judge inferred this promise in order to preserve the senior creditor's right to receive double dividends.[192] The judge's inference relied squarely on the dictum in *Cherno*. He read *Cherno* to mean that any discharge of junior debt violates a duty implied into all subordinations.[193]

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191. *Id.* The Second Circuit agreed. 530 F.2d at 452-53. The district court equated the trade for stock with "waiver, forgiveness or cancellation" of the junior debt. 306 F. Supp. at 601. Even though the preferred shares had a five percent cumulative dividend and were redeemable at will by American Foam Rubber, the court noted that the defendants never could receive cash for their shares. Under the terms of the preferred share issue, payments could not occur until the senior debentures were paid. *Id.* at 600. The district court knew that dividends and redemption *could* occur during a period of temporary solvency between payments on plaintiff's debenture, but the issuance of stock was still not a "payment" because "it was highly improbable that [the defendant] would realize any cash . . . by means of the exchange." *Id.*

192. 306 F. Supp. at 605-06. Apparently, this damage theory was the idea of the district court judge. The junior creditor tried unsuccessfully to claim that the appeals court could not consider the theory because the senior creditor did not plead it. 530 F.2d at 453 n.3.

193. *Cherno* did not deal with destruction of double dividends. The junior debt in *Cherno* continued to exist and the parties believed it would generate double dividends. The case dealt with turning over trust property—a payment inconsistent with the complete subordination promise—to the senior creditor, not with discharging the junior debt, which would have destroyed double dividends. Nevertheless, the analogy to discharge of the junior debt is apt. The junior creditor must do no act to destroy the subordination once it has become enforceable.

The Second Circuit decided against broadly implying duties to preserve junior debt for the life of the subordination and reasoned:

> It requires little imagination to conceive of the discharge of a subordinated debt many years prior to bankruptcy, or, indeed, without any subsequent bankruptcy ever taking place. If the decision appealed from is correct, such discharge would nonetheless be a breach of the subordination agreement, because of the remote chance that bankruptcy might someday occur and the senior creditor might thereafter be deprived of a double dividend. We think that if the senior creditor would prohibit a discharge because of such remote contingencies, he should so provide in the subordination agreement.[194]

This holding is correct respecting the typical contingent subordination, especially when the parties provide and expect outright payment before bankruptcy. Under these agreements, discharge by forgiveness cannot be a breach of contract when discharge by payment is acceptable.

But a complete subordination agreement does not preserve prebankruptcy freedom. Discharge by forgiveness is an extraordinary event. The effect of discharge is to enrich the debtor, and hence the general creditors in bankruptcy, and to deny double dividends to the senior creditor.[195] Implying a duty against outright forgiveness either preserves double dividends or forces the debtor to make some sort of payment, such as an illegal prebankruptcy payment of bankruptcy dividends, that benefits the senior creditor.[196]

In any event, contrary to the assumption of the district court and the Second Circuit, *American Foam Rubber* was hardly a forgiveness case. The junior creditors received stock in exchange for the debt. Both courts viewed the issuance of stock as no payment and hence no violation of the complete subordination promise.[197]

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194. 530 F.2d at 456 (footnotes omitted).

195. Sometimes forgiveness of debt is described as a conveyance from the creditor to the debtor. *In re* Assoc. Gas & Elec. Co., 61 F. Supp. 11, 39 (S.D.N.Y. 1944), *aff'd*, 149 F.2d 946 (2d Cir.), *cert. denied*, 326 U.S. 736 (1945); *cf. In re* Abramson, 715 F.2d 934 (5th Cir. 1983) (debtor who released option to buy equipment held to have made a transfer). If this premise is accepted, a discharge of the junior debt by forgiveness is similar to an assignment of a debt a second time. If the first assignment is perfected under Article 9 (when applicable) or under the common law of assignments, the forgiveness (i.e., the second assignment) is not good against the first assignee. Under this theory, the senior creditor remains entitled to double dividends in the common debtor's bankruptcy in spite of the forgiveness.

196. The parties usually will define the length of complete subordinations carefully because they are drastic promises. Therefore, an implied duty against discharge is not a long-term disability upon the junior creditor. It is more palatable than implying the duty in contingent subordinations in which *classes* of senior creditors may exist forever. *See supra* notes 155-60 and accompanying text.

197. *Accord*, Calligar, *supra* note 5, at 399.

The basis for this view was that no assets left the debtor's estate when stock was issued.[198] Nevertheless, the stock was proceeds of the debt with a positive market value and should have been deemed an improper payment to be held for the senior creditor.[199]

Readers will recognize in this discussion an important point for convertible debt securities[200] or for debt-equity swaps in which the debt is subordinated.[201] Because the stock is proceeds of the junior debt, issued in satisfaction of it, the stock should be deemed "trust property" held for senior creditors.[202]

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198. 306 F. Supp. at 601; 530 F.2d at 452-53. The court's characterization of "no payment" rested heavily upon the finding that the stock was "unlikely" to generate cash dividends. Hence, its holding that issuance of stock is not payment must be limited to stock that cannot generate dividends during the life of the subordination promise. *See supra* note 191.

199. A distinction should be made between property received from the debtor in satisfaction of the debt—such as stock in a debt-equity swap—and the sales price received when the subordinated claim is sold to someone other than the debtor. Sale of the debt itself is not payment because the junior debt is not extinguished when it is sold. Double dividends are preserved, so that the senior creditors have little reason to protest the sale of the junior debt after an event of subordination has occurred. Nevertheless, if Article 9 applies, the technical definition of proceeds is such that the sales price of the junior debt falls within it. U.C.C. § 9-306(1) (1977); *see supra* text accompanying notes 142-53.

200. Most recently issued convertible debentures are subordinated. Bratton, *supra* note 16, at 673. The conversion privilege usually belongs to the junior creditor, and the economics disfavor conversion in a time of financial difficulty. *Id.* at 672-80. Nevertheless, this is not always the case. In the gigantic Associated Gas & Electric bankruptcy in the 1940s, the issuer held the conversion privilege and actually exercised it in hard times. *In re* Associated Gas & Elec. Co., 61 F. Supp. 11, 32 (S.D.N.Y. 1944), *aff'd*, 149 F.2d 996 (2d Cir.), *cert. denied*, 326 U.S. 736 (1945); Elias v. Clarke, 143 F.2d 640, 642 n.1, 645-46 (2d Cir.) *cert. denied*, 323 U.S. 778 (1944).

201. Corporations that have issued long-term debt at low interest rates may be tempted to swap stock for debt at discounted prices. The difference between the value of the stock and the face amount of the debt must be characterized as income. I.R.C. § 108(e)(10)(A). Before 1984, however, there was a fiat income exclusion for all debt-equity swaps. *See generally* Bryan, *Cancellation of Indebtedness by Issuing Stock in Exchange: Challenging the Congressional Solution to Debt-Equity Swaps*, 63 TEX. L. REV. 89 (1984).

The effect of swapping debt for stock is an instant increase in the reported value of the issuer. *Id.* at 90. Stock traded to junior creditors who have promised to receive no payment should be deemed held in trust for senior creditors. Under the *American Foam Rubber* rationale, the junior creditors could keep the stock.

202. *Compare* Original ABA Model Indenture, § 14-2(c) (securities issued after event of subordination to be issued to senior creditors) *with Model Simplified Indenture, supra* note 15, § 11.04 (capital stock issued in exchange for subordinated debenture may be retained by junior creditors). The Original ABA Model Indenture has optional language permitting the common debtor's bankruptcy court to issue postbankruptcy securities pursuant to a plan that recognizes the subordinated nature of the junior creditor's claim. Original ABA Model Indenture commentaries, at 570.

B. Secured Subordinated Debt

Two of the leading debt subordination cases in the Second Circuit concerned secured claims subordinated to unsecured claims. In the first case, *Cherno v. Dutch American Mercantile Corp.*,[203] the junior creditor held the security at the time it executed a debt subordination agreement that was effective immediately. The Second Circuit ruled that subordination was not assignment. Therefore, it refused to apply the rule that security automatically travels with the assigned debt. This ruling defeats the purpose of subordination and raises the cost of subordinated lending.[204]

An entirely different set of facts occurred in *Allegaert v. Chemical Bank*.[205] The junior creditor took a security interest in a debtor asset when it was free to accept precontingency payments. The Second Circuit reversed the lower court's ruling that the security interest was a voidable preference. The case was settled before the real merits could be reached.[206] The security interest should have been equated with payment. Because payment was proper, the security interest was proper. The court should not have deemed the security interest trust property held for the senior creditors.

Thus, in *Cherno* the security interest should have been transferred to the senior creditors, but in *Allegaert* it should not have been transferred. The distinction lies with the purpose of the two subordination agreements. A secured creditor that subordinates its debt, effective immediately, promises nothing if it is allowed to realize upon its security. The alternative, allowing the security interest to lie fallow, grants a free ride to nonsenior creditors that were not intended to be benefited. Instead, the security interest should be frozen until the debtor's bankruptcy or until the end of the complete subordination agreement. If the debtor liquidates, then the efficient result is to view the security interest as transferred over to senior creditors. This solution comports with the express promise not to receive payment before bankruptcy and with the principle that only the seniors should get subordination benefits when the debtor liquidates.[207]

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203. 353 F.2d 147 (2d Cir. 1965).
204. *See supra* note 84 and accompanying text.
205. 657 F.2d 495 (2d Cir. 1980), *rev'g* 454 F. Supp. 341 (E.D.N.Y. 1978).
206. Letter from James F. Gleason, Jr. (July 30, 1984) (on file).
207. *See generally supra* notes 34-51 and accompanying text.

In *Allegaert* the junior creditor received security on antecedent debt at a time when payment was proper. If actual payment had been received, then the senior creditors could not have objected. The security interest benefited senior creditors more than payment because the debtor was able to retain the income from the pledged asset until an event of default under the pledge agreement. The junior creditor should be able to receive security when it can receive payment, even if liquidation of the collateral occurs at a time when payment on the junior debt would have been improper.[208]

Allegaert does not alter the conclusion that the rules for assignment fit well in the subordination context. The rule that an assignment carries the corresponding debt and security is a rule invented for assignments that permit the assignee to collect immediately. The *Allegaert* case dealt with an assignment in which the assignor could collect on the obligation until default. If the assignor can destroy the collateral by collecting, it must follow that it can destroy the asset by taking security. A contingent subordination of secured debt, then, is no more than a subordination of the

208. Some contractual language in *Allegaert* arguably is contrary to this conclusion. Paragraph 3.2 of the subordination clause states:

> BANK agrees that it is not taking and will not take or assert as security for the payment of the Note or the payment of interest thereon any security interest in or lien upon . . . any property of BORROWER . . . whicb is or at any time may be in the possession or subject to the control of BANK.

657 F.2d at 499 n.1. This provision could be read as an express promise not to receive security interest, which, according to First Nat'l Bank v. American Foam Rubber Corp., 530 F.2d 450, 456 (2d Cir.), *cert. denied,* 429 U.S. 858 (1976), is fully enforceable. The *American Foam Rubber* court stated that "if the senior creditor would prohibit a discharge because of such remote contingencies, he should so provide in the subordination agreement." *Id.*

The *Allegaert* court, however, noted that the common debtor and junior creditor amended the above language out of existence by executing a subsequent pledge agreement. 657 F.2d at 505; *see id.* at 499-500 n.3 (junior creditor never promised not to make amendments). The junior creditor had complete power to receive total payment. Therefore, the promise not to receive security is highly inconsistent with the contingent nature of the junior creditor's obligation.

The parties probably intended the antipledge language from the original loan agreement to prevent the junior creditor from claiming any setoffs or cross-collateral agreements as security for the subordinated loan. The consequence of this junior creditor power would have been the debtor's loss of a significant accounting advantage. As a stockbroker with net capital requirements, the debtor could have improved its net capital ratio by excluding subordinated debt from its liabilities. If the junior creditor could claim any kind of setoff or other collateral, however, the accounting advantage would have been lost. The execution of the pledge agreement meant that the debtor wished to surrender the accounting advantage. Because the junior creditors could be defeated by payment, there was no compelling reason to read the antipledge language as a promise that the senior creditors have standing to enforce.

unsecured deficit that the debtor owes the junior creditors.[209]

In summary, *American Foam Rubber* and, perhaps, *Allegaert* stand for extensive freedom in the junior creditor and debtor to destroy the junior debt by modification of the loan agreement between the junior creditor and the debtor. Only if the junior creditor expressly has promised not to take the action in question does the senior creditor have grounds to protect its rights. If a subordination agreement permits the junior creditor to take prebankruptcy payments, it is possible for the junior creditor and the common debtor to repeal the subordination agreement over the protests of the senior creditors.[210] Certainly the junior creditor

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209. The analysis must change if Article 9 applies. Under § 9-306, the secured party has an interest in any proceeds of the collateral. Proceeds would include any payment received on the junior claim, even if the payment is prior to a subordination contingency. Thus, any security interest received on the junior debt constitutes proceeds as well. This is an additional reason why Article 9 should not apply to subordination. In a contingent subordination, the parties provide for the amortization of the asset pledged to the senior creditors. Article 9 proceeds theory simply interferes with this expectation.

210. A recent case has held to the contrary, but did not justify this result. Weisman v. Goss, 694 F.2d 179 (9th Cir. 1982).

In *Weisman*, *A* held both stock and subordinated debt of the common debtor. *A* sold the securities to *B* on credit, in exchange for a purchase money security interest in the securities. *B* then sold its equity in the securities back to the common debtor, also on credit, apparently when the debtor was solvent. In exchange the debtor gave *B* an unsubordinated promissory note. This unsubordinated note constituted proceeds of *A*'s collateral, and hence *A* had a security interest in both the unsubordinated note and the subordinated debt.

The debtor filed for bankruptcy. *A* made a claim on both the pledged subordinated debt, the equity of which was owned by the debtor, and the unsubordinated note, the equity of which was owned by *B*. The court of appeals affirmed an order subordinating *A*'s claim on the unsubordinated note.

To the extent the unsubordinated note represented the price of the common debtor's stock, the court based subordination of the note on what appears to be a fraudulent conveyance theory. 694 F.2d at 181. One would have thought that because the note was issued when the company was solvent, the note was not fraudulent as to other creditors.

The *Weisman* court, however, cited McConnell v. Estate of Butler, 402 F.2d 362, 366 (9th Cir. 1968), for the proposition that solvency must be judged when the note actually is paid, not when it is issued. 694 F.2d at 179. *McConnell* was based upon a linguistic quirk in California's capital surplus statute. Its use in a case out of Hawaii seems dubious, unless the debtor was a California corporation.

McConnell dealt with the exchange of stock for unsubordinated debt and hence did not apply to that part of the common debtor's unsubordinated note that represented an exchange for subordinated debt. The court therefore had to fend for itself in deciding whether subordinated debt could be exchanged for unsubordinated debt. This part of the court's opinion contradicts the statement in the text of this Article. The court's solution is incomprehensible and any exegesis is treacherous. The exact "rationale," therefore, is set forth in full:

> *McConnell* is generally not applicable when a corporation issues new debt instruments in exchange for previously issued debt.
>
> That rule does not apply to any portion of the [unsubordinated] notes, however. To understand why this is so it must be remembered that when [*A*] sold [subordi-

could accept a complete repayment and then lend the money back on an unsubordinated basis. Simple repeal of the subordination clause achieves the same goal with less paperwork.

Therefore, the *American Foam Rubber* opinion illustrates that many contingent subordinations are practically worthless until the subordination contingency actually occurs. When the junior creditor is in a position to collude with the common debtor, it can escape its subordination obligations altogether, *unless* the subordina-

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nated] notes to [*B*] they remained as collateral a security interest in those notes. The subsequent sale by [*B*] to [the common debtor] was made subject to tbis security interest of [*A*]. Both the trustee and the district court fully acknowledge the legitimacy and priority of [*A*'s] security interest in the [subordinated] notes. The claim which this interest represents *has not been subordinated.*

Because [the debtor] remains liable to [*A*] on tbe [subordinated] notes, tbe issuance by [the debtor] of the [unsubordinated] notes and [*B*'s] pledge to appellants of a portion of those notes resulted in enhancing [*A*'s] security with respect to the [subordinated] notes. It would be improper to provide [*A*] at the expense of the other creditors *two unsubordinated claims when in fact one adequately represents the value of the property given in exchange for the claims.* The situation might be different if new and additional value bad been given by [*A*] exchange for the [unsubordinated] notes. This was not the case, however.

694 F.2d at 181-82 (emphasis added). The bizarre result here is that the court subordinated the unsubordinated note owned by *B* and pledged to *A*, but it desubordinated the subordinated note owned by the common debtor and pledged to *A*. Furthermore, the court would have allowed the unsubordinated note to be asserted in full if *A* had given *B* new value for the note.

The *Weisman* court should have inquired whether the note was wholly or partly a fraudulent convenyance. It should have upheld exchange of the note by the common debtor for its own stock vis-a-vis other creditors if the common debtor was solvent at the time. Similarly, exchange of the unsubordinated note for the subordinated debt clearly was not fraudulent to creditors generally, if it was for fair consideration or if the trade took place when tbe debtor was solvent.

Separate from fraudulent conveyance cousiderations, the court should have investigated whether the trade of the note for the subordinated debt violated the contractual rights of the senior creditors. If the subordinated debt could have been prepaid at the time it was exchanged for unsubordinated debt, the exchange was not a hreach of contract. Even if it was a breach of contract, *A* should have had an unsubordinated claim against the common debtor under these circumstances. The only consequence of the breach of contract is whether the unsubordinated note is an "improper payment" held for the senior creditors, *see supra* text accompanying notes 60-69, or whether *A* could retain the bankruptcy dividends on this note for himself.

Under no circumstances should *A* be able to desubordinate the subordinated debt simply because *A* held the subordinatcd debt as collateral for *B*'s obligation to *A*. But a serious caveat is in order. Hawaii has not passed the proposed § 1-209 of the UCC, which exempts subordination from Article 9 coverage. Under the Article 9 priorities, the first secured party to perfect or file wins. UCC § 9-312(5) (1977). *B*, as purchaser of the subordinated claim, had knowledge of the senior creditors' security interest and so was junior to the senior creditors. *Id.* § 9-301(1)(c). But *A* was a secured party that perfected before the senior creditors. Under this reasoning, the court *did* properly desubordinate the claim.

The *Weisman* decision proves that courts should declare by fiat that Article 9 does not apply to subordination of debt. *See supra* text accompanying notes 142-46.

tion agreement contains express limitations on the right of the junior creditor to accept accelerated prebankruptcy payments. Without this limitation, the subordinated loan always can be repaid and replaced by an unsubordinated loan.

The opportunity to refinance subordinated debt is not necessarily a negative development. Unsubordinated debt draws lower interest rates than subordinated debt. The ability to refinance without the senior creditors' consent is entirely proper when the chances of the debtor's liquidation are low. Nevertheless, senior creditors that place high value on their right to double dividends should realize that, unless subordination covenants are supplemented with a covenant against paying the junior debt, their subordination rights can be repealed without their consent.

VI. Conclusion

This Article has shown that debt subordination can be understood as the junior creditor's promise not to receive payment after a designated time until the named senior creditors have been paid. All of the other common features of the standard form subordination agreements are derivable from this promise. Among these features is the assignment of bankruptcy dividends from the junior creditor to the senior creditor. This concept suggests a proprietary claim of the senior creditors in an asset of the junior creditor.

In addition, lien priority subordination should be distinguished as a different agreement altogether. The junior creditor does not promise that it will not receive payment in satisfaction of its claim. As a result, lien subordination is not an assignment. Suggestions to the contrary could lead to secret liens in the debtor's bankruptcy.

Finally, subordination prior to the contingency on which it depends is a worthless right unless supplemented with further covenants restricting the right to prepay the junior claim. Closely related to the dubious value of precontingency subordination is the concept of secured subordinated debt. When payment is permitted, the junior creditor should be able to accept collateral to secure the junior debt. This collateral is held solely for the junior creditor. If payment would not have been permitted, then the security interest received by the junior creditor should be deemed held for the benefit of the senior creditors.