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Circuit Split Created Over Enactment of Section 510(a) of the Bankruptcy Code and its Effect on the Rule of Explicitness

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Introduction

Bankruptcy law seeks to equitably distribute a debtor's remaining assets among creditors.[1] However, prior to bankruptcy, creditors can contract around their pro rata equitable distribution by executing inter-creditor agreements.[2] Inter-creditor agreements are executed to delegate the rights and priorities of creditors as to a common borrower in the event the borrower defaults.[3] Subordination agreements are a type of inter-creditor agreement, where junior creditors consent to senior creditors having their loans repaid in full before junior creditors receive their payment.[4] Bankruptcy courts enforce subordination agreements through section 510(a) of title 11 of the United States Code (the "Bankruptcy Code"), which states that a "subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable non-bankruptcy law."[5]

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[1] *See* Union Bank v. Wolas, 502 U.S. 151, 161 (1991).
[2] *Id.*
[3] *In re* Southeast Banking Corp.("Southeast I"), 156 F.3d 1114, 1118 (11th Cir. 1998).
[4] *Id.*
[5] 11 U.S.C. § 510 (2018); *Southeast I*, 156 F.3d at 1123.

The Rule of Explicitness is a canon of construction that courts apply in interpreting post-petition interest payment priority in subordination agreements.[6] Under the Rule of Explicitness, senior creditors can recover post-petition interest from junior creditors, if such payment priority is explicitly stated in the subordination agreement.[7] The Rule of Explicitness allows creditors to contract around section 502(b)(2) of the Bankruptcy Code, which prohibits collection of post-petition interest.[8]

After enactment of section 510(a) to the Bankruptcy Code, a circuit split developed over whether section 510(a) abrogates use of the Rule of Explicitness when interpreting subordination agreements.[9] The issue turns on whether courts characterize the Rule of Explicitness as a bankruptcy-specific rule of equity or as a tool of state contract law.[10] The First and Eleventh Circuits hold that enactment of section 510(a) abrogated the Rule of Explicitness because the rule is a bankruptcy-specific rule of equity.[11] However, lower courts in the Second Circuit, and the New York Court of Appeals continue to apply the Rule of Explicitness as a tool of state contract law.[12] This memorandum explores this circuit split in two parts. Part I examines the First, Second, and Eleventh Circuits' stance on whether section 510(a) abrogated the Rule of Explicitness. Part II discusses the significance of the circuit split, and the issues the split raises.

I. Circuit courts are split on whether section 510(a) abrogates the Rule of Explicitness when interpreting subordination agreements.

The circuit courts are split on whether the Rule of Explicitness can be applied when interpreting subordination agreements.[13] The issue turns on whether courts characterize the Rule

[6] *In re* Southeast Banking Corp. ("Southeast II"), 93 N.Y.2d 178, 182 (1999).
[7] *Id*.
[8] 11 U.S.C. § 502 (2018).
[9] *In re* Bank of New England Corp., 364 F.3d 355, 365 (1st Cir. 2004).
[10] *Id.*
[11] *See id.* at 359; *Southeast I*, 156 F.3d at 1116.
[12] U.S. Bank Nat'l Ass'n v. T.D. Bank, N.A., 569 B.R. 12, 22 (S.D.N.Y. 2017); *Southeast II*, 93 N.Y.2d at 185.
[13] *In re* Bank of New England Corp., 364 F.3d at 365.

of Explicitness as a bankruptcy-specific rule of equity or as a tool of state contract law.[14] Prior to 1978, there was no reference to subordination agreements in the Bankruptcy Code, so bankruptcy courts enforced these agreements using their equitable powers.[15] Enforcement of subordination agreements was considered equitable because creditors freely entered into these agreements.[16] However, bankruptcy courts scrutinized subordination agreements with respect to post-petition interest, when senior creditors sought to prioritize post-petition interest payment over loan repayment to junior creditors.[17] Thus, the Rule of Explicitness, an equitable doctrine, was created to strike a balance between judicial scrutiny and a creditor's freedom to contract with respect to post-petition interest.[18]

In 1978, Congress enacted section 510(a) of the Bankruptcy Code.[19] By enacting this provision, Congress conferred on the bankruptcy courts the power to apply non-bankruptcy law when enforcing subordination agreements, rather than relying solely on their equitable powers.[20] Following enactment of section 510(a), there is disagreement among the circuits as to whether this provision abrogated the Rule of Explicitness.[21]

A. The Eleventh Circuit no longer applies the Rule of Explicitness following enactment of section 510(a).

The Eleventh Circuit's position is that section 510(a) of the Bankruptcy Code abrogated the Rule of Explicitness because the rule is a bankruptcy-specific rule of equity.[22] In coming to this opinion, the Eleventh Circuit reasoned that section 510(a) promulgates that subordination

[14] *Id.*
[15] *Id.* at 361–62.
[16] *Id.* at 362.
[17] *Id.*
[18] *In re* Time Sales Fin. Corp., 491 F.2d 841, 844 (3d Cir. 1974).
[19] *In re* Bank of New England Corp., 364 F.3d at 364.
[20] *Id.*
[21] *Id.*
[22] *Southeast I*, 156 F.3d at 1115.

agreements be enforced through non-bankruptcy law.[23] Because the Rule of Explicitness is a bankruptcy-specific rule of equity, it cannot be used to interpret subordination agreements under section 510(a) and state law contract law governs interpretation of subordination agreements instead.[24]

In *Southeast I*, Southeast Banking Corporation filed a petition for relief under chapter 7 of the Bankruptcy Code.[25] At issue were five subordination agreements that provided payment priority for senior creditors.[26] Each of the subordination agreements contained a clause stating that New York contract law would govern enforcement of the agreements.[27] However, none of the agreements specified whether payment priority to senior creditors included post-petition interest payment.[28] After liquidation, the senior creditors sought to extend the priority to the post-petition interest on their senior notes.[29] The Eleventh Circuit held that section 510(a) abrogated the Rule of Explicitness, so interpretation of the five subordination agreements was dictated by New York contract law.[30] In applying New York contract law, the Eleventh Circuit held that senior creditors were not entitled to post-petition interest.[31]

B. *The First Circuit does not recognize the Rule of Explicitness when interpreting subordination agreements.*

The First Circuit holds that enactment of section 510(a) abrogated the Rule of Explicitness because the rule is a bankruptcy-specific equitable doctrine.[32] In section 510(a), the

[23] *Id.* at 1122.
[24] *Id.* at 1123-24.
[25] *Id.* at 1116.
[26] *Id.*
[27] *Id.* at 1117.
[28] *Id.*
[29] *Id.*
[30] *Id.*
[31] *Id.*
[32] *In re* Bank of New England Corp., 364 F.3d at 359.

phrase "non-bankruptcy law" applies to both federal and state law.[33] However, since the interpretation of subordination agreements is solely an issue of contract law, only state law is relevant.[34] Therefore, in interpreting subordination agreements through section 510(a), bankruptcy courts must apply state contract law.[35] Since the Rule of Explicitness is a bankruptcy-specific rule of equity and not part of contract law, the rule is abrogated by enactment of section 510(a).[36]

In *In re Bank of New England Corp.*, the Bank of New England issued six separate series of debt instruments.[37] Each of the debt instruments had respective subordination agreements that expressed payment priority for senior debt.[38] Eventually, the Bank of New England filed a voluntary petition for bankruptcy while most senior and junior debt was still outstanding.[39] All creditors conceded that the subordination agreements validly designated payment priority to the senior debt, but the issue became whether the priority included post-petition interest.[40] Because the First Circuit declined to recognize the Rule of Explicitness, it applied New York contract law to interpret the agreements and held that senior creditors were not entitled to post-petition interest.[41]

C. Lower courts in the Second Circuit, and the New York Court of Appeals continue to apply the Rule of Explicitness when interpreting subordination agreements.

Although the Second Circuit has yet to rule on whether enactment of section 510(a) abrogated the Rule of Explicitness, lower courts in the Second Circuit, and the New York Court

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33 *Id.* at 363.
34 *Id.*
35 *Id.*
36 *Id.*; *see* Hanover Ins. Grp., Inc. v. Chartis Specialty Inc. Co., 2013 WL 4495659, at *2 (D. Mass. Aug. 19, 2013).
37 364 F.3d at 360.
38 *Id.*
39 *Id.* at 361.
40 *Id.*
41 *Id.* at 368.

of Appeals continue to apply the rule in interpreting subordination agreements.[42] Under this approach, the Rule of Explicitness is viewed as a tool of state contract law, not a bankruptcy-specific rule of equity.[43] Therefore, the Rule of Explicitness is considered a non-bankruptcy law under section 510(a), so the rule can still be used to interpret subordination agreements.[44] Additionally, enactment of section 510(a) does not affect the prohibition against collection of post-petition interest, so the Rule of Explicitness is still a valid mechanism that allows creditors to contract around that prohibition.[45]

In *U.S. Bank Nat'l Ass'n*, the Southern District of New York was forced to interpret whether an inter-creditor agreement required that junior creditors pay senior creditors post-petition interest.[46] Defendant, T.D. Bank, argued that the inter-creditor agreement did not explicitly mention post-petition interest, so the Rule of Explicitness prohibited payment of post-petition interest.[47] Conversely, Plaintiff, the bond trustee, argued that the Rule of Explicitness was no longer valid.[48] The District Court held that the Rule of Explicitness is an interpretive tool of contract law, so the rule is still valid following enactment of section 510(a).[49] Thus, in applying the Rule of Explicitness, the district court held that senior creditors were entitled to post-petition interest because the inter-creditor agreement explicitly put junior creditors on notice of post-petition interest payment.[50]

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[42] *U.S. Bank Nat'l Ass'n*, 569 B.R. at 22; *In* re K-V Discovery Sols., Inc., 496 B.R. 330, 337 (Bankr. S.D.N.Y. 2013); *In re* Ionosphere Clubs, Inc., 134 B.R. 528, 535 (Bankr. S.D.N.Y 1991); *Southeast II*, 93 N.Y.2d at 185.
[43] *Southeast II*, 93 N.Y.2d at 188.
[44] *Id*.
[45] *Id.* at 185.
[46] *U.S. Bank Nat'l Ass'n*, 569 B.R. at 15.
[47] *Id.* at 17.
[48] *Id.* at 18.
[49] *Id.* at 22.
[50] *Id.*

D. The circuit split arises over whether the Rule of Explicitness is a bankruptcy-specific rule of equity or a tool of state contract law.

The circuit split over the Rule of Explicitness turns on whether the rule is considered a bankruptcy-specific rule of equity or a tool of contract law.[51] The Eleventh and First Circuits hold that the Rule of Explicitness was abrogated by enactment of section 510(a) because the rule is a bankruptcy-specific rule of equity.[52] Under this approach, since section 510(a) designates that only non-bankruptcy law can be used to interpret subordination agreements, the Rule of Explicitness is no longer valid.[53]

Lower courts in the Second Circuit, and the New York Court of Appeals have continued to apply the Rule of Explicitness when interpreting subordination agreements, despite enactment of section 510(a).[54] Under this approach, the Rule of Explicitness is viewed as a tool of contract law.[55] Therefore, the Rule of Explicitness is a non-bankruptcy law for purposes of section 510(a) and can be used to interpret subordination agreements.[56]

II. The circuit split over application of the Rule of Explicitness following enactment of section 510(a) raises important issues.

The Rule of Explicitness acts as an enforcement mechanism that allows creditors to contract around section 502(b)(2) of the Bankruptcy Code.[57] Section 502(b)(2) codified the longstanding rule that creditors are not entitled to post-petition interest; interest accrual stops the moment the debtor files for bankruptcy.[58] Therefore, senior creditors wanting to receive post-petition interest from junior creditors must explicitly state so in their subordination agreement.[59]

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[51] *See id.*; *Southeast I*, 156 F.3d at 1115.
[52] *See In re* Bank of New England Corp., 364 F.3d at 359; *Southeast I*, 156 F.3d at 1116.
[53] *In re* Bank of New England Corp., 364 F.3d at 363.
[54] *U.S. Bank Nat'l Ass'n*, 569 B.R. at 22; *Southeast II*, 93 N.Y.2d at 185.
[55] *U.S. Bank Nat'l Ass'n*, 569 B.R. at 22.
[56] *Southeast II*, 93 N.Y.2d at 188.
[57] *In re* Bank of New England Corp., 364 F.3d at 362.
[58] *Id.*
[59] *Id.*

The Rule of Explicitness is then used as an interpretive tool to enforce payment of that post-petition interest.[60]

Post-petition interest is significant because there is often a long delay from when a debtor files for bankruptcy and when creditors receive payment, so there can be large accruals of post-petition interest.[61] Currently, there are many active subordination agreements where creditors drafted post-petition interest terms in reliance on their circuit using the Rule of Explicitness to enforce those terms.[62] Therefore, whether senior creditors receive these large interest payments will depend on whether their circuit continues to recognize the Rule of Explicitness, despite enactment of section 510(a).[63]

Further, the First Circuit notes that the Rule of Explicitness amplifies the tension between federal and state law in bankruptcy.[64] Since the interpretation of subordination agreements generally arises in bankruptcy cases, there is an interest in providing a uniform federal approach to interpret them.[65] However, interpretation of agreements is by nature a facet of state contract law.[66] Thus, the jurisdictional issue turns again on whether the circuit views the Rule of Explicitness as a bankruptcy-specific rule of equity or as a tool of state contract law.

Conclusion

It is important that the circuits reconcile their differences regarding the Rule of Explicitness, given that creditors rely on the rule when drafting subordination agreements. As the current law stands, the First and Eleventh Circuits hold that enactment of section 510(a)

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[60] *Southeast I*, 156 F.3d at 1119–21.
[61] *Id.*
[62] *Southeast II*, 93 N.Y.2d at 183–84.
[63] *Id.*
[64] *In re* Bank of New England Corp., 364 F.3d at 359.
[65] *Id.* at 363–64.
[66] *Id.*

abrogated the Rule of Explicitness.[67] Although the Second Circuit has not ruled on the issue, lower courts within the circuit and the New York Court of Appeals continue to apply the rule when interpreting subordination agreements.[68]

The Rule of Explicitness is an important facet of bankruptcy law because it dictates how creditors will draft their inter-creditors agreements with respect to post-petition interest.[69] If a senior creditor contracted to receive post-petition interest, the senior creditor would only be guaranteed payment if their governing circuit recognized the Rule of Explicitness. In addition, the Rule of Explicitness brings to light the jurisdictional conflict between federal and state law when interpreting creditor agreements in bankruptcy cases.[70]

In sum, if the Rule of Explicitness is considered a bankruptcy-specific rule of equity like in the First and Eleventh Circuit, then for purposes of federal uniformity, the U.S. Supreme Court may consider ruling on whether section 510(a) abrogated the rule. However, if the Rule of Explicitness is viewed as a tool of state contract law, a stance taken by courts in the Second Circuit and the New York Court of Appeals, then the rule should only be applied if the law of the state the federal court sits in recognizes the rule.

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[67] *In re* Bank of New England Corp., 364 F.3d at 359; *Southeast I*, 156 F.3d at 1116.
[68] *U.S. Bank Nat'l Ass'n*, 569 B.R. at 22; *Southeast II*, 93 N.Y.2d at 185.
[69] *Southeast I*, 156 F.3d at 1119–21.
[70] *In re* Bank of New England Corp., 364 F.3d at 359.