INSIDE THE MINDS

Creditors' Rights in Chapter 11 Cases

Leading Lawyers on Representing and Enforcing the Rights of Creditors in Bankruptcy Matters

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ASPATORE

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The Time Bomb in Your Indenture—No Action Clauses and Creditor Standing

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Introduction

Hearing the judge's ruling, I wondered whether the bondholders could have done anything differently. Judge Lifland had just confirmed a cramdown, prepackaged Chapter 11 plan that wiped out secured bondholders, as well as all unsecured creditors. The ruling occurred at a combined disclosure statement and confirmation hearing held a little more than a month after the bankruptcy filing.[1] Only one creditor was entitled to vote under the plan, because all other classes of creditors received nothing and therefore were deemed to reject. The only creditor voting to approve the plan was slated to receive all of the debtors' assets as a distribution for its secured claim based upon a valuation supplied by the debtors, which the bondholders were not allowed to challenge. It was troubling that this creditor had orchestrated the bankruptcy in the first place pursuant to a pre-petition settlement of litigation it had brought against the debtors. To make matters worse, this creditor's lien was *pari passu* with the bondholders' liens, jumping ahead only because of pre-petition transactions that led to the bankruptcy filing, which the bondholders challenged and asserted did not result in their liens being primed under the controlling financing agreements.[2]

Could this scenario really happen? It did in the bankruptcy court for the Southern District of New York in the *American Roads* case.[3] While the result was harsh, the court followed controlling case law. I wondered what led to this result.

In *American Roads*,[4] the court held that an *ad hoc* committee of secured bondholders had no standing to participate in the bankruptcy, even though the bondholders had direct claims against the debtor and asserted a serious conflict of interest by the "control party" that was entitled to enforce the bondholders' rights.[5] The liens securing the bondholders' claims were

[1] The author represented a client that was not a party in interest in the bankruptcy case.
[2] *See* Emergency Motion Of The Ad Hoc Committee Of Bondholders For An Order Adjourning The Combined Hearing To Consider The Adequacy Of The Disclosure Statement and Confirmation Of The Debtors' Joint Prepackaged Chapter 11 Plan at 10-12; *In re Am. Roads,* 496 B.R. 727 (Bankr. S.D.N.Y. 2013); *and* Memorandum Of The Ad Hoc Committee Of Bondholders In Support Of Its Standing To Participate In Theses Chapter 11 Cases (Ad Hoc Committee Standing Memorandum) at 1-6, *Id*.
[3] *In re Am. Roads LLC,* 496 B.R. 727.
[4] *Id*.
[5] *See* Ad Hoc Committee Standing Memorandum *supra* n. 2 at 30-31.

shared *pari passu* with a monoline insurer that guarantied the bonds under a financing sometimes referred to as an "insured unitranche" structure.[6] Under this structure, the bondholders and the monoline insurer shared a single lien. Proceeds of the collateral were to be distributed pursuant to a waterfall of priorities. After payment of certain expenses, the principal balance of the bonds and the reimbursement obligations owed to the monoline insurer shared distributions on a *pro rata* basis. The only potentially significant claim that was paid first was a potential claim under the debtors' swap agreements.

Prior to the bankruptcy filing, the monoline insurer entered into a back-to-back arrangement with the swap counterparty whereby for an up-front payment, the monoline insurer was entitled to payments made to the swap counterparty by *American Roads* in the event of a breach of the swap agreement. The monoline insurer exercised its power to direct *American Roads* to default under the swap, thereby triggering a payment due from *American Roads*. As the insurer, the monoline insurer paid the swap counterparty because of the default under the swap agreement. However, as contemplated by the back-to-back agreement, the monoline insurer paid the default amounts to itself. The money that the insurer paid to itself was elevated to a senior priority claim when it was subrogated to the swap counterparty's claims. The result was that the monoline insurer transformed its potential insurance claim that was *pari passu* with the bondholders to a mature senior priority claim. Further, the insurer was designated as the sole party that could enforce the bondholders' claims against the debtor.

Several bondholders formed an *ad hoc* committee and objected to the disclosure statement and plan confirmation, which were being heard in a joint hearing on the same day. Separately, the *ad hoc* committee sought an adjournment of the hearing date. In addition to the argument that the insurer had a serious conflict of interest, the *ad hoc* committee relied on an exception to the insurer's sole right to exercise remedies on behalf of the bondholders. The indenture provided that in the event of a "Senior Credit Reserved Action," the insurer was not entitled to the sole right to exercise the bondholders' rights. A Senior Credit Reserved Action was defined as an action that resulted in a reduction in the principal amount, a change of

[6] *Am. Roads*, 496 B.R. at 729.

maturity, or a reduction in interest rate of the bonds.[7] The debtor's plan, which was negotiated pre-petition with the insurer, wiped out the bondholders' claims and, due to the proposed valuation, stripped the bonds of their liens. While the monoline insurer's guaranty continued to be enforceable, it is difficult to accept that depriving the bondholders of all claims against the debtor and finding that the bondholders' claims were unsecured was not a "Senior Credit Reserved Action." Even though the *ad hoc* committee raised serious issues regarding the seniority of the insurer's lien, the good faith of the plan, and the insurer's conflict of interest,[8] the court held that the bondholders had no standing to challenge the plan and disclosure statement.

Borrowers may issue bonds through indentures, whereby a trustee is granted responsibility for pursuing remedies if an event of default occurs. It is common for indentures to contain "no action clauses" that prohibit individual bondholders from enforcing their rights under the indenture unless 25 percent of the bonds give written direction to the trustee to act and the trustee fails to act after a specified waiting period. In inter-creditor agreements, no action clauses typically prevent junior creditors from exercising their remedies until the senior creditors are paid in full.

Purpose of No Action Clauses

In general, no action clauses in indentures are intended to prevent individual creditors from pursuing litigation for their individual interests, rather than the interests of the securities holders as a whole.[9] Some courts have described their purpose as deterring individual noteholders from bringing frivolous litigation, thereby diminishing the resources of the issue.[10] No action clauses deter such litigation by vesting the sole power of enforcement in either a trustee or to holders of a substantial amount of the notes.[11] Because indentures typically provide that trustees have no fiduciary duties to the noteholders, no action clauses may have far-reaching effects, particularly in

[7] *See American Roads*, 496 B.R. at 731-2.
[8] *Ad hoc* committee's allegations were set forth in the Memorandum of Law of the Ad Hoc Committee of Bondholders In Support Of Its Standing To Participate In The Chapter 11 Cases, (Case No. 13-12412), [Docket No. 119], August 26, 2013.
[9] *See In re Dura Auto. Sys. Inc.*, 379 B.R. 257, 263 (Bankr. D. Del. 2007).
[10] *See generally Feldbaum v. Mccrory Corp.*, 18 Del. J. Corp. L. 630, 639 (1992).
[11] *Id.*

bankruptcy cases. In addition, trustees may be reluctant to act at all for fear that their actions could lead to liabilities. In inter-creditor agreements, no action clauses are designed to prevent junior creditors from taking actions to the detriment of senior creditors until senior creditors have been paid in full. Generally, once senior holders are paid in full, the junior holders are entitled to pursue their enforcement rights against the borrower.

No action clauses typically contain common elements, but can differ in significant ways. These differences may result in different legal outcomes where a court must analyze the legal effect of the specific provisions of the no action clause. Some no actions clauses specifically contemplate the waiver of certain rights in bankruptcy cases, while other clauses do not address the effect of a bankruptcy. In bankruptcy cases, where alliances can shift, the "control party" may develop conflicts with the very creditors whose rights the control party has the sole ability to exercise. As a result, no action clauses negotiated without considering treatment in bankruptcy cases can result in consequences not anticipated by the drafters. Although a no action clause may be reasonable outside of a bankruptcy case, enforcement in a bankruptcy case may cause an injustice not anticipated by any of the parties.

Cases interpreting "no action clauses" are not a new development,[12] and state courts have routinely enforced their provisions.[13] However, in seeking to disenfranchise creditors, debtors and senior creditors have increasingly asked courts to enforce no action clauses in bankruptcy cases. Recently, courts have interpreted no action clauses more broadly and have held that they must be enforced regardless of their effects in bankruptcy cases. This enforcement is directly contrary to a critical principle in the bankruptcy process—that all parties in interest have a right to participate and be heard in bankruptcy cases. In fact, Section 1109 of the Bankruptcy Code[14] specifically protects this right. After all, only a bankruptcy case can discharge a borrower's debt without paying it in full, over the creditors' objections. While junior creditors may be content to allow senior creditors to run the show when there is sufficient value to pay all debts, junior

[12] *See, e.g., Friedman v. Chesapeake & Ohio Ry. Co.*, 261 F. Supp. 728 (S.D.N.Y. 1966) (enforcing no action clause in indenture to strike complaint filed by bondholders without complying with requirements of no action clause).
[13] *See Feldbaum, supra* n. 10; *Elliott Associates, L.P. v. Bio-Response, Inc.*, CIV. A. 10624, 1989 WL 55070 (Del. Ch. May 23, 1989).
[14] 11 U.S.C. §§ 101 *et seq.*; 11 U.S.C. § 1109 (West).

creditors become much more concerned when their claims will not be paid at all, let alone full. Typically, many parties have competing claims against the debtor in bankruptcy cases. Inter-creditor agreements, bond indentures, and servicing agreements are often focused on governing the rights between and among creditors. However, in bankruptcy cases, debtors are empowered by the ability to bind non-consenting holders, to cramdown plans, and to strip the liens from under-secured creditors. Further, once a debtor commences a bankruptcy case, multiple parties are entitled to participate and be heard regarding use and distribution of the debtor's limited assets. Conflicts between and among creditors may develop that are not envisioned by parties bound by no action clauses. For example, for secured claims, if the value of the collateral is insufficient to pay both senior and junior claims, the Bankruptcy Code treats the portion of debt that exceeds the collateral value as an unsecured claim.[15] The significance of granting and enforcing no actions clauses, which limit standing to certain creditors, becomes heightened where some claims may be treated as secured, while others are treated as unsecured. Further, creditors' committees have statutory powers to pursue rights of unsecured creditors. However, *under-secured* creditors that are treated as *unsecured* creditors may have waived their rights to coordinate with the committee by virtue of no action clauses. Therefore, enforcement of no action clauses in bankruptcy cases may result in inequities when they operate to disenfranchise certain creditors.

Do No Action Clauses Constitute Knowing Waivers?

No action clauses are necessarily intended to disenfranchise parties in interest from enforcing their rights. They typically require a minimum threshold of outstanding noteholders to direct the trustee to act and to wait a minimum period before the holders can pursue their rights. While Section 1109(b)[16] specifically grants the right to be heard to parties in interest, unlike some other federal statutes,[17] parties can waive their

[15] Where the debtor owns 100% of the collateral, 11 U.S.C. § 506(b) provides that a claim is secured only to the extent of the creditors' interest in the collateral. Where the senior liens are greater than or equal to the value of the collateral, the junior lienholders' claims are treated as unsecured claims.

[16] Unless otherwise indicated, all sections refer to the Bankruptcy Code.

[17] For example, the Securities Acts of 1933 and 1934 specifically prevent parties from waiving protection thereunder.

protection. Courts have generally enforced pre-petition waivers by creditors of their right to be heard.

In enforcing no action clauses in bankruptcy cases, courts frequently do not analyze whether creditors made a knowing waiver, particularly where the court holds that the no action clause is not ambiguous on its face, and therefore, admits no evidence of intent. Further, some courts have enforced no action clauses even in the face of allegations of fraud and collusion against the parties entrusted to protect the creditors' rights.[18] No creditor would make a knowing waiver in such circumstances. The one constant in bankruptcy cases is that alliances can shift depending on the issue and whether the creditor has reached an agreement with the debtor. While the Bankruptcy Code provides certain protections for creditors' rights, current case law does not require courts to determine whether creditors understood the implications in bankruptcy cases resulting from their waiver. As a practical matter, there are two addition limitations to these protections—first, the ability to cramdown a plan over a class of creditors' objection, and second, the reality that a creditor will almost always get a better return in a Chapter 11 case than in a Chapter 7 liquidation, typically allowing a plan easily to satisfy the confirmation test contained in Section 1129(a)(7).[19]

Enforcement of No Action Clauses—In General

Because the Bankruptcy Code specifically grants standing to parties in interest, one could reason that courts would carefully scrutinize pre-petition waivers. To the contrary, courts routinely enforce these kinds of waivers. For example, in one of the many Enron decisions, the bankruptcy court for the Southern District of New York enforced a lending syndicate's delegation of enforcement rights to an administrative agent.[20] Relying on the language in the loan agreement, the Court concluded that the lenders voluntarily delegated their rights.[21] Therefore, the individual lenders had no

[18] *Cf. American Roads Akanthos Capital Mgmt., LLC v. Compucredit Holdings Corp.*, 677 F.3d 1286, 1289 (11th Cir. 2012).

[19] 11 U.S.C. § 1129(a)(7*)* generally provides that a dissenting creditor class must get at least as much as it would in a Chapter 7 liquidation. Except in extreme cases, this condition is often easy to fulfill.

[20] *In re Enron Corp.*, 302 B.R. 463 (Bankr. S.D.N.Y. 2003).

[21] The Court relied on the following language in the loan agreement: "The Flagstaff Agreement provides that each of the members of the Bank Group 'irrevocably appoints'

standing to appear before the bankruptcy court in matters relating to their loans.[22] While creditors with direct claims against the debtor are "parties in interest" for purposes of Section 1109,[23] courts nonetheless enforce no action clauses against these creditors, thus depriving them of standing to participate in bankruptcy cases.

Bankruptcy courts have enforced no actions clauses—even when the enforcement results in an injustice or allegations are made of fraud or collusion between the debtor and the party designated to enforce the rights of the complaining creditor. For example, in *Innkeepers*,[24] creditors subject to no action clauses sought to participate in hearings on the debtor's auction procedures. Because the trustee supported one of the competing bids, the creditors argued that the trustee could not independently represent their rights. Despite the alleged conflict of interest, the court upheld the creditors' waivers of standing, thereby preventing their participation in the hearings. Similarly, the court in *American Roads* enforced a no action clause where noteholders alleged that the underlying documents were not interpreted correctly and that the control party may have acted in bad faith.[25] Some courts reason that the creditors got a benefit in return for waiving their right to be heard. In *American Roads*, the court held that the control party's guaranty of the notes justified enforcing the creditors' pre-petition waiver of standing. Other courts do not explore the potential benefit that creditors may have received, looking only to the language of the no action clause—even if enforcement results in an injustice.[26] A surprising result given that bankruptcy courts are courts of equity.[27]

Surprisingly, non-bankruptcy courts are more likely than bankruptcy courts to excuse compliance with no action clauses where a noteholder

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Chase as Administrative and Collateral Agent 'to take such action on its behalf and to exercise such powers as are delegated to the Administrative Agent . . .'" *Enron Corp.*, 302 B.R. at 473.

[22] *Enron Corp.*, 302 B.R.at 477.

[23] *See Matter of Rimsat, Ltd.*, 193 B.R. 499 (Bankr. N.D. Ind. 1996).

[24] *In re Innkeepers USA Trust*, 448 B.R. 131 (Bankr. S.D.N.Y. 2011).

[25] *Am. Roads*, 496 B.R. 727.

[26] *See, e.g. Akanthos*, 677 F.3d at 1289; *Howe v. Bank of New York Mellon*, 783 F. Supp. 2d 466 (S.D.N.Y. 2011); *Sterling Fed. Bank, F.S.B. v. DLJ Mortgage Capital., Inc*, 09 C 6904, 2010 WL 3324705 (N.D. Ill. Aug. 20, 2010).

[27] *See Young v. United States*, 535 U.S. 43, 50 (2002) (as courts of equity, bankruptcy courts apply principles and rules of equity jurisprudence).

alleges that the trustee had a conflict of interest or breached another duty—particularly in recent cases.[28] In contrast, bankruptcy courts are more likely to hold that the mere inequitable result of enforcing a no action clause does not constitute a basis for relief.[29] In enforcing a no action clause that prevented bondholders from asserting fraudulent transfer claims against a bond issuer, the Eleventh Circuit[30] held that giving a consistent, uniform interpretation to no action clauses was important to ensure the effective functioning of the financial markets. The Eleventh Circuit acknowledged one exception—where allegations are made that the trustee had conflicts or had exhibited irrational behavior that barred judicial relief.[31] However, without allegations of conflicts, relief from the no action clause was not warranted despite the impossibility of satisfying the prerequisites for bondholders to assert claims. In *Akanthos*,[32] bondholders alleged that the company's proposed dividend constituted a fraudulent transfer, where the company had admitted that it could not pay its debts. The bondholders argued that because the company intended to pay the dividend in twenty days, it was impossible to comply with the no action clause's requirement that bondholders give the trustee sixty days to act before they could commence litigation. Without hearing the merits of the fraudulent transfer claim, the Eleventh Circuit dismissed the plaintiffs' action, because the plaintiffs did not specifically allege either conflicts by or infirmity of the trustee. Despite the impossibility of satisfying the no action clause's requirements to enable bondholders to assert claims, the Eleventh Circuit enforced the provision. The Court reasoned that the bond indenture authorized the company to pay dividends on twenty days' notice. Therefore, the company was not obligated to wait the requisite period to enable bondholders to bring their own litigation to prevent the dividend. The court held that despite the impossibility of satisfying the waiting

[28] *See Feldbaum,* 18 Del. J. Corp. L. at 640; *Howe v. Bank of N.Y. Mellon,* 783 F.Supp 2d. at 473-74 (S.D.N.Y. 2011) (holding that no action clause requirements do not apply to claims asserting breach of duties or tort claims).

[29] *cf. Feldbaum,* 18 Del. J. Corp. L. at 640 (equity may dictate relief from no action clause requirements where specific facts alleged that trustee breached its duties or is incapable of disinterred behavior); *Am. Roads,* 496 B.R. 727 (enforcing no action clause despite allegations of fraud and collusion).

[30] *Akanthos,* 677 F.3d at 1289.

[31] *Id*. at 1294-5; *c.f. Am. Roads,* 496 B.R. 727 (enforcing no action clause despite allegations of fraud and collusion by control party).

[32] *Akanthos Capital,* 67 F.3d 1286.

period required by the no action clause, the bondholders were nonetheless not excused from its requirements before bringing litigation.[33]

How Broadly or Narrowly Should No Action Clauses Be Construed?

The determination of whether to enforce no action clauses is a mixed question of fact and law.[34] Because no action clauses often do not enumerate the specific bankruptcy rights that are waived, courts must analyze whether the language of the no action clause is sufficiently broad to warrant a waiver of specific bankruptcy rights. State law governs how broadly a no action provision should be applied.[35] In *American Roads*, the court (Judge Lifland) acknowledged that no action clauses must be read narrowly,[36] but found that specific bankruptcy actions need not be listed in order for a pre-petition waiver to be enforceable. Judge Chapman, also a judge in the bankruptcy court for the Southern District of New York, applied a more stringent standard by holding that "[i]f a secured lender seeks to waive its rights to object to a 363 sale, it must be clear beyond a peradventure that it has done so."[37] Reading this holding alone could lead to the conclusion that bankruptcy rights must be specifically listed in order for a creditor to waive its standing regarding a particular action in a bankruptcy case. However, Judge Chapman's holding is much more nuanced. In reaching her conclusion, Judge Chapman relied on a stipulation between the first and second lienholders agreeing that an objection to a 363 sale motion did not constitute an exercise of remedies. Judge Chapman explained that her decision refusing to enforce the no action clause resulted from a "perfect storm" of a "poorly drafted agreement," a provision allowing second lienholders to retain their rights to object as unsecured creditors, and a stipulation whereby the first and second lienholders agreed that objecting to the 363 sale of the debtor's property was not an "exercise of remedies." Even with the convergence of these three factors, Judge Chapman stated that the decision allowing the bondholders to participate in the 363 sale despite the no action clause was a "very close call."[38]

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[33] *Id.* at 1297.
[34] *In re Boston Generating, LLC*, 440 B.R. 302, 317 (Bankr. S.D.N.Y. 2010).
[35] *See e.g. In re Globo Comunicacoes e Prarticipacoes S.A.*, 317 B.R.235 (S.D.N.Y 2004); *In re Erickson Ret. Communities, LLC*, 425 B.R. 309, 314 (Bankr. N.D. Tx. 2010).
[36] *Am. Roads*, 496 B.R at 729.
[37] *Boston Generating*, 440 B.R. at 319.
[38] *Id.* at 320.

In determining whether the specific language of a no action clause constitutes a waiver of a particular bankruptcy right, courts have differed in articulating the standard. While the terms of no action clauses differ, they are typically triggered by a borrower's default under a financial agreement and prevent creditors from exercising their enforcement rights absent a demand on the trustee or other agent by a minimum threshold of debt holders. Interpreting no action clauses as a pre-petition waiver of all rights in bankruptcy cases disenfranchises the holder's party to the relevant agreement, where unsecured creditors and a host of other creditors have the right to be heard. In contrast, requiring no action clauses to enumerate the specific bankruptcy rights that holders are waiving clarifies the parties' relative standing in a bankruptcy case of the borrower, where creditors typically are not paid in full.

Some courts have analyzed the no action clause in the context of all of the provisions of the indenture in refusing to disenfranchise creditors absent specific waivers. For example, in a case decided almost ten years ago,[39] the District Court for the Southern District of New York refused to enforce a no action clause where it was ambiguous whether all actions relating to the debt were prohibited or only actions to exercise remedies.[40] In the *Globo Comunicacoes* case, a group of US investors filed an involuntary case against a Brazilian company. The debtor argued that the "no action clause" prohibited the bondholders from filing an involuntary case. The no action clause prohibited noteholders from proceeding directly against the issuer "to enforce the performance of any of the provisions of this Trust Deed," unless the trustee failed to do so after receipt of written request by holders of 25 percent or more of the outstanding notes.[41] In contrast, the jurisdictional clause in the indenture subjected the issuer to New York jurisdiction for "any suit, action or proceedings . . . which may arise out of or in connection with" the notes.[42] The court found that while the no action clause was drafted narrowly to prevent enforcement of the notes

[39] *Globo Comunicacoes*, 317 B.R.235 (S.D.N.Y 2004).
[40] It is interesting to note that the language found to be ambiguous by the District Court for the Southern District of New York is virtually the same language interpreted by the bankruptcy judges in the same district some ten years later. However, the bankruptcy courts in the more recent cases did not find the language ambiguous. *See Am. Roads*, 496 B.R. 727.
[41] *Globo Comunicacoes*, 317 B.R. at 248.
[42] *Id.* at 248-9.

without consent from the requisite holders, the jurisdictional clause was much broader. The court acknowledged that the drafters may have intended to preclude a broader universe of actions by the noteholders, however, the only action prohibited under the clause was the enforcement of the deeds of trust. As such, the district court held that the no action clause was ambiguous, thereby allowing the court to consider the intent of the parties in interpreting the provisions.[43] The court remanded the case back to the bankruptcy court to interpret the clause's provisions in accordance with the district court's ruling.

Standing for "Non-Direct" Creditors

In contrast to the no action cases, which address the rights of "parties in interest" subject to no action clauses to assert claims against a debtor, courts have held that parties *without* direct claims against a debtor do not have standing to assert claims in the debtor's bankruptcy case. Section 1109 provides "parties in interest" with statutory authority to raise, appear, and be heard on any issue in a bankruptcy case.[44] Further, Section 1128(b) provides that a "party in interest" has the right to object to a plan of reorganization.[45] However, the Bankruptcy Code does not define the term "party in interest." As a result, the determination whether a party is eligible for protection under Section 1109 is left to the discretion of the courts. Courts have generally held that in order to be a party in interest, the creditor must have a direct legal interest in the case.[46] Some courts have articulated the standard as requiring the party to have a direct claim against the debtor.[47]

Creditors that have direct claims against the debtor generally have standing to be heard in a bankruptcy case. However, some courts have held that even for creditors with direct claims against the debtor, such creditors lack standing to be heard or intervene for matters in which they do not have a direct pecuniary interest. For example, in *In James Wilson Associates*,[48] the Seventh Circuit held that Section 1109 grants standing to any party that has a legally protected interest that could be affected by the bankruptcy case in

[43] *Id*.
[44] 11 U.S.C. § 1109.
[45] 11 U.S.C. § 1128(b).
[46] *See Rimsat*, *supra* n. 23.
[47] *See e.g.*, *In re Innkeepers*, 448 B.R. at 141.
[48] 965 F.2d 160 (7th Cir. 1992).

the particular matter in which the creditor seeks to be heard. In determining that a first lien mortgage holder on the debtor's real property could not intervene in the debtor's motion to extend the time to assume a lease, the Seventh Circuit acknowledged that the mortgage holder had a direct interest in the lease assumption. The court explained that assumption of the lease mattered to the mortgage holder, because at the time of the bankruptcy filing, it had commenced a foreclosure proceeding due to a pre-petition default. The debtor filed a plan that proposed to cramdown the mortgage and stretch out the maturity on the mortgage loan for up to seven years. Despite the mortgage lender's interest in the lease assumption, the Seventh Circuit held that the mortgage lender could not enforce the statutory deadline[49] to assume the lease, because the mortgage holder did not have an interest in the lease itself. The court reasoned that the deadline to assume a lease is meant to protect the lessor and/or lessee. In the instant case, the lessee had consented to the assumption. Therefore, the first mortgage holder had no direct interest in extending the time to assume and, as a result, no standing to enforce the statutory deadline.[50]

Courts in the Seventh Circuit have also differentiated between the "direct pecuniary interest standard" versus the "party in interest standard" in analyzing whether a party has standing pursuant to Section 1109. For example, the District Court for the Northern District of Illinois relied on the Seventh Circuit ruling that in order to have standing to challenge a bankruptcy order, the party objecting must be "a person aggrieved" by the order.[51] ""The party must demonstrate that it has a pecuniary interest in the outcome of the bankruptcy proceedings.""[52] In *Columbia Casualty Co.*, an insurance carrier that provided excess coverage to Johns-Manville objected to the debtor's proposed settlement with a primary insurer. The excess insurer asserted standing on the theory that the settlement with the primary insurer could result in increasing its obligations under its excess liability coverage of the debtor. In denying the excess insurer's standing, the court relied on the Seventh Circuit's decision in *In James Wilson Assoc.*,[53] in which the Seventh Circuit held that in order to have standing to invoke the

[49] *See* 11 U.S.C. § 365(d)(4) (West).
[50] *Id.* at 169.
[51] *In re C.P. Hall Co.*, 12 C 2978, 2013 WL 140048 (N.D. Ill. June 10, 2013)
[52] *C.P. Hall*, at *1 (quoting *In re Holly Marine Towing, Inc.*, 669 F.3d 796, 800 (7th Cir. 1998)).
[53] *Matter of James Wilson Associates*, 956 F.2d 160, 168 (7th Cir. 1992).

protection of a particular statute, the party "'must be one of the persons whom the statute is intended to protect.'"[54] Therefore, not every party in interest can seek relief on every issue.[55] Earlier cases in the Third Circuit held that the plain language of Section 1109 provided a party in interest a statutory right to participate in any issue in the case.[56] However, in 2011, the Third Circuit adopted the Seventh Circuit's rule in the *James Wilson* case that in order to have standing, a party is required to have a concrete injury that is actual or imminent, and the injury must be traceable to the challenged action.[57] Similarly, earlier decisions in the Second Circuit found that a party in interest could challenge any issue in the case.[58] However, more recent decisions have limited the standing of parties in interest to actions that cause it direct harm. Further, the Second Circuit has held that a party in interest does not have standing to assert a right that is purely derivative of another party's right.[59] Some courts have applied the heightened standard to enable a party to bring an appeal—as opposed to being heard at the bankruptcy court level.[60]

Creditors without Direct Claims against the Debtor

Having limited the standing of parties with direct claims against the debtor, courts have held parties *without* direct claims against the debtor have no standing to contest matters, even if those matters directly affect the ultimate recovery on their claims. These holdings have significant implications for creditors in complex financial transactions. Investors in structured and other complex financings may be surprised to learn that they may have no standing in a bankruptcy case that directly affects their collateral. In cases where these types of complex financing were at issue, the District Court for the Southern District of New York has reasoned that while a creditor of one of the debtor's creditors may be "deeply concerned about the bankruptcy case, the party's legal rights and

[54] *C.P. Hall*, at *3 (quoting *James Wilson*, 965 F.2d at 169) *and* relying on *In re Rimsat*, 193 B.R. 499, 503 (Bankr. N.D. Ind. 1996).
[55] *Id*.
[56] *See In re Marin Motor Oil, Inc.*, 689 F.2d 445 (3d Cir. 1982).
[57] *In re Global Industrial Tech., Inc.*, 645 F.3d 201, 210-11 (3d Cir. 2011).
[58] *See, In re Caldor Corp.*, 303 F.3d 161 (2d Cir. 2002).
[59] *In re Refco, Inc.*, 505 F.3d 109, 117 (2d Cir. 2007).
[60] *See e.g., Rimsat, supra* n. 23; *Innkeepers, supra* n. 24; *and Matter of James Wilson Associates supra* n. 53. *See also In re Dykes*, 10 F.3d 184, 187 (3rd Cir 1993); *Kane v. Johns-Manville Corp.*, 843 F.2d 636, 641 (2d Cir. 1988).

interests can only be asserted against the debtor's creditor, not against the debtor, and therefore is not a party in interest."[61]

Basics of Structured Finance

To understand the broad implications of these cases, it is important to understand how securitizations and collateral debt obligations are structured. A securitization is the process of creating securities by pooling assets together.[62] Typically, the assets are similar in nature, such as mortgages or corporate loans, among others. Any asset may be securitized as long it produces a positive cash flow. The assets may be originated by a single entity (for example, a lender of residential mortgage loans) or they can be purchased from multiple institutional originators (for example, corporate bonds). These assets are pooled together and either sold or contributed to a trust or other bankruptcy remote entity. These entities are sometimes referred to as special purpose vehicles (SPV). The SPV issues securities that are backed by the pool of assets. The SPV then sells the securities to investors. The securities are not secured by the assets in the pool. Rather, because the SPV has no business other than holding the pool of assets, it should have virtually no creditors, other than the investors in the SPV. The investors are sometimes referred to as certificate holders, because they hold certificates issued by the SPV. The cash proceeds from the assets in the pool are used to pay the securities or certificates. Because there are numerous assets (third-party obligations) in the pool, cash proceeds are deposited in the pool at different times, resulting in a continued stream of cash flows. In general, a security issued by an SPV that is backed by a pool of debt obligations is referred to as a collateralize debt obligation (CDO). If the assets in the pool are mortgages, the security issued by the SPV is generally referred to as a collateralize mortgage obligation (CMO). The holders of collateralized obligations have claims against the SPV, and the SPV in turn has claims against the borrowers. Therefore, in securitizations, even though the investors have beneficial claims to the pools of assets, they do not have direct claims against obligors

[61] *S. Blvd. Inc. v. Martin Paint Stores*, 207 B.R. 57, 61 (S.D.N.Y. 1997).

[62] The description of securitizations above incorporates explanations provided by the Securities Industry and Financial Markets Association (SIFMA) *available at* www.investinginbonds.com/learnmore. SIFMA is a non-profit industry association that represents the interests of participants in financial markets.

under the debt instruments in the pools. When the SPV collects the cash flow from assets in the pool, the trustee distributes the proceeds of the collateral to the certificate holders. Several courts have analyzed the rights of certificate holders having claims against an SPV. Typically, the indentures for the collateralized obligations provide that the trustee has the sole authority to enforce the rights of the certificates. In some collateralized structures, a depositor accumulates assets to deposit in the pool. In such structures, the depositor may provide a limited guaranty regarding the quality of the loans placed in the pool. As a result, the SPV may also have claims against the depositor of the loans.

Courts Have Held that Investors in Securitizations Have No Standing Against Debtors

Courts have denied standing to certificate holders in SPVs based on two lines of reasoning. First, the certificate holders have no direct claims against the debtors, and second, no action clauses are enforceable in bankruptcy. For example, in *Innkeepers*,[63] a certificate holder in an SPV that held secured loans made to the debtor objected to bidding procedures for the sale of collateral securing the loans. The creditor alleged that it had standing because it had an interest in the secured loans, and it held preferred stock in the debtor.[64] In denying standing to the certificate holder, the bankruptcy court for the Southern District of New York held that the holder was a creditor *of a creditor* of the debtor and not a direct creditor of the debtor. As a further basis for denying standing to the certificate holder, the court held that the certificate holder was bound by the no action clause contained in the servicing agreement that governed the collateral in the SPV. The court reasoned that the delegation of rights to special servicers would be rendered meaningless if individual certificate holders were granted standing to oppose positions taken by the servicer.[65] Further, such a holding would result in a proliferation of litigation.[66] Even though the investor argued that the special servicer was hopelessly conflicted because it favored a specific bidder, the court ruled that the investor's proper recourse was to pursue its remedies under the servicing agreement—an unsatisfying result, because the

[63] *Innkeepers*, 448 B.R. at 131.
[64] *Innkeepers*, 448 B.R. at 138-9.
[65] *Id*. at 144.
[66] *Id*.

certificate holder relied on the value of the assets in the pool, not the financial condition of the servicer. The court relied on the Second Circuit's decision upholding *Refco*[67] in reasoning that bankruptcy courts are designed to resolve disputes between debtors and their creditors—not a forum to resolve disputes between SPVs and their investors.[68]

In *Refco*,[69] a different judge in the bankruptcy court for the Southern District of New York (Judge Drain) held that investors in a non-debtor segregated portfolio company had no standing to object to a settlement between the portfolio company and the Official Unsecured Creditors' Committee. Because the investors had no claims against the debtor, they were not parties in interest. In affirming the bankruptcy court's decision, the Second Circuit held that the investors in the non-debtor portfolio had no standing to challenge the settlement between the official committee and the non-debtor portfolio company, even though the investors alleged that the settlement was the product of collusion and fraud.[70] The Second Circuit held that if the servicer violated its fiduciary duties, the investors may have a claim against the servicer, but those claims should not be heard in the bankruptcy court. While there is some initial appeal in this reasoning, the Second Circuit was content to allow a settlement without any court hearing the evidence regarding the alleged fraud. By limiting the objectors' redress to a breach of fiduciary suit against the servicer in a different court, the Second Circuit essentially guaranteed that the plan would be long ago confirmed and consummated by the time the investors could offer proof that the settlement was the product of fraud. The Second Circuit *in dicta* held that it would have overruled the investors' objections on the merits even if the investor had standing.[71]

Other courts addressing the standing of creditors in securitizations have also held such creditors have no standing. For example, in *In re Shilo Inn*,[72] the court held that certificate holders in a trust could not vote on the plan of reorganization because the trusts—not the certificate holders—were creditors of the debtor, and the pooling and servicing agreement gave the servicer the

[67] *In re Refco, Inc.*, 505 F.3d at 110.
[68] *Innkeepers*, 448 B.R. at 145.
[69] *In re Refco, Inc.*, 505 F.3d at 114.
[70] *In re Refco, Inc.*, 505 F.3d at 110.
[71] *In re Refco, Inc.*, 505 F.3d at 146-48.
[72] *In re Shilo Inn, Diamond Bar, LLC*, 285 B.R. 726 (Bankr. D. Or. 2002).

sole right to vote on the plan. The court further held that the investors' relationship was with the SPV holding the assets—not with the debtor.

Conclusion

Courts have generally upheld no action clauses to prevent creditors with direct claims against debtors from asserting standing without satisfying the requirements of the no action clauses. Inequitable results have not swayed bankruptcy courts from enforcing no action clauses even though non-bankruptcy courts have given creditors more leeway in cases where the creditor has asserted fraud and collusion. Where creditors do not have direct claims against a debtor, courts have routinely refused standing to creditors to assert such claims. These rulings—that indirect creditors have no standing to assert claims in bankruptcy cases—have broad implications in securitizations and complex financing transactions, where creditors often have claims against trusts or other entities. Given the state of the law, bondholders and certificate holders in securitizations should be fully briefed on their likely inability to participate in bankruptcy cases, even though the cases may directly affect their interests. In the event that no action clauses and complex financing structures are not consistent with creditors' expectations, they must insist on changes when entering into these transactions to avoid waiving their standing in bankruptcy cases that may directly affect their interests. These rights are particularly important where the trustee or the designed control party has conflicts of interest or otherwise has no incentive to enforce rights for the benefit of the creditor group as a whole. By understanding the treatment of their claims in bankruptcy, creditors can accurately evaluate the returns necessarily to compensate for such risks.

Key Takeaways

- While no action clauses may be reasonable outside of a bankruptcy case, they may cause inequitable results when enforced in bankruptcy cases. Creditors should consider the effects of enforcement in bankruptcy cases to protect their rights and prevent unanticipated, inequitable results.
- Creditors should consider the impact and significance of agreeing to no actions clauses, which may prevent standing to pursue creditors' interests in the event of a bankruptcy, where

unsecured creditors and other parties will retain their right to be heard in a bankruptcy case of the borrower.

- Creditors that are under-secured (and therefore treated as unsecured in bankruptcy) may be deemed to have waived their rights to coordinate with the unsecured creditors' committee by virtue of no action clauses.
- There is one constant in bankruptcy cases: alliances can shift depending on the issue and whether the creditor has reached an agreement with the debtor. While the Bankruptcy Code provides certain protections for creditors' rights, current case law enforces pre-petition waivers of these rights, even when the waiver is not given knowingly.
- As a practical matter, there are two addition limitations to the Bankruptcy Code's protection of creditors' rights—first, the debtor's ability to cram down a plan over a class of creditors' objection, and second, the reality that a creditor will almost always get a better return in a Chapter 11 case than in a Chapter 7 liquidation, thereby allowing a plan to satisfy easily the best interest test required to confirm a plan of individual creditors' objections.
- While the Bankruptcy Code generally provides an opportunity for "parties in interest" to be heard in bankruptcy cases and to object to proposed plans of reorganization, the Bankruptcy Code does not define the term "party in interest," and as a result, courts have applied differing standards to determine its meaning.
- Courts have denied standing to certificate holders in SPVs based on two lines of reasoning: first, the certificate holders have no direct claims against the debtors, and second, no action clauses are enforceable in bankruptcy.
- Many bankruptcy courts have enforced no actions clauses—even when the enforcement resulted in an injustice or where allegations of fraud or collusion were asserted. Creditors should understand the effects of no action clauses to ensure their returns compensate their actual risk.

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