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## ENFORCEABILITY OF INTERCREDITOR AGREEMENTS IN BANKRUPTCY

*Intercreditor agreements are fixtures of modern corporate finance transactions, yet the extent to which their provisions are enforceable in bankruptcy remains the subject of ongoing controversy. This article attempts to explain the persistence of such disputes. By examining three recurring issues that have animated many recent disputes over the enforceability of intercreditor agreements in bankruptcy: (1) ascertaining the scope of fundamental intercreditor terms, such as “common collateral,” “proceeds,” and “exercise of remedies”; (2) the degree to which junior creditors may waive their right to participate in bankruptcy proceedings of the relevant obligor; and (3) whether the Bankruptcy Code permits a bankruptcy court to confirm a “cram-down” plan that does not comport with an otherwise enforceable intercreditor agreement.*

By Christopher M. Dressel \*

In principle, one would not expect the enforcement of intercreditor agreements in bankruptcy to engender significant controversy. Such agreements are fixtures of contemporary corporate finance transactions, and defining the relative rights of creditors in bankruptcy is among their core functions. To that end, creditors almost invariably characterize their intercreditor agreements as “subordination agreements” within the meaning of section 510(a) of the Bankruptcy Code. That provision, in turn, flatly declares that “[a] subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law.”<sup>1</sup> Yet the treatment and

enforceability of intercreditor agreements in bankruptcy remains a topic of perennial controversy.

What explains the persistence of these disputes? Following a brief overview of intercreditor agreements and their principal functions in corporate-finance transactions, this article highlights three recurring issues that animate many disputes over the enforceability of intercreditor agreements in bankruptcy: (1) ascertaining the scope of fundamental intercreditor terms, such as “common collateral,” “proceeds,” and “exercise of remedies”; (2) the degree to which junior creditors may waive their right to participate in bankruptcy proceedings of the relevant obligor; and (3) whether the Bankruptcy Code permits a bankruptcy court to confirm a “cram-down” plan that does not comport with an otherwise enforceable intercreditor agreement.

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<sup>1</sup> 11 U.S.C. § 510(a).

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## PRINCIPAL FUNCTIONS OF INTERCREDITOR AGREEMENTS

“Intercreditor agreement” is a familiar term among participants in debt capital markets and the professionals who advise them but eludes precise definition. Neither the Bankruptcy Code nor the Uniform Commercial Code supplies an authoritative and generally applicable definition of the term.<sup>2</sup> In common usage, the term carries both broader and narrower senses.

The American Bar Association “task force” that prepared a now-familiar model intercreditor agreement characterized such agreements as contracts “used in a variety of financing transactions to establish the respective rights and remedies of two or more creditors in credit facilities provided to a common borrower,” including agreements that “include payment subordination provisions” but “do not involve collateral.”<sup>3</sup> The task force clarified, however, that it “concentrated its efforts” on the subset of such agreements that “govern the relative rights and priorities of each creditor’s liens in the borrower’s assets” in connection with “secured financing transactions”<sup>4</sup> — that is, where lien priorities effectively establish the relative ranking of the obligor’s<sup>5</sup> funded debt obligations.

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<sup>2</sup> Some statutes and regulations define “intercreditor agreement” in specific contexts, however. *See, e.g.*, 10 C.F.R. § 609.2 (2024) (defining “Intercreditor Agreement” for purposes of a U.S. Department of Energy program to facilitate financing for qualifying clean-energy projects).

<sup>3</sup> Comm. on Com. Fin., ABA Section of Bus. L., *Report of the Model First Lien/Second Lien Intercreditor Agreement Task Force*, 65 Bus. Law. 809, 809 (2010) [hereinafter *ABA Task Force Report*].

<sup>4</sup> *Id.*

<sup>5</sup> Although the ABA task force uses terminology customary for “bank” debt (for example, “credit facilities” and “borrower”), *ABA Task Force Report*, *supra* note 4, at 809, trustees for holders of secured debt securities frequently are party to intercreditor agreements as well. Accordingly, this article generally employs generic terminology like “obligor” or “debtor” to refer to the borrower of the relevant loans, or issuer or the relevant debt securities, as the case may be.

A lien-subordination intercreditor agreement of this type is premised on the existence of common collateral — that is, property of an obligor encumbered by two or more liens, each held by a particular creditor to secure a distinct debt obligation — and performs two principal functions. *First*, it establishes the relative priority of the creditors’ liens, overriding by agreement the default rules supplied by the Uniform Commercial Code and other applicable law governing the priority of liens.<sup>6</sup> Thus, the typical 1L–2L intercreditor agreement provides (potentially subject to negotiated exceptions) that the lien of the first-lien creditor on the common collateral “will at all times be senior and prior in all respects to” any lien of the second-lien creditor on the common collateral, regardless of the time such liens actually attached or were perfected, any perfection defects, and like matters.<sup>7</sup>

*Second*, the intercreditor agreement regulates the parties’ exercise of their rights and remedies with respect to the common collateral. A customary 1L–2L intercreditor agreement affords the first-lien creditor substantial, but not unlimited, discretion to exercise (or forbear from exercising) secured-creditor remedies with respect to the common collateral, and forbids the second-lien creditor from interfering with the first-lien creditor’s permissible exercise of those prerogatives.<sup>8</sup> The precise boundaries of the first-lien creditor’s exclusive enforcement right, however, are often intensively negotiated.

Although usage varies, “intercreditor agreement” often refers to this type of lien-subordination arrangement. Agreements that establish payment, rather than (or in addition to) lien, priorities are sometimes

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<sup>6</sup> The general rule for most types of collateral under the UCC is that “[c]onflicting perfected security interests . . . rank according to priority in time of filing or perfection,” such that “[p]riority dates from the earlier of the time a filing covering the collateral is first made or the security interest . . . is first perfected.” U.C.C. § 9-322(a) (Am. L. Inst. & Unif. L. Comm’n 2021). The UCC permits secured creditors to modify the priorities of their respective liens by agreement. *Id.* § 9-339.

<sup>7</sup> *ABA Task Force Report*, *supra* note 4, at 817–18.

<sup>8</sup> *Id.* at 840–44.

distinguished by the appearance of “subordination” in the title.<sup>9</sup> This nomenclature is of more than pedantic interest. As noted, section 510(a) of the Bankruptcy Code provides that a “subordination agreement” is enforceable in bankruptcy if it is enforceable outside of bankruptcy.<sup>10</sup> But it does not define “subordination agreement”<sup>11</sup> and makes no reference to “intercreditor agreements.” And while intercreditor agreements customarily declare themselves to be subordination agreements within the meaning of section 510(a), bankruptcy courts are not necessarily bound by such characterizations.<sup>12</sup> In short, it is not obvious solely from the text of the statute that an intercreditor agreement among secured creditors whose respective claims rank *pari passu* in right of payment can claim the protection of section 510(a).

Although it is now well-established that intercreditor agreements that establish lien, but not payment, priorities are indeed subordination agreements under section 510(a),<sup>13</sup> such agreements were not the principal objects of Congress’s attention when it enacted section 510(a). To the contrary, the legislative history of the provision, though scant, is almost exclusively concerned with the treatment of *payment*-subordination agreements in bankruptcy. As a result, the Bankruptcy Code lacks details provisions governing lien-subordination agreements of a type and form customary in corporate-finance transactions today, thus leaving most questions concerning their treatment in bankruptcy open to development through case law.

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<sup>9</sup> See, e.g., Faraday Future Intelligent Elec. Inc., Current Report (Form 8-K) exhibit 10.3 (Sept. 6, 2024) (agreement titled “Subordination and Intercreditor Agreement,” which provides for both lien and payment subordination).

<sup>10</sup> 11 U.S.C. § 510(a).

<sup>11</sup> Cf. *Lehman Bros. Special Fin. Inc. v. BNY Corp. Servs. Ltd.* (In re *Lehman Bros. Holdings Inc.*), 422 B.R. 407, 421 (Bankr. S.D.N.Y. 2010).

<sup>12</sup> Cf. *Pepper v. Litton*, 308 U.S. 295, 305 (1939).

<sup>13</sup> See, e.g., *Pilot v. Alesco Preferred Funding XV, Ltd.* (In re *First Baldwin Bancshares, Inc.*), No. 13-00563, 2013 WL 5429844, at \*7 (Bankr. S.D. Ala. Sept. 30, 2013) (distinguishing between agreements of lien and claim subordination but suggesting that section 510(a) encompasses both), *aff’d sub nom. Pilot v. Alesco Preferred Funding XV, Ltd.*, No. CIV.A. 13-0628-WS-M, 2014 WL 1900668 (S.D. Ala. May 13, 2014). But cf. *In re Hart Ski Mfg. Co.*, 5 B.R. 734, 736 (Bankr. D. Minn. 1980) (“The intent of [section 510(a)] . . . is to allow the consensual and contractual priority of payment to be maintained between creditors among themselves in a bankruptcy proceeding.”).

## ENFORCEABILITY OF INTERCREDITOR AGREEMENTS IN BANKRUPTCY

### *Collateral, Proceeds, and Remedies in Bankruptcy*

The requirements of a customary 1L–2L intercreditor agreement are relatively straightforward where the first-lien creditor responds to the obligor’s default by selling common collateral in a foreclosure sale or exercising similar state-law remedies. In such cases, the first-lien creditor applies the cash proceeds of the foreclosure sale to the first-lien obligations and turns over to the second-lien creditor any residual proceeds.

But a state-law foreclosure is often an inadequate solution when a large corporate debtor defaults. Such debtors more commonly resort to chapter 11, which furnishes a more adaptable setting to restructure unsustainable debt. But the flexibility of chapter 11 poses difficulties for conventional lien-subordination intercreditor agreements, as consideration paid or distributed to secured creditors in chapter 11 is not obviously analogous to cash proceeds realized in a foreclosure sale. For instance, a secured creditor in chapter 11 could receive: adequate protection payments in exchange for use of cash collateral or consent to priming debtor-in-possession financing; subscription rights to participate in, and fees to backstop, a new-money rights offering; interests in a litigation trust or similar vehicle; equity securities of the reorganized debtor; and myriad other forms of consideration. Whether such payments and distributions constitute proceeds of common collateral under a lien-subordination intercreditor agreement is a recurring issue in intercreditor litigation in bankruptcy.

The highly contested chapter 11 cases of MPM Silicones L.L.P. and its affiliates (“Momentive”)<sup>14</sup> illustrate the issue and its implications. Momentive sought confirmation of a chapter 11 plan that proposed to equitize its second-lien notes. The plan also afforded second-lien holders subscription rights to purchase additional shares of reorganized Momentive’s common stock in a new-money rights offering. Holders of a majority of the second-lien notes agreed to backstop the rights offering in exchange for a \$30 million backstop fee and reimbursement of professional fees.<sup>15</sup>

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<sup>14</sup> *In re MPM Silicones, LLC*, Case No. 14-22503 (RDD) (Bankr. S.D.N.Y.).

<sup>15</sup> *BOKF, NA v. Wilmington Sav. Fund Soc’y* (In re *MPM Silicones, L.L.C.*), 596 B.R. 416, 423–25 (S.D.N.Y. 2019).

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The plan proposed two alternatives for Momentive’s first- and 1.5-lien notes (collectively, the “senior-lien noteholders”): if the class accepted the plan, payment of principal and accrued interest at par on the effective date of the plan, excluding a make-whole amount and postpetition interest at the default rate; if the class rejected the plan, replacement notes equal in present value to the allowed amount of the noteholders’ claims, including the make-whole premium, if ultimately allowed by the bankruptcy court.<sup>16</sup>

The senior classes’ rejection of the plan precipitated intense, multifaceted litigation, including a dispute concerning the implications of an intercreditor agreement among the senior-lien noteholders and the second-lien noteholders. The senior-lien noteholders contended that the second-lien noteholders breached the intercreditor agreement in two principal respects: first, that the second-lien noteholders’ vote to accept the plan obstructed the senior-lien noteholders’ exclusive right to exercise remedies; second, that the second-lien noteholders violated the turnover provisions of the intercreditor agreement by retaining new common stock, the backstop fee, and professional fee reimbursement payments before the senior-lien notes were paid in full.<sup>17</sup>

The dispute hinged on the intercreditor agreement’s exercise-of-remedies and turnover provisions. The former afforded the senior-lien holders “the exclusive right to enforce rights” and “exercise remedies . . . with respect to the Common Collateral.”<sup>18</sup> The latter required the second-lien noteholders to turn over to the senior-lien noteholders “[a]ny Common Collateral or proceeds thereof received by any [second-lien creditor] in connection with the exercise of any right or remedy . . . relating to the Common Collateral in contravention of this Agreement.”<sup>19</sup>

The bankruptcy court and, on appeal, the district court<sup>20</sup> embraced a narrow interpretation of the intercreditor agreement, holding that its exercise-of-remedies and turnover provisions did not bar the second-lien noteholders’ receipt and retention of plan

distributions and backstop consideration. The district court reasoned that the agreement required turnover only if the second-lien noteholders (1) acted in their capacities as secured creditors; (2) exercised rights and remedies with respect to common collateral; and (3) in connection with that exercise of rights and remedies, recovered common collateral or its proceeds.<sup>21</sup> The “common thread” linking these requirements “is that they all have to do with an action that exhausted, decreased, diluted, or otherwise used up the Common Collateral.”<sup>22</sup>

But, the district court reasoned that the distribution of reorganized common stock on account of a claim secured by common collateral does not imply a “diminution in value of the Common Collateral.”<sup>23</sup> Rather, the senior-lien noteholders could demonstrate that the second-lien noteholders’ plan distributions were proceeds of common collateral only by identifying a “literal exchange or transformation of the object comprising the collateral.”<sup>24</sup> But the second-lien noteholders’ plan distributions effected no such “exchange or transformation.” To the contrary, the common collateral revested in reorganized Momentive upon consummation of its plan, subject to the senior-lien noteholders’ liens, and the common collateral was not “diminished one iota by the distribution of new common stock under the plan.”<sup>25</sup> The senior-lien noteholders’ complaint that the consideration afforded to the second-lien noteholders under a restructuring support agreement and backstop agreement violated the intercreditor agreement failed for substantially similar reasons.<sup>26</sup>

An intercreditor dispute precipitated by a plan of reorganization for Texas Competitive Electric Holdings Company LLC (“TCEH”) yielded a similar result. TCEH, the merchant-generating subsidiary of Energy Future Holdings Corporation (“EFH”), obtained confirmation of a chapter 11 plan predicated on its spin-off from EFH. TCEH’s first-lien creditors (consisting of credit-facility lenders, noteholders, and hedge and swap counterparties) received plan distributions comprising stock of reorganized TCEH, cash, and rights to payments under a tax receivables agreement. The plan allocated these distributions ratably among the first-lien creditors

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<sup>16</sup> *Id.*

<sup>17</sup> *Id.* at 428–29, 432–33.

<sup>18</sup> *Id.* at 436–37 (quoting intercreditor agreement).

<sup>19</sup> *Id.* at 433 (quoting intercreditor agreement).

<sup>20</sup> *BOKF, N.A. v. JPMorgan Chase Bank, N.A. (In re MPM Silicones, LLC)*, 518 B.R. 740 (Bankr. S.D.N.Y. 2014), *aff’d sub nom. BOKF, NA v. Wilmington Sav. Fund Soc’y (In re MPM Silicones, L.L.C.)*, 596 B.R. 416 (S.D.N.Y. 2019).

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<sup>21</sup> *MPM Silicones*, 596 B.R. at 433–34.

<sup>22</sup> *Id.* at 434.

<sup>23</sup> *Id.* at 436.

<sup>24</sup> *Id.* at 434.

<sup>25</sup> *Id.* at 435 (quoting *MPM Silicones*, 518 B.R. at 755).

<sup>26</sup> *Id.* at 438–39.

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based on amounts outstanding as of the petition date, subject, however, to post-confirmation litigation concerning distribution priorities among them.<sup>27</sup>

The indenture trustee for TCEH's first-lien notes sued the credit-facility agent, asserting that an intercreditor agreement among the first-lien creditors required that these distributions be made ratably based on amounts outstanding at the time such distributions were made.<sup>28</sup> The dispute turned principally on two related provisions of the intercreditor agreement: its definition of the term "proceeds" and its payment waterfall provision. The agreement assigned the term "proceeds" substantially the same meaning given to it under the Uniform Commercial Code. The indenture trustee argued that the first-lien creditors' plan distributions were "proceeds," as so defined, and thus allocable among the first-lien creditors pursuant to the payment waterfall in the intercreditor agreement. That provision required that "Collateral or any proceeds thereof received in connection with the sale or other disposition of, or collection on, such Collateral upon the exercise or remedies . . . be applied" ratably to first-lien obligations "then due and payable." In short, all parties agreed that plan distributions must be made ratably among first-lien creditors, but disputed whether such shares should be fixed as of the petition date or calculated when such distributions were actually made, based on amounts "then due and payable." Because the notes bore a higher rate of interest than the other first-lien obligations, much turned on the distinction.<sup>29</sup>

The bankruptcy court and, on appeal, the district court and the Third Circuit, rejected the indenture trustee's claims, concluding that these plan distributions were not proceeds of collateral realized upon an exercise of remedies.<sup>30</sup> The courts concluded that the intercreditor agreement's payment waterfall applied only if: (1) the collateral agent received proceeds "from a sale, collection, or disposition of collateral" and (2) the relevant "sale, collection, or disposition" was an exercise

of remedies directed by the collateral agent.<sup>31</sup> Eliding a dispute over whether the complex spin transaction underlying TCEH's plan amounted to a sale of common collateral, the Third Circuit concluded that the transaction, in any case, "was not a remedy implemented *by the collateral agent*."<sup>32</sup> Thus, the plan properly allocated distributions to first-lien creditors based on the amounts of their respective claims as of the petition date.<sup>33</sup>

An intercreditor dispute arising out of the 2017 bankruptcy of La Paloma Generating Company, LLC, a merchant-power generator, ostensibly presented a variation on the same theme. Yet seemingly minor, technical differences between the intercreditor agreement at issue in that case, compared to the agreements litigated in *Momentive* and *TCEH*, drove a diametrically opposite result.

La Paloma, like *TCEH*, obtained confirmation of a plan of reorganization that sidestepped a significant, unresolved intercreditor dispute. The plan contemplated that La Paloma's first-lien lender would acquire La Paloma's generating facility by credit bidding first-lien loans secured by a properly recorded mortgage on the facility. The first-lien agent had, however, inadvertently allowed its UCC-1 financing statement to lapse, thus rendering La Paloma's personal property unencumbered. The plan provided that these assets would be distributed ratably among La Paloma's unsecured creditors, including its first- and second-lien lenders in respect of their deficiency claims. The plan, however, reserved the first-lien lender's right to pursue turnover of the second-lien lender's distribution pursuant to an intercreditor agreement between them. The second-lien lenders responded that they received their distributions as unsecured creditors and could retain such distributions in the same capacity.<sup>34</sup>

The bankruptcy and district courts in *La Paloma* framed the issue similarly to the *Momentive* and *TCEH* courts: did the disputed plan distributions constitute proceeds of common collateral realized by the defendant creditors upon an exercise of remedies?<sup>35</sup> The *La*

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<sup>27</sup> *Del. Tr. Co. v. Morgan Stanley Cap. Grp. (In re Energy Future Holdings Corp.)*, 773 F. App'x 89, 91–92 (3d Cir. 2019).

<sup>28</sup> *Id.* at 92.

<sup>29</sup> *Del. Tr. Co. v. Wilmington Tr., N.A. (In re Energy Future Holdings Corp.)*, 566 B.R., 669, 672–80 (Bankr. D. Del. 2017).

<sup>30</sup> *Del. Tr. Co. v. Wilmington Tr., N.A. (In re Energy Future Holdings Corp.)*, 566 B.R., 669, 672–80 (Bankr. D. Del. 2017), *aff'd*, 585 B.R. 341 (D. Del. 2018), *aff'd sub. nom. Del. Tr. Co. v. Morgan Stanley Cap. Grp. (In re Energy Future Holdings Corp.)*, 773 F. App'x 89 (3d Cir. 2019).

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<sup>31</sup> *Del. Tr. Co.*, 773 F. App'x at 93.

<sup>32</sup> *Id.* at 94.

<sup>33</sup> *Id.* at 94.

<sup>34</sup> *In re La Paloma Generating Co.*, 595 B.R. 466, 470–71 (Bankr. D. Del. 2018).

<sup>35</sup> *Id.* at 471; *In re La Paloma Generating Co.*, 609 B.R. 80, 96 (D. Del. 2019).

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*Paloma* courts, however, reached the opposite conclusion and thus required turnover of the second-lien lenders' plan distributions. Their decisions rested on two key premises: first, that the second-lien lenders' plan distributions constituted proceeds of common collateral; second, that the second-lien lenders received their distributions through an exercise of remedies.<sup>36</sup> The *La Paloma* courts had little difficulty concluding that the second-lien lenders' plan distributions constituted collateral proceeds for purposes of the intercreditor agreement. As is typical, the intercreditor agreement defined collateral broadly as any property intended to constitute collateral, regardless of any perfection defects. The first-lien agent's lapsed financing statement, therefore, was of no reason for the intercreditor dispute.<sup>37</sup>

Although the Third Circuit's reasoning in *TCEH* that a debtor-proposed plan cannot amount to an exercise of remedies by a secured creditor might have appeared to dictate the same result in *La Paloma*, the bankruptcy and district courts in the latter case pointed to a small but significant drafting difference to reach the opposite result. Specifically, the exercise-of-remedies provision in the *La Paloma* intercreditor agreement included a subsection reading: "Notwithstanding the foregoing, the [second-lien creditors] may . . . [f]ile a claim or statement of interest in a Bankruptcy of La Paloma or any other Grantor." In contrast, the intercreditor agreement in *TCEH* explicitly defined the term "Exercise of Remedies" but did not include the filing of a proof of claim within that definition. From this distinction, the *La Paloma* courts concluded that the second-lien lenders exercised secured-creditor remedies merely by filing a proof of claim in respect of the second-lien obligations. And because their distributions arose from that exercise of remedies (in that distributions were made to them on account of the claims asserted in their proofs of claim), the intercreditor agreement required their turnover.<sup>38</sup>

### ***Insolvency Provisions***

Whereas cases like *Momentive*, *TCEH*, and *La Paloma* consider the application to chapter 11 plan distributions of core intercreditor provisions that do not expressly address chapter 11 plans, other intercreditor disputes concern insolvency-specific provisions.

A customary 1L–2L intercreditor agreement includes a suite of detailed provisions governing the first- and second-lien creditors' rights in a bankruptcy proceeding. Other species of lien-subordination intercreditor agreements typically address all or a subset of the same topics, albeit on different terms.

The table in the appendix outlines the issues these provisions often address, the core principles they establish, and certain exceptions, qualifications, and other variations for which one or the other party may seek to negotiate in a particular transaction.

Overlaid on top of these specific provisions in most intercreditor agreements is a general provision permitting junior-lien creditors to act in their capacities as unsecured creditors, except where otherwise prohibited. This provision is fundamental to the bargain between senior- and junior-lien creditors because it attempts to balance two fundamental, yet competing, principles: On the one hand, a lien-subordination intercreditor agreement defines the parties' relative rights, not as general creditors of a common obligor, but as holders of liens on common collateral. From this perspective, a junior-lien creditor's exercise of rights, remedies, and other actions that do not derive from its status as a secured creditor but that are common to all creditors of the obligor fall outside the concern of the intercreditor agreement. On the other hand, permitting a junior-lien creditor unbounded latitude to exercise the rights of an unsecured creditor would allow the junior-lien creditor to undermine the senior-lien creditor's core entitlements (for example, by challenging the validity of its liens) and thus effectively render illusory the commitments made by the junior-lien as a secured creditor. Accordingly, most intercreditor agreements incorporate a qualified, rather than absolute, allowance for the exercise of unsecured creditor rights. Where this balance is struck may vary significantly from one transaction to the next.

Purported assignments of plan voting rights are responsible for an outsized share of case law concerning the enforceability of bankruptcy-related provisions in intercreditor agreements. Some courts have held that provisions in intercreditor and other subordination agreements that purportedly permit a senior creditor to vote on a chapter 11 plan on behalf of a junior creditor are unenforceable on various grounds. Some courts have located a prohibition on such arrangements in provisions of the Bankruptcy Code and Federal Rules of Bankruptcy Procedure governing plan voting. In particular, some courts have inferred from section 1126(a) of the Bankruptcy Code, which confers a right to vote on a chapter 11 plan to the "holder of a

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<sup>36</sup> 595 B.R. at 472–74; 609 B.R. at 96–100.

<sup>37</sup> 595 B.R. at 741–72; 609 B.R. 96–97.

<sup>38</sup> 595 B.R. at 472–74; 609 B.R. at 99–100.

claim,” an implicit prohibition on assignment of voting rights.<sup>39</sup> The same cases draw a similar conclusion from Rule 3018(c) of the Federal Rules of Bankruptcy Procedure, which permits a creditor’s “authorized agent” to vote on the creditor’s behalf. On this view, a senior creditor exercising a junior creditor’s plan voting right acts adversely to (and not at the instruction of) the junior creditor. And, under basic principles of agency law, this adversity disqualifies the senior creditor as an “authorized agent” of the junior creditor.<sup>40</sup> Other courts conclude that voting assignment provisions are contrary to public policy, analogizing them to a debtor’s pre-bankruptcy waiver of the automatic stay.<sup>41</sup>

Other courts have reached the opposite conclusion on various grounds, including that: section 510(a) of the Bankruptcy Code renders such voting-assignment arrangements enforceable; the public-policy considerations articulated by courts declining to enforce such provisions derive from inapposite case law addressing putative pre-bankruptcy waivers of the automatic stay *by debtors*; and neither section 1126(a) of the Bankruptcy Code nor Rule 3018(c) of the Federal Rules of Bankruptcy Procedure bars a creditor’s delegation of its vote to an agent nor requires that the agent’s interest be sufficiently aligned with the assigning creditor’s.<sup>42</sup>

In any event, case law concerning purported assignments of voting rights sheds only limited light on the enforceability of bankruptcy provisions customary in typical lien-subordination intercreditor agreements. Voting assignment provisions are most common in connection with payment-subordinated debt intended to be “deeply” subordinated (for instance, debt provided by an equity sponsor or that has other equity-like features). In contrast, typical lien-subordination intercreditor agreements generally bar junior-lien creditors from

voting to accept a chapter 11 plan inconsistent with the priorities established by the agreement but rarely purport to assign junior-lien creditors’ voting rights to senior-lien creditors.

In disputes over bankruptcy-related provisions typical in 1L–2L and other lien-subordination intercreditor agreements, on the other hand, matters of interpretation predominate. In most of the relatively few reported cases declining to enforce a waiver of the junior-creditor’s rights in bankruptcy, the court signaled that the disputed provision would have been enforced had the agreement been more clearly drafted. In one case, for instance, a bankruptcy court declined to bar second-lien creditors’ objection to a sale of collateral under section 363 of the Bankruptcy Code supported by the debtor’s first-lien creditors, notwithstanding an intercreditor agreement that afforded the first-lien creditors the “exclusive right to . . . make determinations regarding the . . . sale . . . with respect to the Collateral” and barred the second-lien creditors from “tak[ing] any action that would hinder any exercise of remedies under the First-Lien Documents . . . including any sale . . . of the Collateral.”<sup>43</sup> Acknowledging that the second-lien creditors’ sale objection contravened the “*spirit* of the Intercreditor Objection,” the bankruptcy court nonetheless failed to locate in the parties’ “poorly drafted agreement” a sufficiently clear waiver of the second-lien creditors’ right to object.<sup>44</sup> The major culprit in that and other cases was an “ill-defined” unsecured-creditors’-rights exception that undid, or at least cast doubt on the scope of, the junior-creditor’s agreement to limit its rights in bankruptcy.<sup>45</sup>

To be sure, some courts presume that an intercreditor agreement preserves the junior-creditor’s right to participate in a bankruptcy proceeding to the extent otherwise permitted by the Bankruptcy Code unless the agreement specifically and expressly provides

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<sup>39</sup> *In re Fencepost Prods., Inc.*, 629 B.R. 289, 292–96 (Bankr. D. Kan. 2021); *In re 203 N. LaSalle St. P’ship*, 246 B.R. 325, 330–32 (Bankr. N.D. Ill. 2000); *In re Croatan Surf Club, LLC*, No. 11-00194-8-SWH, 2011 WL 5909199, at \*2–3 (Bankr. E.D.N.C. Oct. 25, 2011).

<sup>40</sup> Cases cited *supra* note 41.

<sup>41</sup> *See, e.g.*, *LaSalle St.*, 246 B.R. at 331.

<sup>42</sup> *See, e.g.*, *In re Coastal Broad. Sys., Inc.*, No. 11-10596, 2012 WL 2803745, at \*6–8 (Bankr. D.N.J. July 6, 2012); *Blue Ridge Invs., II, LP v. Wachovia Bank N.A. (In re Aerosol Packaging, LLC)*, 362 B.R. 43, 46–47 (Bankr. N.D. Ga. 2006); *In re Curtis Ctr. Ltd. P’ship*, 192 B.R. 648, 659–60 (Bankr. E.D. Pa. 1996); *In re Inter Urban Broad. Of Cincinnati, Inc.*, Civ. A. Nos. 94-23832 94-2383, 1994 WL 646176, at \*2 (E.D. La. 1994).

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<sup>43</sup> *In re Bos. Generating, LLC*, 440 B.R. 302, 317–18 (Bankr. S.D.N.Y. 2010) (quoting the intercreditor agreement).

<sup>44</sup> *Id.* at 320 (emphasis added).

<sup>45</sup> *Id.*; *see also MPM Silicones*, 596 B.R. at 429–32. But cf. *Ion Media Networks, Inc. v. Cyrus Select Opportunities Master Fund, Ltd. (In re Ion Media Networks, Inc.)*, 419 B.R. 585, 597–98 (Bankr. S.D.N.Y. 2009) (second-lien lender could not invoke rights-as-unsecured-creditor provision to object to plan supported by first-lien lenders, as that provision “explicitly incorporate[d] . . . prohibitions on Second-Lien Lender action in the chapter 11 cases” set forth elsewhere in the agreement).

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otherwise.<sup>46</sup> Aside from those cases declining to enforce voting-assignment provisions, however, little if any recent case law supports the proposition that the Bankruptcy Code or public-policy principles render clear and express bankruptcy waivers in customary lien-subordination intercreditor agreements unenforceable.<sup>47</sup>

### **Intercreditor Agreements and Cram-Down Plans**

Unclear statutory drafting has generated persistent confusion concerning the weight a court most accord to an intercreditor agreement in assessing compliance with the Bankruptcy Code's cram-down requirements. Section 1129(b)(1) of the Bankruptcy Code ostensibly appears to render section 510(a) inoperative when a plan proponent seeks confirmation of a cram-down plan. It provides:

*Notwithstanding section 510(a) of this title, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if [various cram-down requirements are satisfied].<sup>48</sup>*

Courts have struggled to ascertain the significance of the statute's prefatory phrase. On the one hand, the statute appears to require the court to disregard the

priorities established by the relevant intercreditor agreement in assessing compliance with the cram-down standards and determining whether to confirm the plan.

On the other hand, section 1129(b)(1)'s apparent command to disregard, for purposes of plan confirmation, an intercreditor agreement that section 510(a) makes enforceable in other contexts defies easy explanation. The legislative history offers some support for the proposition that Congress intended the "notwithstanding" clause merely to preclude dissenting holders within a class of senior creditors from enforcing a subordination agreement if the requisite majority of the class accepted a plan despite its non-compliance with the agreement.<sup>49</sup> On this view, the placement of the clause is merely infelicitous drafting.

Section 1129(b)(1)'s lead-in phrase figured prominently in at least two relatively recent cases. In *In re TCI 2 Holdings*, a bankruptcy court allowed junior-lien creditors to co-sponsor a plan of reorganization that violated certain terms of an intercreditor agreement but otherwise complied with the requirements of section 1129. Senior-lien creditors objected to confirmation, arguing that the intercreditor agreement barred the junior-lien creditors from proposing it. The court concluded that section 1129(b)(1)'s "notwithstanding" clause permitted it to confirm the plan without considering whether the plan comported with the intercreditor agreement. The court, however, excluded claims arising under the intercreditor agreement from the plan's third-party release.<sup>50</sup>

The bankruptcy court (and, on appeal the district court and the Third Circuit) reached a similar result in *Tribune*.<sup>51</sup> The *Tribune* plan allocated among a class of senior noteholders and a separate class of trade and other general unsecured creditors distributions that would have been made to two other classes of noteholders but for the contractual subordination of those notes. The senior noteholders — who received approximately \$17 million

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<sup>46</sup> See, e.g., *Bos. Generating*, 440 B.R. at 319 (a waiver "must be clear beyond peradventure"); *MPM Silicones*, 596 B.R. at 430 ("Where — as here — there is no express waiver or specific constricting language in the contract, courts are reluctant to read such constraints into broad provisions.").

<sup>47</sup> See, e.g., *Ion Media Networks*, 419 B.R. at 593–98 (intercreditor agreement eliminated second-lien lender's standing to challenge first-lien lenders' liens and object to plan supported by first-lien lenders); *In re Am. Roads LLC*, 496 B.R. 727, 729–32 (Bankr. S.D.N.Y. 2013) (enforcing no-action provision in financing documents governing unitranche facility to bar dissenting holders from objecting to plan); *In re Erickson Retirement Cmty's, LLC*, 425 B.R. 309, 313–16 (Bankr. N.D. Tex. 2010) (enforcing subordination agreement to bar subordinated creditor from seeking appointment of an examiner); *Aurelius Capital Master, Ltd. v. TOUSA Inc.*, Nos. 08-61317-CIV, 08-61335-CIV, 2009 WL 6453077, at \*8 (S.D. Fla. Feb. 6, 2009) (affirming bankruptcy court's entry of cash-collateral order on a consensual basis, notwithstanding second-lien agent's limited objections to such order, where intercreditor agreement barred such objections).

<sup>48</sup> 11 U.S.C. § 1129(b)(1) (emphasis added).

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<sup>49</sup> H.R. Rep. No. 95-595, at 359 (1977), as reprinted in 1978 U.S.C.A.N. 5963, 6315 ("A subordination agreement will not be enforced, however, in a reorganization case in which the case [*sic*] that is the beneficiary of the agreement has accepted . . . a plan that waives their rights under the agreement.").

<sup>50</sup> *In re TCI 2 Holdings, LLC*, 428 B.R. 117, 140–41 (Bankr. D.N.J. 2010).

<sup>51</sup> *In re Tribune Co.*, 472 B.R. 223 (Bankr. D. Del. 2012), *aff'd sub nom. Law Debenture Tr. Co. v. Tribune Media Co. (In re Tribune Media Co.)*, 587 B.R. 606 (D. Del. 2018), *aff'd sub nom. In re Tribune Co.*, 972 F.3d 228 (3d Cir. 2020).

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(an amount equal to approximately one percent of the face amount of the debt) less than they would have had they received the entirety of the subordinated noteholders' recovery — objected to confirmation, claiming that the plan violated the subordination agreement and discriminated unfairly against them. The Third Circuit, affirming the district court and bankruptcy court below, held that section 1129(b)(1) permitted confirmation of the plan “notwithstanding” its failure strictly to comply with the subordination agreement,

reasoning that the plan text of section 1129(b)(1) permits confirmation of a plan that does not strictly comply with an applicable subordination agreement. Although the statute does not give “debtors and courts . . . carte blanche to disregard pre-bankruptcy contractual arrangements,” it does, the Third Circuit concluded, afford a modicum of “flexibility.” The one-percent reduction in recovery the senior noteholders suffered as a result was not sufficiently material to constitute unfair discrimination.<sup>52</sup> ■

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<sup>52</sup> *Tribune Media Co.*, 972 F.3d at 237–45.

## APPENDIX

Issue	Principle	Variations
<b>Case Financing</b>	2L agrees (i) not to object to DIP financing or use of cash collateral provided or supported by 1L and (ii) to subordinate its lien to any DIP and/or adequate-protection liens	<p>In some deals, the 2L’s agreement not to object to case financing provided or supported by the 1L is unqualified</p> <p>Often, however, the 2L may retain the right to object to case financing that does not comport with negotiated “DIP Financing Conditions,” which may include the following: (i) DIP obligations (or aggregate first-lien obligations, including the DIP) cannot exceed a specified cap; (ii) DIP cannot prescribe the terms of a chapter 11 plan; (iii) DIP cannot require liquidation of collateral prior to a DIP default; and (iv) anti-layering</p> <p>Most ICAs expressly or implicitly forbid 2L from proposing a priming DIP; some entirely forbid 2L from proposing a competing DIP</p>
<b>Adequate Protection &amp; Stay Relief</b>	<p>2L will not oppose 1L’s request for (i) adequate protection or (ii) relief from the stay for lack of adequate protection</p> <p>2L may seek adequate protection subordinate to that granted to the 1L, but may not otherwise seek (i) adequate protection or (ii) relief from the stay for lack of adequate protection</p>	<p>1L may insist that the 2L agree to (i) accept non-cash plan consideration for its adequate-protection claims and (ii) pay over a portion of any cash payments received as adequate protection to the extent necessary to discharge 1L obligations on the plan effective date</p> <p>Some ICAs permit the 2L to seek stay relief if a request for adequate protection permitted by the ICA is denied</p>
<b>Section 363 Sales</b>	2L agrees not to oppose a sale of collateral to which the 1L consents, provided the 2L’s lien attaches to the sale proceeds with the same relative priority as the 2L’s lien on the collateral sold	<p>In some ICAs, the 2L waives only secured-creditor rights (<i>e.g.</i>, rights under sections 363(e) and (f)) but retains the right to object to bidding procedures, etc. to the same extent as unsecured creditors</p> <p>In other transactions, the 2L’s waiver extends broadly to bidding procedures, retention of professionals involved in the sale process, etc.</p> <p>ICAs are sometimes silent on credit bidding but often expressly confirm the 1L’s right to credit bid and forbid the 2L from objecting</p>

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<b>Section 363 Sales</b>	2L agrees not to oppose a sale of collateral to which the 1L consents, provided the 2L's lien attaches to the sale proceeds with the same relative priority as the 2L's lien on the collateral sold	<p>In some ICAs, the 2L waives only secured-creditor rights (<i>e.g.</i>, rights under sections 363(e) and (f)) but retains the right to object to bidding procedures, etc. to the same extent as unsecured creditors</p> <p>In other transactions, the 2L's waiver extends broadly to bidding procedures, retention of professionals involved in the sale process, etc.</p> <p>ICAs are sometimes silent on credit bidding but often expressly confirm the 1L's right to credit bid and forbid the 2L from objecting thereto; some expressly recognize the 2L's right to credit bid, provided the 1L obligations are discharged in connection with such sale</p>
<b>Plan Voting</b>	2L will not vote to accept or otherwise support a chapter 11 plan inconsistent with the priorities established by the ICA unless the 1L class accepts the plan	1L may seek greater control over plan voting, including an agreement by the 2L (i) not to accept or otherwise support any plan the 1L does not accept; (ii) not merely abstain but vote to reject any non-conforming plan; (iii) to accept any plan the 1L supports; (iv) to authorize the 1L to vote on behalf of the 2L, to the extent the 2L fails to vote its claims as required by a specified deadline
<b>Reorganization Securities</b>	The ICA will apply to secured debt obligations of the reorganized debtor distributed to both the 1L and 2L under a chapter 11 plan, such that the debt obligations distributed to the 2L will be subordinated to those distributed to the 1L	<p>1L may seek to broaden this provision to encompass equity securities (such that equity securities distributed to the 2L are subordinate in right of payment to those distributed to the 1L)</p> <p>2L may favor a variation of this provision that expressly permits its receipt of appropriately subordinated reorganization securities</p>

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# BANKRUPTCY AND THE UNIFORM SPECIAL DEPOSITS ACT: INSULATING DEPOSITOR FUNDS FROM CREDITORS

*For nearly a century, commercial parties have eschewed special deposits in favor of more costly and time-consuming mechanisms that, despite their inconvenience, offer more predictable judicial outcomes. However, the Uniform Law Commission recently introduced the Uniform Special Deposits Act (the “Act”), which offers states the ability to adopt a common legal regime that would provide commercial parties with an efficient mechanism to protect funds that will become due to one beneficiary or another upon the occurrence of a contingent future event. This article explores the genesis of the Act, how it will likely interact with existing law, and the benefits it will offer.*

By Jason W. Harbour, Hillary Peet Patterson, and Johanna Jenkins \*

Special deposits should soon be a safe and efficient tool for contracting parties to structure transactions involving contingencies that would trigger a transfer of funds.<sup>1</sup> In particular, Delaware has recently adopted the Uniform Special Deposits Act (the “Act”) in full, which will go into effect on January 1, 2025.<sup>2</sup> Recognizing the inconsistencies and resulting inefficiencies in this area of law, the Uniform Law Commission recently approved and recommended that the Act be enacted in all states.<sup>3</sup> Notably, the Act is an “opt-in” statute, which allows users to specify in their account agreements that they intend to be covered by the Act.<sup>4</sup> Under the Act, commercial parties could use special deposits for apartment rental deposits, as well as more complicated transactions where sophisticated parties currently use escrows, trusts, or letters of credit. This article outlines the animating principles of the Act, analyzes the interplay between the Act and creditors’ rights issues,

and reaffirms the significant incentives that the Act provides to transactional parties and banks.

## WHAT IS A SPECIAL DEPOSIT AND WHY IS A UNIFORM LAW NECESSARY?

While a general deposit can be created by simply placing funds in a bank to be drawn, a special deposit is typically characterized as a pre-funded and segregated bank liability that has been explicitly documented and set aside for a special purpose.<sup>5</sup> Unlike general deposits, which may be subject to a third-party’s reach, special deposits are created to ensure that segregated funds will be distributed only to a particular beneficiary. However, special deposits have long fallen out of favor, as case law is often unclear as to what makes a deposit “special,” mischaracterizes the relationship formed in a special deposit, and references obsolete banking practices, which further obfuscates how a particular deposit should be characterized and treated.<sup>6</sup> A key concern is that a special deposit may be misclassified by courts, which could allow claimants to exercise a right of setoff or facilitate a finding that creditors have priority

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<sup>1</sup> The scope of this article is limited to delineating the impact of the Uniform Special Deposits Act on contracting parties and potential creditors. For a full history of the law surrounding special deposits and tensions within and among jurisdictions, see Joseph H. Sommer, *Special Deposits*, THE BUS. LAW., Vol. 76, Pg. 841 (Summer 2021).

<sup>2</sup> An Act to Amend Title 5 of the Delaware Code Relating to the Uniform Special Deposits Act, S. 308, 152<sup>nd</sup> Cong. (2024). As of this publication date, other states that have passed the Act include Colorado, Oklahoma, and Washington.

<sup>3</sup> UNIF. LAW COMM’N, UNIFORM SPECIAL DEPOSITS ACT (2023).

<sup>4</sup> *Id.*

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<sup>5</sup> See *supra* note 1, at 856-57. Note that courts vary widely in the scope of requirements and flexibility in determining their satisfaction. See also *Pope v. First of Am, N.A.*, 699 N.E. 2d 178 (1998) and *Owosso Masonic Temple Ass’n v. State Sav. Bank*, 273 Mich 682 (1935) for examples of how courts have defined a special deposit versus a general deposit.

<sup>6</sup> See *supra* note 2, at 1-3, 6-7.

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of payment.<sup>7</sup> Furthermore, unlike deposits that are payable on order, a special deposit only becomes payable to a beneficiary upon the occurrence of a specified contingency.<sup>8</sup> Prior to the contingency's occurrence, the creditor's identity remains uncertain, and the funds should remain at the bank, free of any adverse claims.<sup>9</sup> If properly structured, no party — including the original depositor — should be able to access the funds at issue until such contingency has occurred. This is because once the funds are deposited into a special deposit account, the money has been permanently transferred. The only question is who the eventual beneficiary will be. Special deposits should thus be an ideal mechanism for parties who want to streamline the resolution of payment obligations arising upon the occurrence of future events. Usages could range from apartment rental deposits to more complicated transactions where sophisticated parties currently use escrows, trusts, or letters of credit.

However, the absence of any cohesive body of law has generated significant uncertainty as to how special deposits are created and how they may be treated in certain circumstances, including in the bankruptcy of the depositor. The lack of unifying principles among courts means that segregated funds could fall prey to setoff or creditor process, thereby limiting the utility of special deposits because of these risks and the lack of certainty.<sup>10</sup> For instance, under existing law, the creditor process could essentially freeze a special deposit, thus interfering with the intended purpose of the parties.<sup>11</sup> Naturally, this is a significant deterrent, and many parties opt into arrangements that, despite being labor intensive and costly, ultimately provide greater assurance. The Uniform Special Deposits Act seeks to eliminate such uncertainties and provide protections that benefit commercial law and parties by enabling parties to achieve their objectives through more efficient means.<sup>12</sup>

To ameliorate these issues, in the Act the Uniform Law Commission (“ULC”) has laid out specific criteria

for determining whether a deposit is a special deposit.<sup>13</sup> These include (1) a deposit of funds in a bank under an account agreement; (2) for the benefit of at least two beneficiaries, one or more of which may be a depositor; (3) denominated in a medium of exchange that is currently authorized or adopted by a domestic or foreign government; (4) for a permissible purpose stated in the account agreement; and (5) subject to a contingency.<sup>14</sup> The Act defines a “permissible purpose” very broadly as a governmental, regulatory, commercial, charitable, or testamentary objective of the parties stated in an account agreement.<sup>15</sup> As this list is neither prescribed nor exhaustive, contracting parties with diverse purposes should not be dissuaded from utilizing a special deposit agreement for fear that funds may fail to reach the beneficiary.<sup>16</sup>

Under the Act, creditor process is not enforceable against the bank holding the special deposit until the beneficiary has been determined.<sup>17</sup> Once the

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<sup>13</sup> *Id.*

<sup>14</sup> *Id.* at 6.

<sup>15</sup> *Id.* at 2-3.

<sup>16</sup> Potential permissible purposes include the holding of funds in escrow for a sale, as a security deposit, or as a distribution to a defined class after future determination. They may also be used as assurance for a contractual obligation or to settle an obligation that arises in the operation of a securities settlement system. *Id.*; UNIF. LAW COMM’N, UNIFORM SPECIAL DEPOSITS ACT (2023), at 3-6.

<sup>17</sup> UNIF. LAW COMM’N, UNIFORM SPECIAL DEPOSITS ACT (2023), at 9. Specifically, Section 9 of the Act, titled When Creditor Proceed Enforceable Against Bank, states as follows:

(a) Subject to subsection (b), creditor process with respect to a special deposit is not enforceable against the bank holding the special deposit.

(b) Creditor process is enforceable against the bank holding a special deposit with respect to an amount the bank is obligated to pay a beneficiary or a depositor if the process:

(1) is served on the bank;

(2) provides sufficient information to permit the bank to identify the depositor or the beneficiary from the bank’s books and records; and

(3) gives the bank a reasonable opportunity to act on the process.

c) Creditor process served on a bank before it is enforceable against the bank under subsection (b) does not create a right of the creditor against the bank or a duty of the bank to the creditor. Other law determines whether creditor process creates a lien enforceable against the beneficiary on a contingent

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<sup>7</sup> See, e.g., *McKee v. Paradise*, 299 U.S. 119, 122 (1936); *In re Lehman Bros. Holdings Inc.*, 439 B.R. 811, 832 (Bankr. S.D.N.Y. 2010).

<sup>8</sup> See *supra* note 1, at 855-56.

<sup>9</sup> *Id.*

<sup>10</sup> See *supra* note 6.

<sup>11</sup> See, e.g., *In re Kountze Bros.*, 103 F.2d 785, 790 (2d Cir. 1939); *Andrews v. Missouri State Life Ins. Co.*, 61 F.2d 452, 455 (5th Cir. 1932).

<sup>12</sup> See *supra*, note 2.

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contingency occurs, an obligation of the bank arises only to the applicable beneficiary.<sup>18</sup> The obligation that is “due to” the beneficiary may be attached by such beneficiary’s creditors, but this creates no rights in the special deposit itself.<sup>19</sup> The Act also protects the special deposit from creditors seeking to accomplish a similar objective through the use of an injunction or temporary restraining order, except in limited circumstances, such as material fraud.<sup>20</sup>

Additionally, it is common for banks to include very broad setoff rights in their deposit account contracts and to exercise such contractual rights against any person with any interest in a special deposit. This is another natural deterrent against commercial parties’ utilization of special deposits. To address this risk, the Act generally prohibits the bank from exercising a right of setoff or recoupment against a special deposit. Nominal exceptions include fees related to overdraft in the special deposit account and costs related directly to the special deposit.<sup>21</sup>

To further encourage the use of special deposits, the Act also includes significant incentives and safeguards for banks. These include (1) the protection against consequential, special, or punitive damages, (2) exclusive liability to the depositor or beneficiary, rather than a third party, and (3) express exculpation for any liability for failure to make payment if there are not actually and finally collected funds to pay a beneficiary.<sup>22</sup> The Act also explicitly provides that the relationship between the bank and a beneficiary is a debtor-creditor relationship, and the bank does not have a fiduciary duty to any person in connection with a special deposit.<sup>23</sup> A bank may rely on the genuineness of a record that is presented to determine its obligation to pay a beneficiary, if such determination is to be based on a record. Likewise, the Act excuses a bank from the duty of determining whether a special deposit serves and

continues to serve a permissible purpose.<sup>24</sup> Conversely, if a bank determines a special deposit is not serving a permissible purpose, the Act expressly authorizes the bank to take any action necessary, including termination of the special deposit.<sup>25</sup> Such powers and protections increase the likelihood that banks will choose to offer special deposits.

While any creation of statutory protections raises the potential for abuse, the Act contains various mitigants to safeguard against actions taken in bad faith. For instance, a deposit or transfer that would be fraudulent or voidable under other laws will not benefit from the Act. This is due to the fact that a special deposit must serve a “permissible purpose” from the time of creation and until termination.<sup>26</sup> If the special deposit ceases to serve such purpose prior to termination, the Act’s protections will cease to apply.<sup>27</sup> A special deposit may also be subject to an injunction or temporary restraining order if payment would constitute or facilitate a material fraud.<sup>28</sup> These provisions should dissuade bad actors who seek to exploit the Act and hide funds from legitimate creditors.

The Act is intended to dovetail with existing areas of law and promote the autonomy of contracting parties. Complementary bodies of law are intended to supplement the Act, except to the extent that they are inconsistent.<sup>29</sup> These explicitly include the Uniform Commercial Code, consumer protection law, law governing deposits, law related to escheat and abandoned or unclaimed property, and principles of law and equity.<sup>30</sup> The Act provides that parties can elect to be governed by the laws of a state which has enacted the Act, notwithstanding whether there is a reasonable relation between such state and the parties, the forum state, the special deposit, or any related transactions.<sup>31</sup> Parties have the same flexibility in choice of forum for the resolution of disputes. Such choice of law and forum provisions enhance legal certainty while promoting voice and choice.

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*footnote continued from previous page...*

interest of a beneficiary, including a depositor as a beneficiary, even if not enforceable against the bank.

<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

<sup>20</sup> *Id.* at 8.

<sup>21</sup> *Id.* at Section 9.

<sup>22</sup> *Id.* at Sections 9-10.

<sup>23</sup> *Id.*

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<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> *Id.* At 6.

<sup>27</sup> *Id.*

<sup>28</sup> *See supra* note 20.

<sup>29</sup> UNIF. LAW COMM’N, UNIFORM SPECIAL DEPOSITS ACT (2023), at 10-11.

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

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## HOW WILL THE INTERPLAY BETWEEN THE ACT AND BANKRUPTCY CODE WORK?

Without the Act, there are substantial uncertainties as to how special deposits would be treated in the bankruptcy of the depositor or a beneficiary. The Act is intended to eliminate these uncertainties and to provide commercial parties with confidence that special deposits will be respected in bankruptcy proceedings. The Act provides that the applicable beneficiary cannot be determined until the stipulated contingency occurs. Under current law, a depositor could be viewed as having rights to the special deposit before the determination of the applicable beneficiary which, in the event of a depositor bankruptcy, may cause the special deposit to be pulled into a depositor bankruptcy proceeding as property of the depositor's bankruptcy estate.<sup>32</sup>

The Act is intended to make special deposits bankruptcy remote with respect to the bankruptcy of the depositor or a beneficiary.<sup>33</sup> Unlike existing case law, the Act provides that the property interest (e.g., the right to receive payment) only vests after the occurrence of the contingency.<sup>34</sup> Without such a property interest, the special deposit should not constitute property of the bankruptcy estate of the depositor or a beneficiary prior to the occurrence of the applicable contingency.

Specifically, Section 8 of the Act states as follows:

- a. Neither a depositor nor a beneficiary has a property interest in a special deposit.
- b. Any property interest with respect to a special deposit is only the right to receive payment if the bank is obligated to pay a beneficiary and not in the special deposit itself. Any property interest under this subsection is determined under other law.

The wording of the Act as it relates to determination of the contingency is key because there are temporal and classification issues that determine what property is considered part of a debtor's bankruptcy estate. Property of a debtor's estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case."<sup>35</sup> Bankruptcy does not

expand a debtor's interest in property but merely transfers such interest to the bankruptcy estate.<sup>36</sup> As a result, a property interest that is limited in the hands of a debtor prior to the bankruptcy filing is equally limited in the hands of the debtor's bankruptcy estate.<sup>37</sup> Accordingly, the nature and scope of a debtor's property interest is determined by applicable state law.<sup>38</sup> As set forth in Section 8 of the Act, and therefore under applicable state law if the Act applies to a commercial agreement, depositors and beneficiaries should not have property interests in special deposits prior to the occurrence of the applicable contingency.

Analogously, state law determines whether property is held in a valid trust or escrow, which are two methods commercial parties currently use to make contingent funds bankruptcy remote.<sup>39</sup> Section 541(d) of the Bankruptcy Code provides that property in which a debtor only holds legal and not an equitable interest is not property of the debtor's estate.<sup>40</sup> Because a debtor does not own an equitable interest in property held in trust for another, that property is not considered 'property of the estate.'<sup>41</sup> It is well established that

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<sup>36</sup> See, e.g., *In re Sanders*, 969 F.2d 591, 593 (7th Cir. 1992); *In re ANR Advance Transportation Co., Inc.*, 247 BR. 771, 774 (Bankr. E.D. Wis. 2000).

<sup>37</sup> See, e.g., *Sanders*, 969 F.2d at 593 (holding that the "[f]iling of a bankruptcy petition does not expand or change a debtor's interest in an asset; it merely changes the party who holds the interest"); *In re N.S. Garrott & Sons*, 772 F.2d 462, 466 (8th Cir. 1985) (stating that "an interest limited in the hands of a debtor is equally limited in the hands of the estate"); *Moody v. Amoco Oil Co.*, 734 F.2d 1200, 1213 (7th Cir. 1984) (stating that "whatever rights a debtor has in property at the commencement of the case continue in bankruptcy — no more, no less").

<sup>38</sup> See, e.g., *Butner v. United States*, 440 U.S. 48, 55 (1979).

<sup>39</sup> See, e.g., *Barnhill v. Johnson*, 503 U.S. 393, 398 (noting that under the Bankruptcy Code "[i]n the absence of any controlling federal law, 'property' and 'interests in property' are creatures of state law."); *Stevenson v. J.C. Bradford & Co.* (In re Cannon), 277 F.3d 838, 849 (6th Cir. 2002) (holding that whether funds are held in trust is determined under state law); *Gowan v. The Patriot Group, LLC* (In re Dreier LLP), 2011 Bankr. Lexis 2338, at \*64 (Bankr. S.D.N.Y. June 16, 2011).

<sup>40</sup> 11 U.S.C. § 541(d); *U.S. v. Whiting Pools, Inc.*, 462 U.S. 198, 204 n.8 (1983) (stating that the legislative history of Section 541 demonstrated a Congressional intent to exclude property in which the debtor holds only a minor interest from becoming property of the estate).

<sup>41</sup> *Begier v. IRS*, 496 U.S. 53, 59 (1990).

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<sup>32</sup> See *supra* note 7; Joseph H. Sommer, *Special Deposits*, THE BUS. LAW., Vol. 76, Pg. 841 (Summer 2021), at 875, 868.

<sup>33</sup> UNIF. LAW COMM'N, UNIFORM SPECIAL DEPOSITS ACT (2023), at 9-10.

<sup>34</sup> *Id.*

<sup>35</sup> 11 U.S.C. § 541(a)(1).

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“[w]here the debtor’s interest in property is limited to that of trustee, no other interest (including the beneficiary’s equitable interest) in that property becomes part of the estate.”<sup>42</sup> Similarly, property held in a true escrow is not property of the estate.<sup>43</sup>

Similarly, “a letter of credit and the proceeds therefrom are not property of the debtor’s estate.”<sup>44</sup> Instead, “the letter of credit creates an independent obligation of the issuing bank to pay the beneficiary upon timely presentment of the documents specified in the letter.”<sup>45</sup> Accordingly, when the account party is a bankrupt debtor, the beneficiary of a letter of credit is not stayed from drawing on the letter of credit.<sup>46</sup> Nevertheless, to the extent a debtor has a beneficial interest in property, including property held in trust or

escrow, such interest becomes property of the debtor’s bankruptcy estate.<sup>47</sup>

Using trusts, escrows, and letters of credit in commercial transactions to ensure that funds will not be property of the bankruptcy estate of a depositor or a beneficiary can be complicated and expensive. Under the Act, special deposits provide a simpler and more efficient structure for parties to ensure that funds to be paid upon a specified contingency are protected from an intervening bankruptcy of the depositor or a beneficiary. While as of the date of this article no courts have addressed the interplay between the Act and the Bankruptcy Code, the Act has been structured such that it should “work” to protect property in special deposits from becoming property of the bankruptcy estate of a depositor or a beneficiary prior to the occurrence of the applicable contingency.

## CONCLUSION

Delaware’s enactment of the Act presents a novel opportunity for contracting parties to efficiently protect funds that will become due to one beneficiary or another upon the occurrence of a contingent future event. By expressly defining special deposits, clarifying the state law property rights in the funds at issue, and thereby shielding special deposits from creditor process, bankruptcy, and setoff events, the Act fills legal gaps that have long dissuaded commercial parties from utilizing special deposits. Moreover, the choice of law and forum provisions of the Act increase parties’ freedom of choice in bargaining and legal certainty. In sum, Delaware’s enactment of the Act creates a promising and cost-effective opportunity for commercial parties who currently must resort to other, more expensive methods to achieve the same result. ■

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<sup>42</sup> *LFD Operating, Inc. v. Ames Department Stores, Inc. (In re Ames Department Stores, Inc.)*, 274 B.R. 600, 623 (Bankr. S.D.N.Y. 2002), a’ffd, 2004 U.S. Dist. Lexis 17575 (S.D.N.Y. 2004), a’ffd, 144 Fed. Appx. 900 (2d Cir. 2005).

<sup>43</sup> See, e.g., Scanlon, 239 F.3d at 1198 (holding that “funds that are deposited into an escrow account by a debtor, for the benefit of others, cannot be characterized as property of the estate.”); ANR Advance, 247 BR. at 776 (holding that account that was “true escrow” under state law was not included in “property of the estate” and, therefore, was not protected by the automatic stay); *In re Dameron*, 206 B.R. 394, 402 (E.D. Va. 1997) (stating that funds that a debtor has transferred into an escrow pre-petition are not property of the estate); *In re S.E.L. Maduro (Florida), Inc.*, 205 B.R. 987 (Bankr. S.D. Fla. 1997) (stating that “funds that are deposited into an escrow account by a debtor, for the benefit of others, cannot be characterized as property of the estate”).

<sup>44</sup> *Int’l Fin. Corp. v. Kaiser Group Int’l Inc. (In re Kaiser Group Int’l Inc.)*, 399 F.3d 558, 566 (3rd Cir. 2005) (citations omitted); see, e.g., *American Bank of Martin County v. Leasing Service Corp. (In re Air Conditioning, Inc. of Stuart)*, 845 F.2d 293, 296 (11th Cir. 1988) (“We agree . . . that neither a letter of credit nor its proceeds are property of the debtor’s estate.”).

<sup>45</sup> *Papio Keno Club*, 247 B.R. 453, 459 (B.A.P. 8th Cir. 2000) (citing *Global Network Technologies, Inc. v. Regional Airport Auth.*, 122 F.3d 661, 664 n.2 (8th Cir. 1997)).

<sup>46</sup> See, e.g., *Willis v. Celotex Corp.*, 978 F.2d 146, 148 n.3 (holding that the automatic stay did not apply to an irrevocable letter of credit issued by a bank to debtor’s surety because the “letter of credit issued by the bank and its proceeds are not part of the [debtor’s] bankruptcy estate”).

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<sup>47</sup> See, e.g., *In re Stowell*, 232 B.R. 823, (Bankr. N.D.N.Y. 1998) (holding that a debtor’s 50% beneficial interest in a trust is property of the debtor’s estate); *In re Crandall*, 173 B.R. 836, 839 (Bankr. D. Conn. 1994) (holding that a debtor’s remainder interest in a trust is property of the debtor’s estate); *In re Markel*, 2001 Bankr. Lexis 2045 (Bankr. M.D. Fla. 2001).

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