

The *Enron* Enigma

claims trading at its fuzziest

by Neil E. Herman and Kizzy L. Rosenblatt



claims to various third-party purchasers, including hedge funds. The problems began when Enron sued Citibank two years later, seeking to subordinate or disallow Citibank's claim pursuant to sections 510(c) and 502(d)³ of the Bankruptcy Code. In the suit, which is still pending, Enron alleges that Citibank (1) engaged in inequitable and unlawful conduct by aiding and abetting the Enron fraud, and (2) refused to return a voidable transfer, and that as a result, any claims held by Citibank or Citibank's transferees against the Enron bankruptcy estate may be equitably subordinated or disallowed.

On January 10, 2005, Enron instituted adversary proceedings in the United States Bankruptcy Court for the Southern District of New York against each of the transferees to subordinate the claims asserted by such transferees. The basis for such subordination was *not* the conduct of the transferees, but rather solely the alleged wrongdoing of Citibank. A number of the transferees, including Springfield Associates, L.L.C. (which had acquired a portion of Citibank's claim valued at \$5 million), moved to dismiss the actions "on the ground that neither section 510(c) nor section 502(d) may be applied . . . to the claims held by the transferees based solely on the alleged conduct of the transferors of those claims."⁴

The *Enron* decisions

On November 28, 2005, Bankruptcy Judge Arthur J. Gonzalez *denied* the transferees' motion

Late this summer, the distressed debt market breathed a sigh of relief after U.S. District Court Judge Shira Scheindlin reversed two decisions rendered in the *Enron* bankruptcy case¹ (the *Enron* Decisions), relieving purchasers of distressed debt from liability for their sellers' transgressions. Initially, most commentators and the Loan Syndicate Trading Association applauded the decision because of the supposed clarity and freedom it affords purchasers in the distressed debt market.² However, upon closer scrutiny, the decision adds little, if any, value to the market, and the standards articulated by the court may actually harm the distressed debt market by raising many more questions than answers. Questions, of course, lead to uncertainty and increased litigation. In fact, bad-faith creditors seeking to avoid subordination or disallowance of their claims, may in fact be the real winners. Following the decision, creditors guilty of inequitable conduct may now seek to avoid equitable subordination by selling their tainted claims postpetition, thus receiving in return a windfall without fear of having to indemnify the purchasers.

Background

At issue in the *Enron* Decisions was a \$1.75 billion syndicated loan that Citibank provided to Enron prior to commencement of Enron's Chapter 11 case. Enron filed its petition on December 2, 2001, and shortly thereafter Citibank sold portions of its claim to a number of different entities, which in turn sold those

fall/winter 2007

in this issue

- 1 The *Enron* Enigma
claims trading at its fuzziest
- 3 In applying the theory of equitable subordination, the second circuit limits the role of a creditors committee
In re Applied Theory Corporation
- 6 Understanding the risks of recharacterization and equitable subordination

supplement

Recent Noteworthy Decisions

editors

Menachem O. Zelmanovitz
mzelmanovitz@morganlewis.com

Wendy S. Walker
wwalker@morganlewis.com

This communication is provided as a general informational service to clients and friends of Morgan, Lewis & Bockius LLP. It should not be construed as, and does not constitute, legal advice on any specific matter, nor does this message create an attorney-client relationship. This material may be considered Attorney Advertising in some states. Please note that the prior results discussed in the material do not guarantee similar outcomes.

© 2007 Morgan, Lewis & Bockius LLP
1701 Market Street • Philadelphia, PA 19103-2921
Tel: 215.963.5000 • Fax: 215.963.5001

The *Enron* Enigma claims trading at its fuzziest

continued from page 1

to dismiss, holding that a claim in the hands of a transferee could be subordinated or disallowed based on the misconduct of the transferor, irrespective of the innocence of the transferee.⁵ Judge Gonzalez reasoned that the transfer of such debt was affected by an assignment, and under the traditional law of assignment, the assignee takes the debt subject to all claims and defenses that the debtor has against the assignor.⁶ The distressed debt market immediately greeted Judge Gonzalez's decision with shrill pronouncements that "the sky was falling" and dire predictions that the *Enron* Decisions would devastate the liquidity of the multibillion dollar secondary market in distressed debt.

Subsequently, the case came before District Court Judge Scheindlin on appeal. Judge

Scheindlin *reversed* the bankruptcy court's ruling, noting that the "unnecessary breadth of the bankruptcy court's decisions threatened to wreak havoc on the markets for distressed debt."⁷ The district court concluded that "equitable subordination under section 510(c) and disallowance under section 502(d) are personal disabilities [specific to the claimant, and, as such] . . . do not inhere in the claim" when the claim is sold in an open market.⁸ Thus, apparently influenced by the concerns of traders in the distressed debt market, the district court sharply limited—but as we shall see, did not completely eliminate—a debtor's ability to pursue the remedies of equitable subordination and disallowance once a creditor sells his or her claim to a third party.

Characteristic of a claim or personal disability?

In reaching its decision, the District Court analyzed whether equitable subordination and disallowance were inherent characteristics of a claim or personal disabilities of the individual claimant. The district court reasoned that the distinction is important because "[a]lthough characteristics that inhere in a claim may travel with the claim regardless of the mode of transfer, the same cannot be said for personal disabilities of claimants."⁹ Relying on the legislative history and statutory language of equitable subordination under section 510(c) and disallowance under section 502(d), Judge Scheindlin found that both remedies are personal disabilities of claimants and, therefore, inapplicable to innocent purchasers who acquire their claims in good faith and without knowledge of their transferor's alleged misconduct. In other words, these remedies are specific to "the claimant, not the claim."¹⁰

Mode of transfer

According to the district court, because the remedies available under sections 510(c) and 502(d) are personal disabilities, whether they are applicable to subsequent holders of a claim depends entirely on the mode of transfer.¹¹ If the transfer was a "sale," the district court reasoned, the buyer takes the claim free from any claims or defenses against the seller, provided that the

buyer does not have prior or contemporaneous notice of the seller's wrongdoing.¹² In contrast, with a pure "assignment," the assignee takes the claim subject to all claims or defenses that the debtor has against the assignor (including equitable subordination and disallowance).¹³ Thus, the district court held that "unless there was a pure assignment . . . as opposed to a sale of the claim, the claim in the hands of the transferee is not subject to equitable subordination or disallowance based solely on the conduct of the transferor."¹⁴ Consequently, the district court remanded the case for a determination of the actual mode of transfer used by the parties, thus leaving to the bankruptcy court the task of determining the key factual issues.¹⁵

Looking forward

Distinguishing between a "sale" and an "assignment" may not be a simple task, as the district court neither articulated nor cited any case law that set forth an intelligible standard for determining whether a claim is transferred via sale or assignment. The court's decision merely states that: "whether or not a particular transfer is an assignment or a sale . . . depends, not on the name by which it calls itself, but on the legal effect of the provisions."¹⁶ Courts, then, are required to determine the mode of transfer, not by the title of the contract governing the transfer, but rather by examining the *legal effect* of the contractual provisions, and potentially, where such provisions are arguably ambiguous, the subjective intent of the parties. Given that the legal standard is amorphous, at best, and that discovery and a fact-sensitive trial are likely required, it appears that Judge Scheindlin's decision may actually lead to more uncertainty and more litigation.

Had the district court affirmed the lower court's *Enron* Decisions, the market could have easily brought certainty by including in the claim transfer agreement an indemnification of the purchaser by the seller. In the future, parties are likely to include specific language in their contracts describing the transfer as a "sale" and not an "assignment." Still, given the fact that courts are now required to determine the mode of transfer by examining its *legal effect* (and, possibly, the parties' intent), there will undoubtedly be a great deal of time and money expended by parties

Long-term commitment

The Restructuring Practice represents a diverse clientele ranging from financial institutions to media enterprises to retail companies.

Dedicated client relationship teams

We represent our clients in a wide variety of matters, from Chapter 11 proceedings and out-of-court restructurings to turnarounds and liquidations.

In-depth experience

The Restructuring Practice was recognized by *Chambers and Partners* in its annual compilation *Chambers Global: The World's Leading Lawyers 2005–2006*, a ranking of the leading practices and practitioners in the global market.

Top-tier, effective legal advice

The Restructuring Practice consistently ranks in the top 10 in the *Daily Deal's* review of 61 law firms with practices in the corporate bankruptcy area, based on active bankruptcy cases.

litigating over the interpretation of a contract and whether the “form” of transfer merely disguises the actual “substance.” In short, the decision may have rendered the waters of distressed debt transfers nigh impossible to navigate—at least as to equitable subordination issues.

Of even greater significance, perhaps, is that the district court’s failure to extend the remedies of sections 510(c) and 502(d) of the

Bankruptcy Code to subsequent purchasers may well result in “claims washing” on the part of bad-faith transferors. As a practical matter, Judge Scheindlin’s decision renders sections 510(c) and 502(d) ineffectual as applied to such claims. It “enables parties that engaged in wrongdoing to obtain cash for claims—potentially worthless in their own hands—simply by [“selling”] them, and thereby easily escape two defenses

designed specifically to provide remedies for such wrongdoing.”¹⁷ The debtor’s estate, then, will be forced to pay on a claim that may otherwise be subordinated or disallowed as a result of the original claimholder’s wrongdoing. Contrary to the district court’s assertion, this can hardly be the result the legislature had in mind when drafting these provisions.

endnotes

¹ See *Enron Corp. v. Springfield Assocs., L.L.C. (In re Enron Corp.)*, Nos. 01-16034, 05-01025, slip op. (Bankr. S.D.N.Y. Nov. 28, 2005); *Enron Corp. v. Avenue Special Situations Fund II, LP (In re Enron Corp.)*, 340 B.R. 180 (Bankr. S.D.N.Y. 2006) (together, the *Enron Decisions*); *Enron Corp. v. Springfield Assocs., L.L.C. (In re Enron Corp.)*, 2007 WL 2446498 (S.D.N.Y. Aug. 27, 2007).

² The Securities Industry and Financial Markets Association (SIFMA) issued a press release stating that Judge Scheindlin’s decision “is a tremendous victory for the entire market. The decision lifts a horrible cloud that hung over every purchase and sale of debt in the secondary market—a cloud that threatened to choke off these otherwise vibrant markets.” Press Release, Securities Industry and Financial Markets Association, Industry

Associations Applaud Victory in Enron Appeal (Aug. 28, 2007), available at <http://www.sifma.org/news/51536587.shtml>.

³ Section 510(c) of the Bankruptcy Code allows a court to equitably subordinate all or part of a claim if a creditor has engaged in wrongdoing that has harmed the estate or other creditors. 11 U.S.C. § 510(c). Section 502(d) of the Bankruptcy Code requires a court to disallow a claimant’s claims against the bankruptcy estate if the claimant has failed to repay a voidable preference or transfer. 11 U.S.C. § 502(d).

⁴ 2007 WL 2446498, at *2.

⁵ 340 B.R. at 210.

⁶ *Id.* at 195-96.

⁷ 2007 WL 2446498, at *14.

⁸ *Id.* at *8.

⁹ *Id.* at *6.

¹⁰ *Id.* at *9.

¹¹ *Id.* at *6.

¹² *Id.*

¹³ *Id.* at *5.

¹⁴ *Id.* at *8.

¹⁵ *Id.* at *16.

¹⁶ *Id.* at *5.

¹⁷ See Brief of Appellee at 15, *Enron Corp. v. Springfield Assocs., L.L.C.*, 2007 WL 1645716 (S.D.N.Y. 2007).



In applying the theory of equitable subordination, the second circuit limits the role of a creditors committee

In re Applied Theory Corporation

by Andrew D. Gottfried and Karen Gartenberg

The Court of Appeals for the Second Circuit recently held in *Applied Theory Corporation v. Halifax Fund, L.P. (In re Applied Theory Corporation)*¹ that a creditors committee cannot pursue a claim for equitable subordination, without court authorization, when an estate representative believes the purported claim has no merit and the claim only benefits certain creditors but not the estate. The Second Circuit couched the decision as a direct and natural byproduct of its previous cases addressing the roles of creditors committees in pursuing estate litigation. While the conclusion

of the Second Circuit appears correct, the holding unnecessarily concludes that a claim for equitable subordination does not “benefit the estate.”

Standard articulated in *STN Enterprises and Commodore*

The legal standard governing the right of a creditors committee to assert claims on behalf of the estate was originally set forth by the Second Circuit in the context of preferential and fraudulent transfers. In *Unsecured Creditors Committee of Debtor STN Enterprises, Inc. v. Noyes (In re STN*

Enterprises),² a creditors committee of a debtor under Chapter 11 of the Bankruptcy Code (the “Code”) appealed from a judgment of the District Court denying the committee’s motion for leave to commence an action against a former director of the debtor for, among other things, alleged waste, receipt of fraudulent or preferential transfers and mismanagement.³ The District Court denied the committee leave to sue because, among other things, permission to sue would “dramatically expand” a creditors committee’s implied right to sue.⁴

In applying the theory of equitable subordination, the second circuit limits the role of a creditors committee *In re Applied Theory Corporation* continued from page 3

In reversing and remanding, the Second Circuit held that Code sections 1103(c)(5)⁵ and 1109(b)⁶ imply a qualified right for creditors committees to initiate suit with the bankruptcy court's approval, but only in circumstances where "the trustee or debtor in possession unjustifiably failed to bring suit or abused its discretion in not suing to avoid a preferential transfer."⁷ To act upon such implied right, however, a creditors committee must present a colorable claim for relief that would support a recovery, and the bankruptcy court must determine that the assertion of such a claim is likely to benefit the estate or, in other words, that "there is a sufficient likelihood of success to justify the anticipated delay and expense to the bankruptcy estate that the initiation and continuation of litigation [would] likely produce" (collectively, the "STN factors").⁸

The Second Circuit subsequently expanded this legal standard in *Commodore International Limited v. Gould* (*In re Commodore International Limited*),⁹ where it held that a creditors committee

deny equal treatment to creditors based on some inequitable or unconscionable conduct in which they have engaged, or a special position which they occupy vis-à-vis the bankrupt that justifies subordination of their claims.¹¹ As equitable subordination is a remedy to "undo wrongdoing by an individual creditor in the interest of the other creditors,"¹² it may be applied to subordinate such creditor's claim to an entire class of creditors, and it thereby affects the order of priority in which creditors will be paid.¹³

This doctrine has been codified in Code Section 510(c), which provides, in relevant part, that after notice and a hearing, a court may

- (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or
- (2) order that any lien securing such a

loan, but rather a risky investment that should be recharacterized as equity or subordinated to the claims of unsecured creditors.¹⁷ The Committee filed a motion seeking authority to commence an adversary proceeding against the Lenders for various claims, including equitable subordination.¹⁸ The Bankruptcy Court denied the motion, which decision was not appealed. Subsequently, the Chapter 11 trustee submitted a report in which he concluded that the equitable subordination claim that the Committee sought to pursue did not have merit. The Lenders then moved for an order clarifying or limiting the scope of the Committee's authority to engage in litigation against the Lenders.

Both the Bankruptcy Court and the District Court held that the Committee did not have standing to bring an equitable subordination claim pursuant to Code Section 510(c) in light of the Chapter 11 trustee's conclusion that the claim was without merit. The District Court noted that, given the purpose of equitable subordination, which is to remedy a misconduct by one creditor that adversely affects another,¹⁹ many courts have concluded that generally a trustee is the proper party to raise claims for equitable subordination.²⁰ Because the Chapter 11 trustee "would ordinarily be the proper party to bring the claim,"²¹ both the Bankruptcy Court and District Courts held that the STN factors were implicated and ultimately governed resolution of the issue.²² Applying those factors, the District Court concluded that since the claim sought to redress injuries allegedly inflicted upon the Debtor and its creditors generally and was not directed toward any particularized injury to a creditor, the Chapter 11 trustee, [had] the sole and exclusive right to assert," the claim, which consequently left the Committee without standing to assert the claim.²³ The Committee appealed, and the Second Circuit affirmed.

On appeal, in a remarkably brief opinion, the Second Circuit rejected the Committee's position that it was thus not required to seek Bankruptcy Court approval to bring an equitable subordination claim and that the STN factors apply only to derivative claims, and not direct claims.

Without any discussion, the Second Circuit assumed that the legal standard set forth in STN and *Commodore* applies in situations where a

Against this backdrop, the Second Circuit was confronted with the applicability of the STN factors to equitable subordination claims.

may acquire standing to pursue the debtor's claims, not only where the debtor in possession unreasonably fails to bring suit on its claims, but also where the committee has the consent of the debtor in possession or trustee, if the court finds that suit by the committee is (1) in the best interest of the estate, and (2) is "necessary and beneficial" to the fair and efficient resolution of the bankruptcy proceedings.¹⁰

Application of the STN factors in the equitable subordination context

Against this backdrop, the Second Circuit was confronted with the applicability of the STN factors to equitable subordination claims and, specifically, the issue of whether a creditors committee required court approval before bringing such a claim on behalf of the estate.

Equitable subordination, "which is founded upon estoppel, is the doctrine invoked by courts to

subordinated claim be transferred to the estate.¹⁴

Rationale underlying *Applied Theory*

The issue of the applicability of the STN factors in determining whether a creditors committee may assert a claim of equitable subordination was raised in *Applied Theory*. The official committee of unsecured creditors there (the "Committee") sought to set aside a transaction in which certain lenders (the "Lenders"),¹⁵ as insiders of the debtor, allegedly used their control over the debtor to "transform \$30 million in convertible unsecured debt obligations into secured debt to the detriment of other creditors."¹⁶ Alleging that the transaction occurred when the debtor was insolvent, undercapitalized, and experiencing large losses, and that the consideration for the transaction, an advance of an additional \$4 million, was both inadequate and fully secured, the Committee argued that the advance was not a

creditors committee seeks to bring claims for equitable subordination and proceeded to apply the *STN* factors to the facts. Focusing primarily on the “best interest of the estate” prong of the *STN* factors, the Second Circuit determined that a claim for equitable subordination “depend[s] on a judicial determination that [it is] likely to benefit the estate.”²⁴ In view of the estate representative’s, and the Chapter 11 trustee’s, determination that the proposed claim had no merit, and the Bankruptcy Court’s conclusion that it would benefit only certain creditors and not the estate, the Second Circuit held that the Committee’s appeal was “doom[ed].”²⁵

Moreover, separate and apart from the lack of benefit to the estate, the Second Circuit found that the lack of Bankruptcy Court approval for the assertion of the claim provided yet another reason to dismiss the appeal. The Court reasoned that the purpose underlying the requirement of Bankruptcy Court approval was to provide the court with the power to control decisions that commit the time and limited resources of the estate. Such control, in turn, prevents committees and individual creditors from pursuing adversary proceedings “that may provide them with private benefits but result in a net loss to the entire estate.”²⁶ The lack of court approval under these circumstances was fatal to the Committee.

The Second Circuit was not persuaded by the Committee’s assertion that Code Section 510(c) permits parties in interest, other than the trustee, to bring claims of equitable subordination without court approval. The Court distinguished a creditors committee, which has “a close identity of interests with the debtor-in-possession insofar as the latter is obligated to pursue all actions that are in the best interest of the creditors and the estate,” from individual creditors, who may have

an “interest in subordination separate and apart from the interests of the estate as a whole.”²⁷ Since the Committee is not a creditor, “it does not have any rights held by any creditor to assert such a claim against another creditor.”²⁸ As the Committee’s proposed equitable subordination claim “would not be directed toward any particularized injury suffered by any creditor” or the Committee,²⁹ it could not seek to subordinate the Lenders’ claims to those of other creditors by alleging harm to the debtor generally, when the Chapter 11 trustee specifically refused to so act. The Second Circuit held that the Committee was required to obtain court approval prior to asserting a claim of equitable subordination and, having failed to obtain such approval, did not have standing to pursue the claim.

Flaws in *Applied Theory’s* rationale

In attempting to characterize the issues raised in *Applied Theory* as byproducts of the rationale set forth in *STN* and *Commodore*, the Second Circuit relied upon an analysis that did not fit the facts. The Second Circuit did not permit the Committee to pursue claims for equitable subordination on the ground that equitably subordinating claims only aids creditors’ priority position vis-à-vis each other, but provides no benefit to the estate itself. However, the “general goal of debtors and the creditors committees with whom they principally negotiate is the formulation of a largely consensual plan,” and cases “involving numerous disputed claims, partially subordinated creditors, disputes concerning estate property, and the like require that consensus be built. . . .”³⁰ The equitable subordination of claims may contribute to such consensus-building because it affects the classification of claims, which may be necessary in reaching a consensual plan of reorganization. A consensual plan of reorganization, in turn, confers a benefit to the estate. Thus, the equitable

subordination of claims may bestow a benefit to the estate by aiding in the plan process. The Second Circuit’s conclusion to the contrary is certainly debatable.

Nevertheless, the ultimate conclusion of the Second Circuit is correct. The Second Circuit previously held in *Commodore* that the standard set forth in *STN* provided “bankruptcy courts with significant authority both to manage the litigation and to check any potential for abuse by the parties.”³¹ An example of such potential abuse included a debtor in possession acting “under the influence of conflicts of interest,” thereby tempting it “to favor certain creditors over others.”³² Avoiding such conflicts is even more applicable to creditors committees, whose very purpose is to safeguard the interests of all of their constituents. Permitting a creditors committee to pursue claims belonging to the estate against a creditor creates an inherent conflict for the committee. The Second Circuit could and should have limited the rationale for its holding to the Bankruptcy Court’s regulation of the claims that a committee is permitted to litigate on the estate’s behalf and at the estate’s expense. Characterizing claims for equitable subordination as conferring no benefit on the estate was unnecessary and of questionable validity.

Conclusion

As a result of *Applied Theory*, creditors committees are prohibited from asserting claims for equitable subordination, without court approval, particularly where an estate representative believes the claim has no merit and the purported claim only benefits a limited number of creditors, but not the estate. Regardless of which rationale is employed to substantiate the holding, *Applied Theory* clearly imposes a further limitation on a creditors committee’s ability to act on behalf of the estate.

endnotes

¹ 493 F.3d 82, 86-87 (2d Cir. 2007).

² 779 F.2d 901, 904-05 (2d Cir. 1985).

³ The District Court also denied leave for the creditors committee to sue the former director, Janice Noyes, in her capacity as the administratrix of the estate of her husband, the sole shareholder and one of two directors of the debtor. The Court found that the probate estate was practically insolvent, and the statute of limitations to assert

a claim against the estate had already run. The Second Circuit affirmed the District Court’s decision. *STN Enters.*, 779 F.2d at 903 & n.2.

⁴ *Id.* at 904. The District Court also denied leave to sue on the grounds that (i) there was no fiduciary duty running from Noyes, as director, to herself as a stockholder, and (ii) corporate directors owe a fiduciary duty to creditors of a corporation only under certain circumstances. As to the first of these grounds, the Second Circuit noted that the probate estate, and not Noyes, was actually the

sole shareholder, with the creditors of the probate estate having an interest in the stock held by the probate estate. The Second Circuit, however, found the inconsistency moot due to the financial state of the debtor in possession. *Id.*

⁵ Section 1103(c)(5) provides that “[a] committee appointed under section 1102 of this title may . . . perform such other services as are in the interest of those represented.” 11 U.S.C. § 1103(c)(5).

⁶ Section 1109(b) provides that “[a] party in interest, including the debtor, the trustee, a creditors

In applying the theory of equitable subordination, the second circuit limits the role of a creditors committee *In re Applied Theory Corporation* continued from page 5

committee, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee, may raise and may appear and be heard on any issue on a case under this chapter." 11 U.S.C. § 1109(b).

- 7 *STN Enters.*, 779 F.2d at 904.
- 8 *Id.* at 906.
- 9 262 F.3d 96, 100 (2d Cir. 2001).
- 10 *Id.* at 100. In *Commodore*, bankruptcy proceedings were pending before both the Supreme Court of the Commonwealth of the Bahamas and the United States Bankruptcy Court in the Southern District of New York, both of which jointly administered the cases pursuant to a protocol. The court-appointed liquidators in the Bahamian proceeding (the "Liquidators") were granted the rights, powers, and duties of debtors-in-possession in the bankruptcy court proceeding. The creditors committee, with the consent of the Liquidators and pursuant to a general order approving this arrangement entered by the bankruptcy court, brought adversary proceedings on behalf of the estate for fraud, waste, and mismanagement against former directors and officers of the debtors. The defendants moved to dismiss the action on forum non conveniens and international comity grounds. In response, the Liquidators filed suit in the Bahamian court asserting claims identical to those set forth in the creditors committee's complaint filed in the bankruptcy court. The bankruptcy court, holding that the Liquidators' suit divested the creditors committee of standing to pursue claims against the defendants, dismissed the action. The district court affirmed and the appeal to the Second Circuit followed. Applying the standard articulated above, the Second Circuit held that the creditors committee had no standing because its suit was neither necessary nor beneficial in light of the

identical suit filed in the Bahamian court. *Id.* at 97-98, 100.

- 11 *In re Credit Indus. Corp.*, 366 F.2d 402, 408-09 (2d Cir. 1966).
- 12 *Official Comm. of Unsecured Creditors of Applied Theory Corp. v. Halifax Fund, L.P. (In re Applied Theory Corp.)*, 345 B.R. 56, 59 (S.D.N.Y. 2006), *aff'd*, 493 F.3d 82 (2d Cir. 2007).
- 13 *See 80 Nassau Assocs. v. Crossland Fed. Savs. Bank (In re 80 Nassau Assocs.)*, 169 B.R. 832, 837, 840 (Bankr. S.D.N.Y. 1994); *In re W.T. Grant Co.*, 4 B.R. 53, 74 (Bankr. S.D.N.Y. 1980), *on subsequent appeal*, 20 B.R. 186 (S.D.N.Y. 1982), *aff'd*, 699 F.2d 599 (2d Cir. 1983), *cert. denied*, *Cosoff v. Rodman*, 464 U.S. 822 (1983).
- 14 11 U.S.C. § 510(c)(1).
- 15 The Lenders included The Palladin Group, L.P. and Elliott Associates. *In re Applied Theory Corp.*, 345 B.R. at 57.
- 16 *In re Applied Theory Corp.*, 93 F.3d at 84.
- 17 *Id.* at 84.
- 18 The Committee also asserted claims of voidable preference, fraudulent conveyance and aiding and abetting breach of fiduciary duty. *In re Applied Theory Corp.*, 345 B.R. at 57.
- 19 *Id.* at 59 (citing *In re Lockwood*, 14 B.R. 374, 380-81 (Bankr. E.D.N.Y. 1981) ("The fundamental aim of equitable subordination is to undo or offset any inequality in the claim position of a creditor that will produce injustice or unfairness to other creditors in terms of bankruptcy results.")).
- 20 *Id.* at 59. (citing *In re KDI Holdings, Inc.*, 277 B.R. 493, 507 (Bankr. S.D.N.Y. 1999); *Lockwood*, 14 B.R. at 381; and *In re Riccitielli*, 14 Fed. Appx. 57, 58 (2d Cir. 2001) (unpublished table decision) (in

endnotes

- holding that debtor lacked standing to bring an action for equitable subordination, Second Circuit noted that "the purpose of equitable subordination is to remedy wrongdoing by one creditor, in the interests of the remaining creditors"). Some courts have also permitted individual creditors to bring claims for equitable subordination when the bringing of the claim is for that individual's own benefit. *Id.* at 59 (citing *In re Vitreous Steel Prods. Co.*, 911 F.2d 1223, 1231 (7th Cir. 1990), and *In re Hoffinger Indus.*, 327 B.R. 389, 394 (Bankr. E.D. Ark. 2005)).
- 21 *Id.* at 58.
- 22 *Id.*
- 23 The district court noted that the Committee "was required to obtain approval from the Bankruptcy Court before bringing any litigation, and in addressing such an application a bankruptcy court must apply the *STN* factors." *Id.* at 59.
- 24 493 F.3d at 86.
- 25 *Id.* at 86.
- 26 *Id.* at 86.
- 27 *Id.* at 87 (internal citations and quotations omitted).
- 28 *Id.* at 87.
- 29 *Id.* at 87.
- 30 *In re Crowthers McCall Pattern, Inc.*, 114 B.R. 877, 881 (Bankr. S.D.N.Y. 1990).
- 31 262 F.3d at 100.
- 32 *Id.* at 100. (quoting *In re Gibson Group, Inc.*, 66 F.3d 1436, 1441 (6th Cir. 1995) (internal quotations omitted)).

Understanding the risks of recharacterization and equitable subordination *by Wendy S. Walker*



Introduction

Sophisticated lenders understand the risks associated with making a secured loan to a distressed entity outside of bankruptcy, particularly where the lender

making the loan also holds significant equity of the borrower. Potentially the greatest concerns are the risks of recharacterization and equitable subordination in a subsequent bankruptcy proceeding. While there is no way to "bulletproof"

a transaction against such claims, recent decisions provide lenders with sufficient detail and clear examples of factors that support or conflict with claims for recharacterization and equitable subordination.

What are the elements of recharacterization and equitable subordination?

Recharacterization and equitable subordination are related theories through which a creditor's claims arising from its extension of loans or other forms of credit may be either recharacterized as equity or

subordinated to other claims in order to rectify an injury caused by the creditor's inequitable conduct.

"The overarching inquiry in a recharacterization case is the intent of the parties at the time of the transaction . . . determined through a common sense evaluation of the facts and circumstances surrounding a transaction."¹ In *In re Submicron Systems Corp.*, the United States Court of Appeals for the Third Circuit defined the recharacterization inquiry as follows:

[T]he characterization as debt or equity is a court's attempt to discern whether the parties

called an instrument one thing when in fact they intended it as something else. That intent may be inferred from what the parties say in their contracts, from what they do through their actions, and from the economic reality of the surrounding circumstances. Answers lie in facts that confer context case-by-case.²

While at one time a common-law remedy, equitable subordination was codified in Bankruptcy Code section 510(c), which provides that, after notice and a hearing, a bankruptcy court may “under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim.”³ Equitable subordination is an extraordinary remedy and one which is remedial in that it “should be applied only to the extent necessary to offset specific harm that creditors have suffered on account of the inequitable conduct.”⁴

Thus, the principal distinction between recharacterization of debt and equitable subordination is that the latter requires a showing of inequitable conduct (e.g., fraud, breach of fiduciary duty, or undercapitalization), while the former does not.⁵

Managing the risk of recharacterization

In *Radnor*, the bankruptcy court denied a motion by the Official Committee of Unsecured Creditors (the “Committee”) seeking to recharacterize the claims of Tennenbaum Capital Partners, LLC (together with its affiliates, “Tennenbaum”).⁶ Approximately 10 months prior to the commencement of Radnor’s bankruptcy case, Tennenbaum made a \$95 million secured loan and purchased \$25 million of the debtor’s preferred stock, including detachable warrants for approximately 15% of Radnor’s common stock. In addition, pursuant to an investor rights agreement, Tennenbaum was entitled to designate one member of and one observer to the four-person Board of Directors.⁷ Approximately four months prior to the bankruptcy case,⁸ when faced with larger than

expected losses, Tennenbaum made another secured loan to Radnor in the amount of \$23.5 million.

Following the bankruptcy filing, at the auction sale of Radnor’s assets, Tennenbaum, at the request of Radnor, sought to credit bid its debt.⁹ The Committee sought to prevent Tennenbaum from credit bidding, arguing that Tennenbaum was an insider whose true intent was to acquire the debtor (i.e., “loan to own”). The Committee thus contended that Tennenbaum’s claim should be recharacterized as equity and/or equitably subordinated.¹⁰

The Delaware Bankruptcy Court (Judge Walsh) conducted a thorough review of the Tennenbaum transactions and based its denial of the Committee’s motion for recharacterization on the following factors:

- the loan was consistently referred to as a loan or debt in the operative documents and by the parties in their dealings with each other and third parties;
- the loan had a fixed maturity date;
- Tennenbaum had the right to enforce repayment of principal and interest;
- the loan documents did not give Tennenbaum any voting rights;
- the proceeds of the loan were used to repay existing debt and for working capital purposes;
- the loan was structured and treated as a secured loan.¹¹

In rejecting the Committee motion, the bankruptcy court made the following determinations:

- Tennenbaum’s “knowledge that the Debtors were experiencing a liquidity crisis when the . . . Loans were made” was “insufficient to support recharacterization.”¹²
- Although it had the ability to appoint a director to Radnor’s Board, Tennenbaum was not an insider, because one seat on a four-person Board could not and, in any

event, did not enable it to “exercise control over Radnor’s day-to-day operations.”¹³

- Tennenbaum’s “receipt of non-public information and ability to obtain more board seats contributed, at most, a mere ‘right’ or ‘ability’ to control,” which, absent the exercise of that right, did “not constitute the level of control relevant to the issue of recharacterization.”¹⁴
- The inclusion of minimum Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) levels in the credit agreement and warrant calculations was irrelevant to the issue of control for purposes of recharacterization.¹⁵

Finally, the bankruptcy court rejected the Committee’s argument that Tennenbaum intended from the outset to acquire Radnor, finding that Tennenbaum performed “extensive financial, business and legal due diligence” and “had no reason to doubt the financial information that was provided by Radnor management” to demonstrate its financial health and ability to comply with the credit documents.¹⁶

The facts and holding of *Radnor* are similar to those in *Submicron Systems*, where the Third Circuit rejected claims by a plan administrator seeking to recharacterize or equitably subordinate the claims of an assignee of various secured creditors who credit bid such claims at the sale of the borrower.¹⁷ In *Submicron Systems*, the court of appeals upheld the trial court’s finding that the parties intended a lending transaction as opposed to an equity investment, notwithstanding (1) evidence of the borrower’s undercapitalization, (2) the lenders’ seats on the borrower’s board of directors, and (3) the failure of Submicron’s accounting department to issue notes to the lenders.¹⁸

In *Radnor* and *Submicron Systems*, lenders will find useful analyses of the various factors considered by courts in connection with a claim for recharacterization. A lender that makes a secured loan to a distressed entity in which it holds an equity interest should carefully structure the transaction as a

Understanding the risks of recharacterization and equitable subordination

continued from page 7

loan and should ensure that the transaction is treated by all parties as a loan, contains market terms, is supported by the borrower's financial information, and is negotiated on an arm's-length basis. There is nothing wrong, per se, with a lender/owner making a loan to a distressed borrower/affiliate. Thus, the fact that a lender also holds an equity interest in the borrower or seats on the borrower's board of directors should not automatically result in recharacterization.

Managing the risk of equitable subordination

A claim of recharacterization may be transformed into or supplemented with a claim for equitable subordination where the creditor whose claim is at issue has engaged in inequitable conduct and thereby harmed another group of creditors or interest holders.

The bankruptcy court in *Radnor* rejected the Committee's equitable subordination claim against Tennenbaum, again finding that Tennenbaum was

not in control of the debtors' day-to-day operations and, therefore, was not an insider and did not engage in any inequitable conduct.¹⁹ Rather, the loans made by Tennenbaum "enhanced liquidity of the Company and, among other things, allowed the Company to continue operations" as they "resulted in a reduction of the Company's net debt."²⁰

The Third Circuit in *Submicron Systems* also denied the plan administrator's claims of equitable subordination. The trial court did not, however, reach the question of whether any inequitable conduct had occurred. Instead, the court found that there had been no injury to Submicron's unsecured creditors because (1) in the absence of the loan transactions, "the company would have been forced to close down and liquidate, leaving unsecured creditors with nothing" and (2) there were no other interested bidders.²¹

Thus, as with recharacterization, there are obvious ways to manage and limit any exposure to equitable subordination claims. In addition to carefully structuring a loan transaction as a loan,

lenders should, among other things, examine the transaction from the perspective of creditors and equity interest holders below them in the capital structure of the company and assess whether such parties will be better or worse off as a result of the proposed transaction. If they are better off, the lender should not be subject to potential claims for equitable subordination.

Conclusion

Recharacterization, equitable subordination, "loan to own" and other lender liability claims are not new and have been advanced in bankruptcy cases for many years. As with death and taxes, nothing can fully guarantee that a lender will be immunized from any such claims. However, structuring, documenting, and treating loans as loans and avoiding the exercise of control over the borrower—particularly if it harms other creditors—will significantly lower the risks of recharacterization and equitable subordination claims.

¹ *In re Radnor Holdings Corp.*, 353 B.R. 820, 838 (Bankr. D. Del. 2003).

² 432 F.3d 448, 456 (3d Cir. 2006).

³ 11 U.S.C. § 510(c).

⁴ *Submicron Systems*, 432 F.3d at 462, quoting *In re Submicron Systems Corp.*, 291 B.R. 314, 327 (D. Del. 2003).

⁵ *Id.* at 454-55 ("Equitable subordination is apt when equity demands that the payment priority of claims of an otherwise legitimate creditor be changed to fall behind those of other claimants. . . . In contrast, the focus of the recharacterization inquiry is whether 'a debt actually exists' . . . or, put another way, we ask what is the proper characterization in the first instance of an investment.").

⁶ 353 B.R. at 820.

⁷ *Id.* at 829.

⁸ *Id.* at 832.

⁹ *Id.* at

¹⁰ *Id.* at

¹¹ *Id.* at 839.

¹² *Id.* at 840; see also *SubMicron Systems*, 432 F.3d at 457 ("When existing lenders make loans to a distressed company, they are trying to protect their

existing loans and traditional factors that lenders consider (such as capitalization, solvency, collateral, ability to pay cash interest and debt capacity ratios) do not apply as they would when lending to a financially healthy company.").

¹³ *Radnor*, 353 B.R. at 839-40; see also *Submicron Systems*, 432 F.3d at 457-58 (rejecting recharacterization of secured lender claims where lenders held half of the seats on the debtors' Board of Directors, the court stated that it is "not unusual for lenders to have designees on the company's board, particularly when the company [is] . . . distressed").

¹⁴ *Radnor*, 353 B.R. at 840.

¹⁵ *Id.*

¹⁶ *Id.* at 828-29. A Tennenbaum witness testified at trial that Tennenbaum never intended to own Radnor. The Committee presented "no reliable evidence to the contrary" as all parties believed that Radnor was solvent and would be able to comply with the terms of the credit documents. *Id.* at 829-33. The bankruptcy court also found that Radnor was not undercapitalized. *Id.* at 831. Nor did Tennenbaum's actions cause Radnor to file for bankruptcy. Rather, the court found that the freeze of Radnor's revolving credit facility by another lender left Radnor with no choice but to file. *Id.* at 835.

¹⁷ 432 F.3d at 455, 457.

¹⁸ *Id.* at 457-58.

¹⁹ 353 B.R. at 840-41. The Bankruptcy Court also found that Tennenbaum's "access to performance reports and other financial information from the Company is insufficient to establish insider status." *Id.* at 841.

²⁰ *Id.* The bankruptcy court found that the proceeds of the initial Tennenbaum loans were used to repay secured and unsecured indebtedness and for working capital purposes. *Id.* at 829. The proceeds of the last loan were used "partly to the benefit of Radnor's unsecured noteholders . . . to pay down trade debt, but were mostly used for working capital purposes, which assisted the Company's efforts to turn the corner for the benefit of, *inter alia*, unsecured creditors."

²¹ 432 F.3d at 462.

endnotes

- 1 *In re Worldcom, Inc.***, 364 B.R. 538 (Bankr. S.D.N.Y. 2007)
Where a deferred compensation plan's purpose was to defer income and not to provide benefits in the event of sickness, accident, disability, or death, payments thereunder were not "retiree benefits" as defined by the Bankruptcy Code, even though such payments could be used to provide postretirement income and alternative schemes were provided in the event of the death or disability of a participant.
- 2 *In re Amcast Indus. Corp.***, 365 B.R. 91 (Bankr. S.D. Ohio 2007)
Court would not recognize a new cause of action of deepening insolvency because other available claims against the company's directors and officers covered the same ground, and the theory of such a claim was contrary to the business judgment rule and the traditional concept of allowing insolvent businesses to continue operating in an effort to turn around their operations rather than immediately liquidating.
- 3 *In re Foamex Int'l, Inc.***, 368 B.R. 383 (Bankr. D. Del. 2007)
Landlord's claim for damages arising from debtors' breach of a repair and maintenance lease covenant was not a separate claim and was limited by the statutory cap resulting from the debtors' rejection of the lease.
- 4 *In re Nat'l Gas Distrib., LLC***, 369 B.R. 884 (Bankr. E.D.N.C. 2007)
Debtor—natural gas company's contract with a customer was not a "swap agreement" under the Bankruptcy Code, and thus, not entitled to protection from avoidance claims. The contract was not traded on a financial market and only the bankruptcy estate and customer were affected by the trustee's fraudulent transfer claims.
- 5 *In re Sophisticated Communications, Inc.***, 369 B.R. 689 (Bankr. S.D. Fla. 2007)
Bank's application of funds collected on a customer's deposit for which the customer was given provisional credit at the time of deposit was not a transfer on account of an "antecedent debt" for preference purposes, unlike a transfer that cured "ledger balance overdrafts" resulting from bank's allowing the debtor to use funds in excess of the amount in its account based on a promise to deposit funds in the future.
- 6 *In re Qmect, Inc.***, 368 B.R. 882 (Bankr. N.D. Cal. 2007)
Unsecured creditor was entitled to include a contractual claim for postpetition attorneys' fees in its proof of claim.
- 7 *In re Whispering Pines Estates, Inc.***, 370 B.R. 452 (B.A.P. 1st Cir. 2007)
Plan that released a creditor, who was to implement a plan by liquidating the debtor's assets, from liability for gross negligence or willful misconduct was too broad and could not be confirmed.
- 8 *In re Dexterity Surgical, Inc.***, 365 B.R. 690 (Bankr. S.D. Tex. 2007)
Minority shareholders' prepetition claims against the majority shareholder and debtor's officers and directors for fraud, civil conspiracy, and breach of fiduciary duty, which were based on allegations of corporate looting, were derivative in nature under Delaware law and belonged to the bankruptcy estate.
- 9 *In re Dana Corp.***, 367 B.R. 409 (Bankr. S.D.N.Y. 2007)
Notwithstanding deletion of the reference to state law in the statutory provision referencing reclamation rights, BAPCPA did not create a new, independent federal right of reclamation.
- 10 *In re Nat'l Energy & Gas Transmission, Inc.***, 492 F.3d 297 (4th Cir. 2007)
Where a creditor had recovered the full value of the debt, as of the petition date, from a nondebtor guarantor, it could not recover \$17 million from the debtors as unpaid principal by reason of its allocation of the guarantor payment first to interest and then to principal. The Section 502(b)(2) bar to the recovery of unmatured interest was not overcome by the creditor's classification of the payment.
- 11 *In re SPhinX, Ltd.***, 371 B.R. 10 (S.D.N.Y. 2007)
Cayman Islands winding-up proceeding was properly recognized only as a "foreign nonmain proceeding," and the statutory presumption that a foreign debtor's center of main interests was where its registered office was located was rebutted by objective factors, including evidence of forum shopping and intent to frustrate a court-approved settlement.
- 12 *In re Newlin***, 370 B.R. 870 (Bankr. M.D. Ga. 2007)
Chapter 7 trustee's failure to timely assume a partnership agreement resulted in a deemed rejection and precluded the trustee's enforcement of a provision that required the partner to buy out the debtor's interest.
- 13 *In re The 1031 Tax Group, LLC***, 374 B.R. 78 (Bankr. S.D.N.Y. 2007)
Where new management, having no prior association with the debtors or their principal, was appointed shortly before the petition was filed, was irrevocably delegated full management authority, and consisted of experienced, qualified professionals, "cause" did not exist for appointment of a Chapter 11 trustee despite allegations of fraud and diversion of funds against the debtors' principal.
- 14 *In re Brown & Cole Stores, LLC***, 2007 WL 2701283 (B.A.P. 9th Cir. 2007)
Supplier to debtor was entitled to an administrative expense claim under section 503(b)(9) for the value of goods received by the debtor in the ordinary course of business within a 20-day period prior to the filing of the petition, even where the supplier was secured.