

AMERICAN BANKRUPTCY INSTITUTE JOURNAL

Issues and Information for Today's Busy Insolvency Professional

No Court Approval Needed for Creditor Seeking Equitable Subordination of Another's Claim

Written by:

Andrew Rosenblatt
Chadbourne & Parke LLP; New York
arosenblatt@chadbourne.com

In *Algonquin Power Income Fund v. Ridgewood Heights Inc.*, 2007 Bankr. LEXIS 3004 (Bankr. N.D.N.Y. Aug. 30, 2007), the U.S. Bankruptcy Court for the Northern District of New York addressed the issue of whether a creditor has standing to prosecute an equitable subordination action against another creditor without first obtaining approval from the bankruptcy court. The court held that a creditor does have such standing. The court determined that: (1) equitable subordination claims arising under §510(c) of the Bankruptcy Code, unlike avoidance claims arising under §§547 and 548 of the Code, are not claims belonging to the estate; and (2) the concerns necessitating bankruptcy court approval before a creditors' committee may bring an equitable subordination claim do not exist for individual creditors.



Andrew Rosenblatt

Equitable Subordination

Equitable subordination, codified in §510(c) of the Code, is an equitable and extraordinary remedy that permits a court "to 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." In general, equitable subordination applies only when a claimant has engaged in some type of inequitable conduct and the misconduct has resulted in injury to creditors or equity holders or has conferred an unfair advantage on the claimant. The most common scenarios when equitable

About the Author

Andrew Rosenblatt is counsel in the Bankruptcy and Financial Restructuring Group of Chadbourne & Parke LLP in the firm's New York office, where he advises debtors, secured and unsecured creditors and other parties in interest in bankruptcy cases, workouts and cross-border ancillary proceedings.

subordination is appropriate are the following: (1) when a fiduciary of the debtor misuses its position to the disadvantage of other creditors; (2) when a third party controls the debtor to the disadvantage of other creditors; and (3) when a third party actually defrauds other creditors.

Courts have disagreed on which parties have standing to assert equitable-subordination actions. Some courts have held that equitable subordination is a

claims recharacterized as equity contributions as opposed to debt and (3) subordinate the claims to the claims of all other unsecured creditors.

In support of their claims, the plaintiffs alleged that: (1) the insider debt was not reflected on the debtors' books and records; (2) the insider debt was incurred in violation of the prepetition financing documents that prohibited the incurrence of additional indebtedness; (3) the debtors knowingly misrepresented that they owed no debt for borrowed money; (4) the debtors concealed the existence and extent of the insider claims from the debtors' lenders; and (5) the debtors were undercapitalized at the time the insider debt was allegedly incurred. The defendants filed a motion to dismiss the adversary proceeding on several grounds, including that the plaintiffs lacked standing to bring the action. The defendants argued that in bringing the subordination claim, the

Claims Chat

creditor's claim, while other courts have held that subordination is strictly the estate's claim. In the latter situation, therefore, a creditor (or creditors' committee) may have standing, but only after obtaining court approval when a debtor-in-possession or trustee has unjustifiably declined to act.

Case Background

In *Algonquin*, the debtors' prepetition lenders (the plaintiffs) commenced an adversary proceeding against certain of the debtors' affiliates and insiders (the defendants) seeking to challenge the insiders' intercompany claims, all of which appeared on the debtors' schedules as valid claims. Specifically, the plaintiffs sought to (1) expunge the insider claims, (2) have the

plaintiffs were acting in a representative capacity and lacked standing to bring the claim because they failed to obtain authority from the bankruptcy court to act on behalf of the other unsecured creditors.

In support of their position, the defendants relied on cases for the proposition that claims for equitable subordination must be brought by a trustee or debtor-in-possession as a representative of the estate. The defendants then argued that an adversary proceeding commenced by a party in a representative capacity cannot be maintained without (1) the unjustifiable refusal of the trustee or debtor-in-possession (DIP) to bring the suit and (2) court approval to act as a representative after the party seeking to act has moved the court for permission to do so.

The plaintiffs countered by arguing that it would have been futile to have requested the debtors to commence the adversary proceeding given that the defendants were affiliates of the debtors and that the debtors, in their bankruptcy papers, had already conceded the validity of the defendants' claims. The plaintiffs also argued that the cases relied on by the defendants were distinguishable and not relevant to the facts at hand because they involved avoidance claims (*i.e.*, preference and fraudulent conveyance claims under §§547 and 548 of the Code) which, pursuant to the Code, belong to the trustee or DIP. The plaintiffs noted that, unlike §§547 and 548 of the Code, the language of §510(c) of the Code does not provide that equitable subordination claims belong to the estate.

Ruling

The bankruptcy court adopted the plaintiffs' position and denied the defendants' motion to dismiss. First, the bankruptcy court rejected the defendants' position that the plaintiffs were acting in a representative capacity. The bankruptcy court made this determination despite the fact that the plaintiffs sought to subordinate the defendants' claims to those of all other unsecured creditors. In support of this finding, the bankruptcy court adopted the reasoning set forth by the Seventh Circuit Court of Appeals in *In re Vitreous Steel Prods. Co.*, 911 F.2d 1223 (7th Cir. 1990), that equitable subordination is not a benefit to all unsecured creditors equally (in particular the creditor whose claim is objected to) and therefore, a creditor that seeks equitable subordination is not necessarily acting in the interests of all unsecured creditors.

The bankruptcy court then rejected the notion that a creditor must seek court approval before bringing an equitable-subordination claim. In reaching this conclusion, the bankruptcy court distinguished cases involving avoidance actions, which are estate claims that require prior court approval. In support for its holding, the bankruptcy court relied on a recent decision from the Eighth Circuit Bankruptcy Appellate Panel in *In re Racing Services Inc.*, 363 B.R. 911 (8th Cir. B.A.P.N.D. 2007), which held that although a creditor must seek authority in order to have derivative standing to assert an avoidance action on behalf of the estate, a creditor is under no obligation to seek court authority to assert a subrogation claim. The court's reasoning was based on the language of §510(c), which contains no restrictions on who may request the subordination of a claim.

Finally, the bankruptcy court distinguished a recent case decided by the Second Circuit Court of Appeals in *In re AppliedTheory Corp.*, 493 F.3d 82 (2d Cir. 2007), which held that a creditors' committee must seek court approval before bringing an equitable subordination action against a creditor. The bankruptcy court held that the Second Circuit's rationale for requiring bankruptcy court approval before a creditors' committee can commence a subordination action does not apply to individual creditors. Specifically, the bankruptcy court noted that unlike litigation commenced by a committee, which is funded out of the limited resources of the estate, litigation commenced by an individual will rarely be funded by the estate. Accordingly, the bankruptcy court reasoned that cost monitoring and other administrative concerns relevant to a creditors' committee are not implicated when dealing with an individual creditor. In short, the bankruptcy court held that the Second Circuit's ruling was limited to creditors' committees and did not provide a basis for denying the plaintiffs the right to pursue the subordination action.

Conclusion

Although the bankruptcy court's ruling only addressed the narrow issue of whether a creditor has standing to assert a subordination claim against another creditor without prior court approval, the holding raises questions that could have far-reaching implications. For example, in rejecting the notion that equitable subordination claims reflect generalized harm to all creditors and must be brought in a representative capacity, has the bankruptcy court implicitly held that debtors do not have standing to assert a subordination claim? It is well established that a trustee in bankruptcy may only pursue claims that belong to the estate itself and has no standing to sue third parties for injuries to the estate's creditors. If *Algonquin* can be interpreted as standing for the proposition that equitable subordination claims should be considered solely creditor claims, then that may preclude a debtor or trustee from asserting a subordination claim. If the answer is that both debtors and creditors have standing to assert subordination claims, then that could lead to administrative and procedural problems.

In short, *Algonquin* may have generated more questions than it answers. Given the lack of any bright-line rule, the issue of creditor standing to assert an equitable subordination claim may be the subject matter of future bankruptcy litigation. ■

Reprinted with permission from the ABI Journal, Vol. XXVII, No. 9, November 2008.

The American Bankruptcy Institute is a multi-disciplinary, nonpartisan organization devoted to bankruptcy issues. ABI has more than 11,500 members, representing all facets of the insolvency field. For more information, visit ABI World at www.abiworld.org.