

New Jersey Law Journal

VOL. CLXXXIII – NO. 10 – INDEX 795

MARCH 6, 2006

ESTABLISHED 1878

BANKRUPTCY LAW

Lender's Insider Status Does Not Reclassify Debt

Third Circuit decision confirms that reclassification and equitable subordination are not liberally employed

By Stephen V. Falanga

A central tenet of the Bankruptcy Code is to ensure equality of distribution among similarly situated creditors. Indeed, this goal is premised upon the fact that the typical bankruptcy case revolves around the adjustment of competing claims against a debtor's often limited assets.

One of the ways the Bankruptcy Code seeks to ensure equality of distribution is by empowering bankruptcy courts, through the use of the court's equitable powers, to recharacterize the nature of debts to ensure that form will not be elevated over substance. A corollary to this power is the codified right of bankruptcy courts to equitably subordinate claims of creditors under Section 510(c) of the Bankruptcy Code.

While reclassification and equitable subordination are powerful remedies, they are not employed liberally — even in the case of secured creditors of the debtor who are deemed insiders. As the Third Circuit's recent decision in *Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Systems Corporation, Inc., 432 F.3d 448 (3rd Cir. 2006)*, makes clear, a claimant seeking to recharacterize or equitably subordinate an insider's

secured claim still bears the burden of establishing every necessary element by a preponderance of the evidence.

The Third Circuit's holding in *SubMicron* is significant given the secured claims at issue were held by a lending group that comprised the debtor's largest secured creditor and which also came to control three of four seats on the debtor's board of directors. The secured lender independently negotiated a deal with a third party to acquire the assets of the debtor and under the deal, the secured lender received an equity stake in the acquiring company in exchange for the secured lender credit-bidding its claims against the purchase price at the § 363 sale.

After the sale, the plan administrator for the debtor brought an action on behalf of unsecured creditors seeking reclassification and equitable subordination of a portion of the secured lender's claims. In addressing the plan administrator's claims, the Third Circuit held that a claim of reclassification must always be decided prior to the issue of equitable subordination, concluding that if a particular obligation of the debtor is deemed to be equity as opposed to debt, the issue of equitable subordination never needs to be addressed. The Third Circuit also made clear that it is important "to distinguish reclassification from equitable subor-

dination" because they "address distinct concerns."

As the Third Circuit reasoned, equitable subordination is proper when equity demands that the payment priority of claims of an otherwise legitimate creditor be changed to fall behind those of other claimants. The purpose of the recharacterization inquiry, on the other hand, is whether a debt exists at all. In so ruling, the Third Circuit joined the Sixth Circuit in concluding that the issues of recharacterization of debt and equitable subordination must be treated separately in any application.

In *SubMicron*, the secured creditors, after having already made several series of loans to keep the debtor viable, made two additional loans totaling over \$11 million. The plan administrator contended that the additional financing should be recharacterized as an infusion of an equity investment, arguing that the debtor's "dire financial circumstances surrounding the infusion" supported an equity characterization.

In rejecting the plan administrator's recharacterization argument, the Third Circuit noted that courts have utilized a variety of multifactor tests for resolving recharacterization claims, adopted from nonbankruptcy case law. While the Third Circuit recognized the importance of these tests, it ultimately concluded that there is no "mechanistic scorecard"

Falanga is with Connell Foley of Roseland.

that suffices in completely addressing reclassification arguments, noting somewhat remarkably that “Kabuki outcomes elude difficult fact patterns.”

According to the Third Circuit, the nature of the inquiry is an attempt by the court to discern whether the parties called an instrument one thing when in fact they intended it as something else. As the Third Circuit recognized, this intent can be ascertained “from what the parties say in their contracts, from what they do through their actions, and from the economic reality of the surrounding circumstances.”

The overarching conclusion of the Third Circuit was that the “answers lie in facts that confer context on a case by case basis.” In so finding, the Third Circuit joined the Sixth and Ninth Circuits in concluding that a reclassification determination is a question of fact not a conclusion of law, which once resolved by a district court cannot be overturned on appeal unless the finding was clearly erroneous.

In *SubMicron*, the Third Circuit agreed with the district court that the nature of the additional loans was debt, noting particularly that the additional fundings had fixed maturity dates and interest rates and were independently disclosed as debt in the debtor’s 10Q SEC filings and in UCC financing statements. Moreover, the debtor’s financial circumstances at the time the additional loans were made, while material to the inquiry, was ruled not determinative given that “when existing lenders make loans to a distressed company, they are trying to protect their existing loans and traditional factors that lenders consider ... do not apply as they would when lending to a financially healthy company.”

Finally, the Third Circuit dismissed the plan administrator’s contention that the secured creditor’s control of the debtor’s board was sufficient to support an equity recharacterization, noting that the district court relied upon expert tes-

timony which concluded that it was not unusual for lenders to have board representatives, particularly when a company is in distress.

The Third Circuit also dispatched with the plan administrator’s claim that the secured lender’s debt should be equitably subordinated to the claims of unsecured creditors concluding that because there had been no demonstrated harm arising from the conduct of the secured lender in arranging the sale, there could be no equitable subordination.

The doctrine of equitable subordination has its statutory basis in Section 510(c) of the Bankruptcy Code, which, in pertinent part, provides that 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.

Although the doctrine of equitable subordination can be applied to any claimant, it is generally recognized that the claims of insiders are subject to greater scrutiny because of their close relationship with the debtor. However, merely being an insider or controlling the debtor will not, standing alone, provide an adequate basis for subordination. Instead, it is the unconscionable use of that status to the detriment of other creditors of the debtor that governs whether subordination is appropriate.

Relying principally upon its earlier decision in *Citicorp Venture Capital, Ltd. v. Committee of Creditors (In re Papercraft)*, 160 F. 3d 982 (3d Cir. 1998), the Third Circuit recognized that before ordering equitable subordination most courts require a showing that the claimant has engaged in some type of inequitable conduct that has resulted in injury to the creditors of the debtor or conferred an unfair advantage on the claimant.

Agreeing with the district court that the doctrine of equitable subordination

“is remedial, not penal,” and therefore should have applicability only in those situations where the alleged inequitable conduct has rendered specific harm to creditors, the Third Circuit held that the record supported the district court’s conclusion that unsecured creditors were not disadvantaged or harmed by the sale of the assets.

As the district court noted, but for the additional funding, the debtor would have been forced to liquidate, leaving unsecured creditors with nothing. Furthermore, the record demonstrated that there were no other parties interested in acquiring the debtor’s assets at the time of the auction sale and the deal put together by the secured lenders was a deal of “last resort” for a company that had aggressively sought other suitors.

Finally, although plan administrator argued that the secured creditor had breached its fiduciary duties by controlling the board in connection with sale, the Third Circuit noted the plan administrator failed to offer any compelling evidence in support of this contention. In any event, because the court agreed with the district court’s finding that no harm had resulted from the secured lender’s action in arranging the sale of the debtor’s assets, the Third Circuit declined to rule on the issue of whether a showing of inequitable conduct was necessary, recognizing that it had previously ruled that was not a requirement in all cases.

Overall, the Third Circuit’s decision in *SubMicron* should give some level of comfort to a secured lender that appoints members to a borrower’s board of directors. Even in a situation where the lender controls the board, reclassification and equitable subordination claims will not be sustained in the absence of a demonstrated showing that the lender’s debt was intended to be an equitable contribution or that a lender’s actions resulted in identifiable harm to creditors. ■