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Lenders Beware: The Threat of Equitable Subordination in Bankruptcy Cases

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Desperate times call for desperate measures, so in the next few years lenders are likely to see more threats by debtors, bankruptcy trustees or competing creditors to subordinate their claims. Section 510(c) of the Bankruptcy Code grants the bankruptcy courts authority to relegate certain creditors' claims to the 'bottom of the barrel' in terms of priority of payment under the "equitable subordination" doctrine. However, exactly what constitutes sufficient grounds for equitable subordination in a particular case remains the subject of much dispute. This uncertainty, combined with the potential for a lender to suffer a tremendous loss, is precisely what makes the threat of equitable subordination so daunting in many cases.

In a successful equitable subordination action, all or part of any secured or unsecured claim may be subordinated. For example, a senior secured claim might be subordinated to a junior secured claim, or if a secured creditor's conduct was particularly egregious, the court may subordinate a secured claim to the claims of all the debtor's general unsecured creditors. In effect, the theory of equitable subordination allows a court to strip a secured creditor of all validly perfected lien rights.

The requirements for determining whether equitable subordination is merited have been summarized as follows:

1. The offending creditor must have engaged in some type of inequitable conduct;
2. The misconduct must have resulted in injury to the creditors of the debtor or conferred an unfair advantage on the offending creditor; and
3. Equitable subordination must not be inconsistent with other provisions of the Bankruptcy Code.

Most equitable subordination cases involve attempts to subordinate the claims of inside creditors of the debtor (those with a close relationship and/or control over the debtor) when the insiders have allegedly breached their fiduciary duties, become alter egos of their companies or undercapitalized their businesses. Subjecting insider dealings to scrutiny is not uncommon, but when the claims of third-party creditors unrelated to the debtor are the subject of equitable subordination attempts, misconduct can be like beauty – all in the eye of the beholder.

Furthermore, while it is generally accepted that evidence of egregious conduct such as fraud, spoliation or overreaching is required to support subordination of third-party claims, it is difficult to draw general lessons from these cases. One case from the Fifth Circuit Court of Appeals shows just how unpredictable the outcome in such cases can be.

In re Clark Pipe & Supply Co. involved a lender, Associates Commercial Corporation ("Associates"), whose credit line advances to the debtor were secured by a lien on the debtor's accounts and inventory. The loan documents signed by the debtor gave the lender the right to decrease the percentage of advances made on the credit line if the lender determined that the debtor was under financial strain. The lender decided to exercise this right pre-petition, and knowingly advanced a limited amount of funds that would enable the debtor to stay open for business and liquidate inventory (thereby generating accounts receivable that would be used to pay down the credit line due to the lender), but would not be sufficient to allow the debtor to pay its non-essential vendors and other creditors.

The trial court and first level appellate court both allowed equitable subordination of the lender's claim pursuant to Section 510(c). These courts reasoned that the lender had used the debtor as an instrumentality to maximize its own recovery to the detriment of other creditors. No doubt the courts were influenced by evidence of the crass attitude the lender had displayed about the liquidation. For instance, one Associates employee had stated "I want to get the absolute dollars as low as I can, by hook or crook."

Seeing its recovery prospects in the bankruptcy case dwindling, Associates appealed again to the Fifth Circuit Court of Appeals. Initially, the Court affirmed, harshly criticizing the lender for taking advantage of its position of power over the debtor. However, in response to Associates' petition for rehearing, the court surprisingly withdrew its earlier opinion and substituted a new opinion in which it refused to subordinate Associates' claim.

In this new opinion, the Court of Appeals acknowledged that the lender's actions were allowed pursuant to the loan documents, which were signed long before the bankruptcy case and had been approved by counsel for the debtor. The Court stated that the crucial distinction between what is inequitable and what a lender can reasonably and legitimately do to protect its interests is the distinction between the existence of control versus the exercise of that control to direct the activities of the debtor to the detriment of other creditors. Ultimately, the court found that Associates did not deserve subordination of its claim against the debtor because Associates did not take any of the following actions:

- Appreciably alter its procedures for calculating credit availability or reporting requirements when the debtor fell into financial difficulty;
- Contravene its loan agreement with the debtor;
- Make management decisions for the debtor;
- Instruct the debtor which creditors should and should not be paid from available funds;
- Place any of its employees as either a director or officer of the debtor;
- Influence the removal from office of any of the debtor's personnel;
- Request that the debtor take any particular action at a shareholders meeting;
- Get involved in handling the debtor's daily operations; or
- Mislead creditors to continue supplying the debtor with goods or services.

Despite the favorable decision in this case, In re Clark Pipe demonstrates the unpredictability of equitable subordination claims.

To add even more confusion, some courts have applied equitable subordination even in the absence of inequitable conduct. For example, pre-petition tax penalty claims by the IRS have been subordinated to the claims of other general unsecured creditors. In one such case, the appellate court stated that it was "persuaded by this overwhelming consistency in judgments rendered by the federal courts . . . that creditor misconduct is not a prerequisite for equitable subordination." The United States Supreme Court has cautioned against taking subordination too far, but it declined to say "whether a bankruptcy court must always find creditor misconduct before a claim may be equitably subordinated."

In light of these cases, it is clear that lenders should exercise extreme caution when wading into the murky waters of dealing with a distressed borrower. There appears to be a thin line between acceptable exercise of a lender's rights and conduct justifying subordination of a lender's claim, and the distinction will likely depend on a particular court's perspective and hindsight. Experienced creditors' counsel should be consulted to discuss how Section 510(c) has been applied in your jurisdiction.

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