ST. JOHN'S UNIVERSITY
SCHOOL OF LAW

Equitable Subordination- where is applies, what it does, and the Implications that result

2015 | Volume VII | No. 4

Equitable Subordination- where is applies, what it does, and the Implications that result

Lauren Casparie, J.D. Candidate 2016

Cite as: *Equitable Subordination- where is applies, what it does, and the Implications that result,* 7 ST. JOHN'S BANKR. RESEARCH LIBR. NO. 4 (2015).

Introduction

Equitable subordination, as permitted under section 510(c)(1) of the Bankruptcy Code[1], provides the court the ability to reorganize creditor's debt in the light of any inequitable conduct.[2] The code gives courts the ability to subordinate the level of priority of a creditor's claim in light of any inequitable conduct committed by that creditor.[3] This remedy is applied in cases where the creditor has acted in an inequitable manner, causing injury or creating unjust positions for other creditors.[4] This remedy is remedial, not punitive, and limited only to the extent necessary to remedy the damage caused by the wrongdoing creditor.[5] Traditionally, equitable subordination was only applied in cases where the wrongdoing creditor was an insider, however, recently this remedy has been applied to all creditors.[6] In addition, equitable subordination was only applied in instances of fraud, but in recent years has been expanded to remedy all unfair and unjust conduct by creditors.[7]

---

[1] All code sections referred to in this article refer to the Bankruptcy Code.
[2] 11 U.S.C.A. § 510.
[3] 4-510 Collier on Bankruptcy P 510.01
[4] *Id.*; *In re 80 Nassau Associates*, 169 B.R. 832 (Bankr. S.D.N.Y. 1994).
[5] 4-510 Collier on Bankruptcy P 510.01
[6] *Id.*
[7] *In re 80 Nassau Associates*, 169 B.R. at 832.

Recently a creditor who breached the implied contract of good faith was found to have risen to the level of equitable subordination.[8] Specifically, in *In re LightSquared, Inc.*[9], a bankruptcy court equitably subordinated the claim of an entity that the founder, chairman of the board, and controlling shareholder of a competitor of the debtor created in order to circumvent a credit agreement's restrictions on transferring the debt to certain parties.[10] In particular, the court determined that the entity acted in bad conduct by breaching the implied covenant of good faith by (1) circumventing the credit agreement's restrictions and (2) delaying the closing of the entity's purchases of debt from other creditors.[11] Further, the court concluded that this conduct resulted in damage to the other creditors.[12] Accordingly, the court decided to equitably subordinate the entity's claim to the extent necessary to place the other creditors in the position they would have been in if not for the wrongdoing.[13]

This case is significant for creditors because their claims may now be equitably subordinated for conduct technically permitted under an agreement with the debtor. Creditor's need to take precautions to protect themselves in cases where their claims might be equitably subordinated because in the court's discretion their actions caused injury to other creditors. The courts recent broad application of the equitable subordination doctrine may lead to fewer dealings between creditors and debtors due to the fear of losing money.

This Article discusses the bankruptcy courts ability to equitable subordinate a creditor's claims. Part I of this Article discusses the requirements for equitable subordination. Part II discusses the situations in which a bankruptcy court applies equitable subordination, focusing on

---

[8] *In re* LightSquared Inc., 511 B.R. 253 (Bankr. S.D.N.Y. 2014).
[9] *Id*.
[10] *Id*. at 341.
[11] *Id*. at 360-61.
[12] *Id*.
[13] *In re LightSquared Inc*., 511 B.R. at

breach of the implied covenant of good faith as a reason for equitable subordinating a creditor's claims. Part III discusses the implications of applying an equitable subordination remedy in a bankruptcy proceeding.

I. Equitable Subordination Generally

Section 510(c)(1)[14] gives the court the power to subordinate claims, in whole or in part, under principles of equity.[15] In particular, the bankruptcy courts have the ability to invoke equitable principles to achieve fairness and justice in the reorganization process.[16] Under section 510(c), a bankruptcy court may adjust the priorities of creditor's claims and interests and subordinate all or part of a wrongdoing creditor's claim to receive a just result that restores the other affected creditors to the position they would have been in without the wrongdoing creditor's actions.[17]

In applying section 510(c)(1), many courts require a finding that the wrongdoing creditor engaged in inequitable conduct that resulted in injury to other creditors or led to an unfair advantage to the wrongdoing creditor.[18] Although the Supreme Court has declined to decide whether creditor misconduct is a prerequisite to the application of equitable subordination, such misconduct is almost always present in the cases they decide to equitably subordinate a creditor's claim.[19]

---

[14] 11 U.S.C.A. § 510
[15] *Id*.
[16] 4-510 Collier on Bankruptcy P 510.01; *In re Enron Corp.,* 333 B.R. 205, 221 (Bankr.S.D.N.Y.2005) (Gonzalez, J.) ("*In re Enron*") ("A bankruptcy court can subordinate any claim held by a creditor found to have engaged in inequitable conduct to achieve a 'just' result for the debtor's estate").
[17] 4-510 Collier on Bankruptcy P 510.01
[18] *Id*.
[19] *Id*.

Traditionally, the equitable subordination doctrine was only applied to insider claims.[20] Recent case law, however, has expanded the scope of the doctrine to apply to non-insider claims as well.[21] For example, in *In re 80 Nassau Associates*[22], the court equitably subordinated a non-insider's claim in order to remedy the creditor's unfair conduct that affected the claims of other creditors.[23] Importantly, the *80 Nassau Associates* court did not distinguish between insiders and non-insiders in its application of equitable subordination.[24]

Under the *Mobile Steel* test, the court will equitably subordinated a claim if, (1) the claimant engaged in some type of inequitable conduct[25]; (2) the misconduct resulted in injury to the creditors or conferred an unfair advantage on the claimant[26]; and (3) the equitable subordination of the claim is consistent with the provisions of the Bankruptcy Code.[27] The third prong is automatically met if the first two are satisfied.[28]

Under the first prong, the claimant must have engaged in some type of inequitable conduct.[29] Since section 510(c) does not explicitly state what constitutes sufficient inequitable conduct, many bankruptcy courts have developed case law that has determined the scope of the principles of equitable subordination.[30] For example, in *In re Adler, Coleman Clearing Corp.*,[31]

---

[20] *In re 80 Nassau Associates*, 169 B.R. 832 (Bankr. S.D.N.Y. 1994). Under section 101(31) of the Bankruptcy Code, insiders of a debtor corporation include (1) a director of the debtor, (2) a officer of the debtor, (3) a person in control of the debtor, (4) any partnership in which the debtor is a general partner, (5) any general partner of the debtor, or (6) any relative of a general partner, director, officer, or person in control of the debtor.
[21] *Id*.
[22] *In re 80 Nassau Associates*, 169 B.R. 832
[23] *Id*. at 840.
[24] *Id*. at 839.
[25] *Id*.
[26] *Id*.
[27] *In re 80 Nassau Associates*, 169 B.R. at 839.
[28] *Id*. ("The third prong of the *Mobile Steel* test acknowledges that equitable subordination cannot be used to alter the statutory scheme imposed by bankruptcy law. Accordingly, while a bankruptcy court can apply the equitable doctrine at its discretion, its power to subordinate an allowed claim is not boundless and courts cannot use equitable principles to disregard unambiguous statutory language of the Bankruptcy Code.")"
[29] *Mobile Steel Co.,* 563 F.2d 692, 700.
[30] 11 U.S.C.A. § 510.
[31] *In re Adler, Coleman Clearing Corp*., 277 B.R. 520 (Bankr. S.D.N.Y. 2002).

the court concluded that it would be inequitable for the creditor to benefit from his violation of security law on behalf of other creditors that resulted in an increase of his account.[32] The *Adler* court further stated that the validity of the creditor's claim does not affect the court's decision as to whether to equitably subordinate the claim.[33] In addition, the court in *80 Nassau Associates* opined the requisite that inequitable conduct is not limited to fraud, but includes any conduct that is brought about by one's own unconscionable, unjust, unfair, or foul conduct.[34] The court determined that the creditors conduct of deceiving debtors into believing that paying certain real estate taxes on their property would help restructure their mortgages was inequitable.[35]

Under the second prong, the misconduct must have injured the creditors of the debtor or resulted in an unfair advantage on the wrongdoer.[36] In particular the conduct must has caused the other creditors to receive less money than they would otherwise because of the misconduct.[37] This injury must have caused the general creditors to be less likely to collect their debts as a result of the alleged inequitable conduct.[38] The court has the discretion to determine the extent of the injury to the creditor or the unfair advantage to the claimant.[39] In exercising this discretion the court will consider other factors, including administrative convenience and the delay of a bankruptcy proceeding, historical considerations of equity, and the broad equitable principle that creditors should not disadvantage one another by legal delays.[40]

---

[32] *Id*.
[33] *Id*.
[34] *In re 80 Nassau Associates*, 169 B.R. at 837.
[35] *Id*.
[36] *Mobile Steel,* 563 F.2d at 700.
[37] *Id*.
[38] *Id*.
[39] *In re Enron Corp*., 333 B.R. at 218.
[40] *Id*.

If the court determines the creditor has satisfied the *Mobile Steel* test, the court must then decide what extent to equitably subordinate the claim.[41] A claim should only be subordinated to the extent necessary to offset the harm caused by the inequitable conduct.[42] Accordingly, equitable subordination is remedial, not a penal in nature and therefore should be used sparingly.[43] It is designed to undo or offset the affects of the creditor's inequitable conduct that produces injustice or unfairness.[44]

Furthermore, the court in *Enron Corp. v. Ave. Special Situations Fund II, LP* (*In re Enron Corp.*)[45] determined that any claim may be equitably subordinated if doing so is necessary to effectuate the remedy set forth in section 510(c).[46] The court held that although the creditor had not engaged in unlawful conduct by transferring debt under the credit agreement, the claims of the creditor should nevertheless be equitable subordinated.[47] The court opined that the transferring of debt was used solely to escape responsibility and therefore injured other creditors by leaving them to hold the blame.[48] The *Enron* court further stated that inequitable conduct is considered anything that will allow fraud to prevail and will prevent substantial justice from being done.[49] The court held that the application of the *Mobile Steel* test ensures that the remedy of equitable subordination is available, while making certain that its reach does not go too far as to violate any provision of the Bankruptcy Code or make the remedy punitive instead of

---

[41] *Mobile Steel,* 563 F.2d at 700.
[42] *Id*.
[43] *In re Enron Corp*., 333 B.R. at 218.
[44] *Id*
[45] *Enron Corp. v. Ave. Special Situations Fund II, LP* (In re Enron Corp.), 333 B.R. 205 (Bankr. S.D.N.Y. 2005).
[46] *Id*. at 217-19.
[47] *In re Enron Corp.,* 333 B.R. at 237.
[48] *Id*.
[49] *Id*.

remedial.[50] One recent case that has further expanded the reach of equitable subordination is *In re LightSquared*.[51]

II. *In re LightSquared* – Expanding Equitable Subordination

In *LightSquared*, the court held a creditor's claims should be equitably subordinated because the creditor had breached the implied covenant of good faith of a credit agreement by acquiring restricted debt and caused harm to other claimants by delaying the closing of the sales of restricted debt.[52] In *LightSquared*, the debtor entered into a credit agreement that restricted transferring the debt to certain disqualified companies and all natural persons.[53] When a competitor company inquired about purchasing the debt, it discovered that the agreement's schedules listed competitor as a disqualified company.[54] Since the competitor could not purchase the debt directly, its controlling shareholder formed an investment vehicle for the exclusive purpose of buying the debt, thereby circumventing the credit agreement's restrictions on transferring the debt, in order to give the competitor effective control over the debtor's reorganization.[55]

---

[50] *Id*. at 219.
[51] *In re* LightSquared Inc., 511 B.R. 253 (Bankr. S.D.N.Y. 2014).
[52] *Id*. 361.
[53] *Id*. at 267- 68 ("The Credit Agreement restricts transfers of the LP Debt. Section 10.04(a) of the Credit Agreement provides, in pertinent part:

> [N]o Lender may assign or otherwise transfer any of its rights or obligations hereunder except (i) to an Eligible Assignee in accordance with the provisions of paragraph (b) of this *Section 10.04,* (ii) by way of participation in accordance with the provisions of paragraph (d) of this *Section 10.04* or (iii) by way of pledge or assignment of a security interest subject to the restrictions of paragraph (f) of this Section (and any other attempted assignment or transfer by Borrower shall be null and void)."

[54] *Id*. at 269 ("Disqualified Company" is defined in Section 1.01 as follows:

> [A]ny operating company which is a direct competitor of the Borrower identified to the Administrative Agent in writing prior to the Closing Date and set forth on *Schedule 1.01(a),* and thereafter, upon the consent of the Administrative Agent ... such additional bona fide operating companies which are direct competitors of the Borrower as may be identified to the Administrative Agent from time to time and notified to the Lenders. A Disqualified Company will include any known subsidiary thereof.").

[55] *Id*.

The investment vehicle was under capitalized, resulting in the controlling shareholder funding multiple purchases by transferring money from his personal account.[56] While the controlling shareholder always had enough money to cover his purchases, he would delay closing the multiple purchases because the vehicle had the right to vote the debt before the transactions closed.[57] The controlling shareholder submitted a bid to purchase the debtor that would have resulted in the creditor being paid in full and an additional significant profit.[58] Subsequently, after the investment vehicle blocked the debtors attempted to reorganizing, the debtor filed for bankruptcy under chapter 11 of the Bankruptcy Code.[59]

Approximately a year after the debtor filed, one of the debtor's major shareholders commenced an adversary proceeding against, amongst others, the competitor, the investment vehicle, and the controlling shareholder, alleging multiple causes of action arising out of the debt purchases.[60] Subsequently, the debtor intervened in the adversary proceeding and filed a complaint asserting numerous causes of action against the defendants.[61] In response to the debtor's complaint, the defendants each moved to dismiss the complaint.[62] In addition, the investment vehicle also moved to dismiss the major shareholder's complaint.[63] The bankruptcy court then dismissed all of the claims asserted by a major shareholder, except its claim seeking to disallow an investment vehicle's claim under section 502(b).[64] With respect to the debtor's claims, the court only dismissed the debtor's equitable disallowance claim and its tortuous

[56] *In re* LightSquared Inc., 511 B.R. at 277.
[57] *Id*.
[58] *Id*.
[59] *Id*. at 262-63.
[60] *Id*. at 263.
[61] *In re* LightSquared Inc., 511 B.R. at 263.
[62] *Id*.
[63] *Id*.
[64] *Id*.

interference claim against the investment vehicle.[65] The bankruptcy court then held a trial with respect to the remaining causes of action.[66]

With respect to the equitable subordination claim the court applied the *Mobile Steel* test.[67] Under the first prong, the bankruptcy court found that the investment vehicle engaged in inequitable conduct by purchasing the debt thereby breaching the covenant of good faith and delaying the closing of the transactions.[68] The investment vehicles purchase of the debt violated the purpose of the credit agreement's restrictions to prevent competitors from acquiring the debt.[69] Along with the investment vehicle's inequitable conduct in acquiring the debt, the creditor engaged in inequitable conduct by effectively delaying hundreds of millions of dollars of debt.[70] The creditor engaged in such actions even though he was faced with repeated demands to close and had the funds necessary to close readily available.[71]

Under the second prong, the investment vehicles delay in the closing the purchases of the debt resulted in harm to other creditors because it was done for no specific purpose and prevented other creditors from using the money as they desired.[72] Therefore, the investment vehicle's inequitable conduct inflicted unquantified harm on the other creditors as a result of the delay, uncertainty, and increased administrative costs to those creditors.[73] The court determined that the other creditors were harmed by the conduct, but did not determine the amount of the harm.[74] Therefore the court decided to equitable subordinated, but elected that the amount be

---

[65] *Id*. at 264.
[66] *In re* LightSquared Inc., 511 B.R. at 263.
[67] *Mobile Steel,* 563 F.2d at 700.
[68] *In re LightSquared Inc*., 511 B.R. at 341.
[69] *Id*.
[70] *Id*
[71] *Id*.
[72] *Id*. 360-61.
[73] *In re LightSquared Inc*., 511 B.R. at 360-61.
[74] *Id*.

determined later.[75] The issue however, was rendered moot because of the bankruptcy court's plan to sell the creditor's assets.[76] Therefore, not withstanding the court's previous ruling, the debt will not be equitably subordinated as previously decided.[77]

III. Implications of this Expanded Application of Equitable Subordination

Equitable subordination provides the court with a significant and powerful ability to remedy the inequitable conduct of a creditor prior to or during the misconduct. In particular, the remedy protects other creditors from being harmed by such conduct. The remedy of equitable subordination is applied in cases where the creditor's misconduct has produced an unfair advantage for himself and has harmed other creditors. This is a remedial remedy that should be applied very sparingly in bankruptcy courts. Moreover, it is remedial in nature and not punitive, as such the harm of the injured creditors will only be remedied to the extent necessary to restore the injured creditors to the position they would have been in if the conduct had not occurred. It is only designed to protect creditor's who have been harmed by inequitable behavior on the part of another creditor.

While equitable subordination it is traditionally only applied in fraud, it is now applied to many other types of conduct that courts find inequitable. As such creditors should be careful in the actions they take in purchasing debt. *LightSquared,* for example, is important because it demonstrated that competitors should be concerned about gaining a strategic advantage over the

[75] *Id*.
[76] Motion for Order Authorizing LightSquared to File Under Seal Portions of Exhibits Attached to LightSquared's Motion for Entry of Order, Pursuant to 11 U.S.C. §§ 105(a) and 363, Authorizing LightSquared to (A) Enter Into and Perform Under Letters Related to $1,515,000,000 Second Lien Exit Financing Arrangements, (B) Pay Fees and Expenses in Connection Therewith, and (C) Provide Related Indemnities, *In re LightSquared*, 511 B.R. 253 (Bankr. S.D.N.Y. 2014) (No. 12-12080 (SCC)).
[77] *Id*. In applying each of the prongs from the *Mobile Steel* test, the court decided to equitably subordinate the investment vehicle's claim in an amount to be determined later. However, the bankruptcy court subsequently confirmed a chapter 11 plan that would sell the debtor's assets from the competitor and repay in full the investment vehicle. As a result, Controlling shareholder will receive 1.5 billion dollars for his shares and control over the company. Therefore, the investment vehicle's claim notwithstanding the courts previous ruling will not be equitably subordinated as previously held.

debtor to acquire its debt. In particular, if you circumvent ownership restrictions in the credit agreement, the creditor risks having all or part of its debt subordinated. Which in turn will impair its apply to effectuate its desired results. Since equitable subordination can lead to drastic outcomes, such as losing all or part of your claim, creditor's need to be careful in the actions they take in acquiring debt.

The court also demonstrates the subsequent actions that the creditor can take to buy his way out. In *LightSquared*, the creditor was able to reach an agreement with the debtor to give up ownership of his claims to avoid them from being equitably subordinated. Even if the court finds it is inequitable conduct the debtor and the creditor can reach a consensual agreement that resolves the equitable subordination claim in a way such that each party benefits.

LightSquared is also significant because it demonstrates the need to carefully draft a credit agreement in such a way that minimizes the ability of third party to circumvent the agreement's restrictions on transferring the debt. For example, in *LightSquared*, the credit agreement included the undefined term subsidiary in the definition of "Disqualified Company," which was not broad enough to include the investment entity under the definition a "Disqualified Company" because the competitor did not own the investment entity. By failing to include the defined term "Affiliate" in the definition of "Disqualified Company," the credit agreement failed to prohibit the transfer of debt to an entity under common control with a Disqualified Company. Accordingly, had the credit agreement included Affiliate in the definition of Disqualified Company, the investment entity would have qualified as a Disqualified Company because the investment entity and the competitor were under the common control of the shareholder. Additionally, a borrower should attempt to protect itself by including a provision in the credit agreement that makes debt held by Disqualified Companies unenforceable, which would prevent

strategic purchase of the debt. Lenders, however, may not be willing to agree to such a term that could expose them to liability if they transfer the debt to a company that turns out to be ineligible.

If creditors and debtors have to start taking precautions and affirmative steps in their dealings, these dealings many begin to diminish. Bankruptcy courts need to be careful in applying the remedy of equitable subordination so broadly. Although these courts are only trying create fair dealings, their actions but may be eliminating deals altogether.

IV. Conclusion

Bankruptcy courts may equitably subordinate in cases where the creditor has engaged in inequitable conduct that injuries the other creditors or provides an unfair advantage to the offending creditor. The bankruptcy court inquires whether the claimant must have engaged in some type of inequitable conduct that resulted in injury to the creditors or conferred an unfair advantage on the claimant and was consistent with the provisions of the Bankruptcy Code. If court finds that all requirements are meet they will equitably subordinate the claim of the creditor to the extent necessary to remedy the harm. Traditionally applied only in fraud cases, this remedy is now applied in all cases that result in harm to other creditors or an unjust benefit to the wrongdoing creditor. For example, been applied in breach of covenant of good faith. Among other reasons, creditor's need to take certain precautions when entering into agreements since the remedy of equitable subordination is becoming more widely applied. Creditors need to make sure that any action they take will not be considered bad faith or inequitable in the court's view.