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**Equitable Subordination of a Claim Depends on Insider Status, Conduct of the Claimant,
and if There was Harm**

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Introduction

Equitable subordination is a remedial doctrine pursuant to which a creditor's claim may be subordinated to other claims. The doctrine is designed to “undo or to offset any inequality in the claim position of a creditor that will produce injustice or unfairness to other creditors in terms of the bankruptcy results.”¹ Equitable subordination is codified in section 510(c) of Title 11 of the United States Code (the “Bankruptcy Code”). Section 510(c) of the Bankruptcy Code “authorizes a bankruptcy court to ‘subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim.’”² The courts have uniformly adopted a three-part equitable subordination test.³

This memorandum explores what level of inequitable conduct and harm allows a court to subordinate a claim under section 510(c). Part I describes the three-part test applied by courts

¹ *Citicorp Venture Cap., Ltd. v. Comm. of Creditors Holding Unsecured Claims*, 323 F.3d 228, 233 (3d Cir. 2003) (citing *Burden v. U.S. (In re Burden)*, 917 F.2d 115, 117 (3d Cir. 1990)).

² *In re HH Liquidation, LLC*, 590 B.R. 211, 298 (Bankr. D. Del. 2018) (quoting 11 U.S.C. § 510(c)).

³ See *U.S. v. Noland*, 517 U.S. 535, 539, 116 (1996) (“The district courts and courts of appeals have generally followed the Mobile Steel formulation.”).

when analyzing a request to equitably subordinate a claim. Part II analyzes what constitutes inequitable conduct. Part III explores when inequitable conduct actually causes an injury to another creditor or confers an unfair advantage on the claimant.

Discussion

I. The Equitable Subordination Test is Uniform.

Section 510(c)(1) of the Bankruptcy Code provides “[a 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 or all or part of an allowed interest to all or part of another allowed interest.”⁴ The equitable subordination test was created by the Fifth Circuit in *Benjamin v. Diamond*, which has been cited with approval by the Supreme Court and uniformly adopted by other courts.⁵ A court will generally subordinate a claim if a party demonstrates that (1) the claimant engaged in some type of inequitable conduct; (2) the misconduct resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; and (3) equitable subordination of the claim would not be inconsistent with the provisions of the Bankruptcy Code.⁶ The third element, “has been read as a ‘reminder to the bankruptcy court that although it is a court of equity, it is not free to adjust the legally valid claim of an innocent party who asserts the claim in good faith merely because the court perceives that the result is inequitable.’”⁷ All the elements of equitable subordination are required in order for a court to equitably subordinate a claim.⁸

⁴ 11 U.S.C. § 510 (2018).

⁵ *Benjamin v. Diamond (In re Mobile Steel Co.)*, 563 F.2d 692, 699-700 (5th Cir. 1977); see *Noland*, 517 U.S. at 538-39.

⁶ *Shubert v. Lucent Techs. Inc (In re Winstar Commc’ns, Inc.)*, 554 F.3d 382, 411 (3d Cir. 2009).

⁷ *Noland*, 517 U.S. at 539 (quoting Andrew DeNatale, Prudence B. Abram, *The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors*, 40 BUS. LAW. 417, 428 (1985)).

⁸ See *In re Mid-Am. Waste Sys.*, 284 B.R. 53, 71 (Bankr. D. Del. 2002).

Finding Inequitable Conduct Depends on the Level of Scrutiny the Court Applies.

A. Insider Status Determines the Level of Scrutiny a Court Applies and Changes the Burden in Most Jurisdictions.

In a majority of jurisdictions, the level of scrutiny a court applies depends upon whether the claimant is an insider.⁹ “Insider” is defined in the Bankruptcy Code and includes a director of a corporation, an officer of a corporation, a person in control of the debtor, and a relative of a general partner, director, officer, or person in control of the debtor.¹⁰ However, the list is not an exclusive list, and courts determine whether someone is an insider on a case-by-case basis.¹¹ Courts consider what level of control the claimant had in determining whether the claimant is an insider.¹² Generally, creditors do not have fiduciary responsibilities to their debtors and are therefore not insiders.¹³ However, “[w]here the creditor controls the corporate debtor by voting control of its stock, dominant influence in its management or ability otherwise to control its business affairs, the creditor may have a fiduciary duty to its corporate debtor” and could be considered an insider.¹⁴ In *N & D Properties*, a shareholder became an insider when she retained legal counsel to evaluate the company’s options and attempted to negotiate an extension of the debtor’s loans.¹⁵ In that case, a minority shareholder became an insider before she was even a director.¹⁶ In contrast, the court in *In re M. Paoella & Sons, Inc.* found that a creditor was not an insider because the creditor “did not participate in the debtor's management, determine its

⁹ See *Fabricators, Inc. v. Tech. Fabricators, Inc. (In re Fabricators, Inc.)*, 926 F.2d 1458, 1465 (5th Cir. 1991).

¹⁰ 11 U.S.C. 101(31).

¹¹ *In re Friedman*, 126 B.R. 63, 69 (B.A.P. 9th Cir. 1991); *In re M. Paoella & Sons, Inc.*, 161 B.R. 107, 118 (E.D. Pa. 1993).

¹² See *Estes v. N & D Props., Inc. (In re N & D Props., Inc.)*, 799 F.2d 726, 731 (11th Cir. 1986).

¹³ *In re Teltronics Servs., Inc.*, 29 B.R. 139, 170 (Bankr. E.D.N.Y. 1983).

¹⁴ *Id.* (quoting Margaret H. Douglas-Hamilton, *Creditor Liabilities Resulting from Improper Interference with the Management of a Financially Troubled Debtor*, 31 BUS. LAW. 343, 352, 365 (1975)).

¹⁵ *In re N & D Props.*, 799 F.2d at 732.

¹⁶ *Id.*

operating decisions, or have any presence on its board.”¹⁷ Although the claimant monitored the debtor’s business for the most opportune time to foreclose, the court found this did not constitute control of the debtor making the claimant an insider.¹⁸

In a majority of jurisdictions, insiders are subject to heightened scrutiny because they have a fiduciary duty to the debtor or they exercise some control over the debtor.¹⁹ Insiders are subject to heightened scrutiny when a party moves to equitably subordinate an insider’s claim.²⁰ Non-insiders are subject to less scrutiny, and a moving party must show more egregious conduct such as fraud, spoliation or overreaching, to meet the heightened standard of inequitable conduct for a non-insider.²¹ “For claims against insiders only, the party seeking to subordinate a claim bears the burden to show material evidence of inequitable conduct, but once inequitable conduct has been demonstrated, the claimant bears the burden of showing that the transaction was fair.”²² Unlike claims against insiders, the burden is always on the one seeking to subordinate the claim to prove the higher level of egregious conduct has occurred for non-insiders.²³

The Second Circuit Court of Appeals last heard an equitable subordination case in 1978, and the court did not address what level of inequitable conduct is necessary to subordinate a claim for insiders and non-insiders.²⁴ In the Southern District of New York, there is no

¹⁷ *In re M. Paoletta & Sons, Inc.*, 161 B.R. at 118.

¹⁸ *Id.*

¹⁹ See *Boyajian v. DeFusco (In re Giorgio)*, 862 F.2d 933, 939 (1st Cir. 1988); *Shubert v. Lucent Techs. Inc (In re Winstar Commc’ns., Inc.)*, 554 F.3d 382, 412 (3d Cir. 2009); *EEE Comm. Corp. v. Holmes (In re ASI Reactivation, Inc.)*, 934 F.2d 1315, 1323 (4th Cir. 1991); *Summit Coffee Co. v. Herby's Foods, Inc. (In re Herby's Foods)*, 2 F.3d 128, 131 (5th Cir. 1993); *First Nat'l Bank v. Rafoth (In re Baker & Getty Fin. Servs.)*, 974 F.2d 712, 718 (6th Cir. 1992); *In re Sentinel Mgmt. Grp.*, 728 F.3d 660, 669–72 (7th Cir. 2013) (reversing the District Court’s factual findings, but remaining silent on the District Court’s use of the heightened standard for non-insiders); *In re Bellanca Aircraft Corp.*, 850 F.2d 1275, 1282 (8th Cir. 1988); *Henry v. Lehman Commer. Paper, Inc. (In re First All. Mortg. Co.)*, 471 F.3d 977, 1006 (9th Cir. 2006); *Sender v. Bronze Grp., Ltd. (In re Hedged-Investments Assocs., Inc.)*, 380 F.3d 1292, 1301 (10th Cir. 2004); *In re N & D Props., Inc.*, 799 F.2d at 731.

²⁰ *Id.*

²¹ *Id.*

²² *In re N & D Props., Inc.*, 799 F.2d at 731.

²³ *Id.*

²⁴ *Jezarian v. Raichle (In re Stirling Homex Corp.)*, 579 F.2d 206, 214 (2d Cir. 1978).

heightened or different standard for non-insiders.²⁵ However, a bankruptcy court in the Southern District of New York acknowledged that “there may be fewer traditional grounds available [to subordinate the claim of a non-insider] because neither undercapitalization nor breach of fiduciary duty applies to the conduct of a non-insider.”²⁶ The Southern District of New York is unique in declining to apply different levels of scrutiny, even in the Second Circuit.²⁷

B. *Non-Insiders are Rarely Found to Have Engaged in Inequitable Conduct due to a Heightened Threshold of Inequitable Conduct and Less Scrutiny*

For non-insiders, more egregious conduct, such as fraud, spoliation or overreaching, is required to show inequitable conduct.²⁸ This egregious conduct must be shown with particularity.²⁹ Claims against non-insiders require a higher level of proof.³⁰ In *Osborne*, the court found that one non-insider secured creditor acted inequitably toward another unsecured creditor by deliberately misleading the unsecured creditor into believing that the debtor would be able to pay its debts.³¹ The court reasoned that the secured creditor had superior knowledge and acted for its own benefit by falsely inducing the unsecured creditor to continue to supply the debtor when the secured creditor knew the debtor would not be able to pay.³²

However, claims of non-insiders are rarely subordinated because of the higher threshold required to show inequitable conduct.³³ In *In re M. Paoletta & Sons, Inc*, the unsecured creditors argued that a secured creditor’s conduct was inequitable because “it embarked on a policy to garner additional information so as to exercise its contractual rights not to lend at a propitious

²⁵ *In re LightSquared Inc.*, 511 B.R. 253, 348 (Bankr. S.D.N.Y. 2014).

²⁶ *Id.*

²⁷ *In re Teltronics Servs., Inc.*, 29 B.R. 139, 169 (Bankr. E.D.N.Y. 1983); *In re Mayo*, 112 B.R. 607, 650 (Bankr. D. Vt. 1990).

²⁸ *In re N & D Props., Inc.*, 799 F.2d at 731.

²⁹ *Id.*

³⁰ *Henry*, 471 F.3d at 1006 (citing *In re Pac. Express, Inc.*), 69 B.R. 112, 116 (B.A.P. 9th Cir. 1986).

³¹ *In re Osborne*, 42 B.R. 988, 1000 (W.D. Wis. 1984).

³² *Id.*

³³ *In re M. Paoletta & Sons, Inc.*, 161 B.R. 107, 118 (E.D. Pa. 1993).

time relative to the other unsecured creditors.”³⁴ The secured creditor extended additional credit to the debtor when it was advantageous to the debtor, but then the secured creditor foreclosed when it was advantageous for itself to foreclose, to the detriment of the unsecured creditors.³⁵ The court held it is not inequitable for the claimant, a non-insider secured creditor, to monitor the debtor to determine the most advantageous time to foreclose on a loan when the financing agreement authorized the creditor to monitor the debtor in the event of a default.³⁶ The court was further persuaded that the other unsecured creditors knew there was no guarantee that the secured creditor would continue to finance the debtor, and they knew that the secured creditor could foreclose at any time.³⁷

C. Insiders are More likely to have Engaged in Inequitable Conduct due to Courts Applying Stricter Scrutiny.

There are three categories of misconduct that are generally recognized as inequitable conduct for insiders: (1) fraud, illegality, and breach of fiduciary duties; (2) undercapitalization; and (3) claimant’s use of the debtor as a mere instrumentality or alter ego.³⁸ Undercapitalization alone is generally not sufficient to equitably subordinate a claim.³⁹ However, an insider loaning money to an undercapitalized corporation may be enough to constitute inequitable conduct when the insider fails to inject capital into the corporation, and no third party is willing to loan the corporation money.⁴⁰ An insider exercising its contractual rights is generally not a defense to inequitable conduct.⁴¹

³⁴ *Id.* at 120.

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.*

³⁸ *In re Mid-Am. Waste Sys.*, 284 B.R. 53, 71 (Bankr. D. Del. 2002).

³⁹ *Summit Coffee Co. v. Herby's Foods, Inc. (In re Herby's Foods, Inc.)*, 2 F.3d 128, 132 (5th Cir. 1993).

⁴⁰ *Id.*

⁴¹ *See Shubert v. Lucent Techs. Inc (In re Winstar Commc'ns., Inc.)*, 554 F.3d 382, 412 (3d Cir. 2009).

Insiders commit inequitable conduct when the insider uses its power to control the debtor for its own advantage.⁴² In *Citicorp*, the Third Circuit held that an insider committed inequitable conduct by purchasing unsecured claims which the insider then used to benefit its own position in the bankruptcy case to the detriment of the other creditors.⁴³ In that instance, the insider used confidential information to buy claims to object to a Chapter 11 plan and force an asset sale that would benefit the insider.⁴⁴ According to the court, the insider breached its fiduciary duty by engaging in such conduct.⁴⁵ In *Herby's Foods*, the Fifth Circuit equitably subordinated the claim of an insider because the insider, the parent company of the debtor, loaned money to the debtor corporation that was undercapitalized.⁴⁶ The court reasoned that the loan was inequitable because the insider parent company knew the debtor was undercapitalized, insolvent, the insider parent company never injected any capital into the debtor, and no other third-party lender was willing to loan Herby's money because of its poor financial position.⁴⁷

II. Courts Still Must find that Inequitable Conduct Caused Harm or Conferred an Unfair Advantage to Subordinate a Claim.

Inequitable conduct must have caused an injury to the creditors of the debtor, or conferred an unfair advantage on the claimant to subordinate a claim.⁴⁸ The inequitable conduct does not need to be a major cause of the debtor filing for bankruptcy relief.⁴⁹ The party seeking equitable subordination needs to demonstrate that the claimant's conduct harmed the debtor or

⁴² See *Citicorp Venture Cap., Ltd. v. Comm. of Creditors Holding Unsecured Claims*, 160 F.3d 982, 986 (3d Cir. 1998).

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.* at 985–86.

⁴⁶ *Herby's Foods, Inc.*, 2 F.3d at 132.

⁴⁷ *Id.*

⁴⁸ *In re Winstar Commc'ns, Inc.*, 554 F.3d at 411.

⁴⁹ See *In re Mid-Am. Waste Sys.*, 284 B.R. 53, 71 (Bankr. D. Del. 2002).

another creditor.⁵⁰ A claim should be subordinated in proportion to the extent of the harm the inequitable conduct caused to other creditors.⁵¹ Good faith is not a defense to causing injury because it does not “negate the harm sustained by . . . creditors; neither would it lessen the advantage gained by the [i]nsiders.”⁵² Courts often determine there was an injury to another creditor or the claimant obtained some unfair advantage after the court determines there was inequitable conduct.⁵³ In *Winstar*, the court found equitable subordination was warranted because the inequitable conduct caused the debtor to purchase unneeded equipment.⁵⁴ Further, the *Winstar* court found an injury to other creditors because the claimant purposefully delayed issuing its refinancing notice in order to induce the other creditors to invest in the debtor.⁵⁵ Additionally, the *Citicorp* Court found that the inequitable conduct caused damage to other creditors because it delayed a proposed plan of reorganization in order to propose its own plan.⁵⁶ Finally, in *Herby’s Foods*, the court determined the debtor’s inequitable conduct, characterizing equity contributions as loans, injured the other creditors because it increased their credit exposure.⁵⁷ The insiders used their position, to encourage the other creditors to increase their credit exposure which ultimately harmed those other creditors.⁵⁸ Further, the other creditors were also injured by the inequitable conduct because their percentage of the distribution in the bankruptcy was reduced because the debtors characterized equity contributions as loans.⁵⁹

⁵⁰ *Id.*

⁵¹ See *Citicorp Venture Cap.*, 160 F.3d at 991.

⁵² *Herby’s Foods, Inc.*, 2 F.3d at 132.

⁵³ See, e.g., *Estes v. N & D Props., Inc. (In re N & D Props., Inc.)*, 799 F.2d 726, 731 (11th Cir. 1986); *In re Winstar Commc’ns, Inc.*, 554 F.3d at 414; *Citicorp Venture Cap.*, 160 F.3d 982 at 990.

⁵⁴ *In re Winstar Commc’ns, Inc.*, 554 F.3d at 414.

⁵⁵ *Id.*

⁵⁶ *Citicorp Venture Cap.*, 160 F.3d at 990.

⁵⁷ *Herby’s Foods, Inc.*, 2 F.3d at 134.

⁵⁸ *Id.*

⁵⁹ *Id.*

Conclusion

Courts consider the impact the inequitable conduct had on the debtor or other creditors in determining if there was any harm. Insiders are subject to stricter scrutiny than non-insiders and courts are more likely to find that insiders engaged in inequitable conduct because of the heightened scrutiny. Creditors ought to refrain from exercising control over their debtors so a court will not deem the creditor an insider. Whether there has been inequitable conduct is highly fact dependent and case specific, but once a court finds inequitable conduct, the court still must find that the inequitable conduct caused some harm or conferred an unfair advantage of the claimant.