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Developments in the World of "Loan-to-Own"
Jean R. Robertson and Jeffrey T. Cicarella, Calfee, Halter & Griswold, LLP, Cleveland

An emerging strategy many hedge and private equity funds are pursuing is known as the "loan-to-own" investment. In this type of investment, a Fund's investors acquire debt, and sometimes certain amounts of equity or management control, such as voting power or board seats, from a lender of a distressed company. The Fund often buys the debt at a deep discount, then nudges the Company toward a bankruptcy filing where the Fund can take advantage of the economic leverage associated with the face amount of the debt it acquired to turn the debt into an equity ownership of the Company in the chapter 11 process.

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Of Claims, Plane and Automobiles - Recent Developments on 503(b)(9) and Reclamation Claims
Judith Greenstone Miller, Jay L. Welford, and Paul L. Hage, Jaffe Raitt Heuer & Weiss, P.C., Southfield, Michigan

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 made various changes to the provisions of the Bankruptcy Code governing claims in a chapter 11 proceeding. This article examines two of these changes—new section 503(b)(9) and revised section 546(c)—and their impact on creditors in recent Chapter 11 cases.

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"Decoupling" Issues in Bankruptcy
Bradford J. Sandler and Kari Coniglio, Benesch Friedlander Coplan & Aronoff LLP, Philadelphia and Cleveland

In recent years, the structured credit markets have created derivative instruments in which economic rights can be decoupled from their governance rights. Decoupling is a term used to describe the separation of economic rights from voting rights in various instruments. More specifically, debt decoupling is "the unbolting of the economic rights, contractual control rights, and legal and other rights normally associated with debt, through credit derivatives and securitization [sic]." The most common, and perhaps simplest, derivative instrument is the credit default swap ("CDS"). This article provides a basic understanding of the mechanics of a CDS and touches on several issues that a CDS creates in bankruptcy and in out-of-court workouts.

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Inequitable Insubordination: The Seventh Circuit's Unsatisfying Decision
Peter C. Bergan, Jr., third year student at Loyola University Chicago School of Law
In a case decided October 20, 2008, the Seventh Circuit held that a corporation formed by the debtors for the sole purpose of purchasing one of the claims in their own bankruptcy did not automatically subject the corporation's claim to equitable subordination. The case of *In re Kreisler* illustrates the perverse events that can unfold in the unregulated area of claims trading; that is, the buying and selling of creditors' claims in a bankruptcy proceeding. The Seventh Circuit's opinion reveals that equitable subordination will not be easily granted and that inequitable conduct, without harm to the other creditors, is not enough to deprive a scheming claimant of his "piece of the pie."

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Lisa P. Sumner and Jill C. Walters, Poyner Spruill, Raleigh

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At the Fall Meeting of the ABA Section of Business Law Business Bankruptcy Committee in Scottsdale, Arizona, Michael St. Patrick Baxter, Chair of the Committee, awarded the first annual Kathryn R. Heidt Memorial Award to Los Angeles attorney Sharon Z. Weiss. Weiss is a partner with the law firm of Richardson & Patel LLP and has been active in the ABA's Section of Business Law and the Committee for many years.

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DEVELOPMENTS IN THE WORLD OF “LOAN-TO-OWN”

By: Jean R. Robertson and Jeffrey T. Cicarella

I. The Loan-to-Own Strategy

An emerging strategy many hedge and private equity funds (each a “Fund,” and collectively the “Funds”) are pursuing is known as the “loan-to-own” investment. In this type of investment, a Fund’s investors acquire debt, and sometimes certain amounts of equity or management control, such as voting power or board seats, from a lender of a distressed company (each a “Company,” and collectively the “Companies”). The Fund often buys the debt at a deep discount, then nudges the Company toward a bankruptcy filing where the Fund can take advantage of the economic leverage associated with the face amount of the debt it acquired to turn the debt into an equity ownership of the Company in the chapter 11 process.

Funds are the main players in these loan-to-own transactions. Moreover, Funds’ opportunistic investment strategy of investing in distressed companies with a view of gaining a controlling position in the capital structure of such Companies is more aggressive, and entails more risk, than the investment principles of traditional secured creditors, whose primary goal is a long term return of capital. As Funds seek to maximize returns in the distressed debt arena, they often possess a much higher tolerance for risk and litigation than the more traditional and conservative financing institutions.

Although acquiring discounted loans is the preferred method, Funds generally will also consider providing debtor-in-possession financing (“DIP”) to the distressed company with terms that facilitate the transition of reorganization value and equity to the Fund investors as stalking horse bidders. These terms often include: (i) requirements for quick section 363 sales; (ii) confirmation of the investors’ liens and claims; and (iii) short time limits on the creditors’ ability to challenge the Fund’s prepetition liens.

II. From Debt Investment to Controlling Equity Positions—Credit Bids

The bankruptcy tool that is typically used to transform pre-petition discounted debt and equity acquisition into post-petition complete and clean ownership by the Fund is the right to credit bid at a public auction sale of a Company under section 363(k) of the Bankruptcy Code. As a matter of theory, credit bidding allows Funds to set the bidding threshold at the face amount of the debt, rather than at the discounted value paid. The theory being, if the fair market value of the Company is closer to the value paid by the Fund prepetition, the creation of the competitive bidding threshold at the artificially high face amount will reduce the likelihood of competitive bids, which is the desired outcome for the Fund.

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Absent competitive bidding there is no chance of any increase in the cash resources of the
Company that would typically fund distributions to creditors. Thus, in many cases the unsecured
creditors are left with little or no recoveries on their claims. The classic loan-to-own scenario,
resulting in a rapid section 363 sale to the prepetition Fund, is nothing more than a liquidation
with a predetermined result, benefiting only the top ranks of the creditor food chain.

Creditor committees and other creditors have asserted that such proceeding contradict the
historical purpose of chapter 11, which is to rehabilitate the debtor for the benefit of all its
creditors, and provide the debtor with a fresh start.

The question is: what recourse is there for creditors? What arguments can creditors
assert to assure an auction sale occurs at fair market values and with a greater possibility that the
sale for the benefit of the Fund will also result in benefits and recoveries for unsecured creditors?

III. Challenging Credit Bids

A. Lack of Competition in the Bidding Process

Under section 363(k) of the Bankruptcy Code:

At a sale under [Section 363(b) of the Code] of property that is
subject to a lien that secures an allowed claim, unless the court for
cause orders otherwise the holder of such claim may bid at such
sale, and, if the holder of such claim purchases such property, such
holder may offset such claim against the purchase price of such
property.\(^2\)

Thus, in a sale of assets outside the ordinary course of business, a secured creditor is allowed to
bid the allowed amount of its claim against the purchase price, unless the court orders otherwise.
The express terms of section 363(k) limit the right to credit bid to holders of an “allowed” claim.
Consequently, the holder of a claim that has not been determined to be valid may not bid its
claim.\(^3\) Under section 502(a), a claim is deemed “allowed” to the extent a party in interest has
not objected.\(^4\)

Therefore, the express language of the statute provides two opportunities: (1) the court
has discretion to “order otherwise” to condition or limit a credit bid upon cause shown, opening
the door to a variety of potential arguments;\(^5\) and (2) a debtor or committee facing a loan-to-own
may object to the Fund’s claim by way of an adversary proceeding challenging the allowance of


the prepetition debt holder’s liens (assuming, of course, that there are valid bases to do so). Once the objection is lodged, the credit bid should at least be delayed pending determination of the merits of the objection.

The principal argument that should be employed to limit or condition a credit bid is the fundamental unfairness of setting a competitive bid threshold at the face value of debt—such debt having been purchased at a discount—when it can be shown that, especially in relation to the time at which the debt was purchased, the purchase price of the debt reflects the market value more accurately than does the face amount. Competitive bidding is at the core of the section 363 auction process and the courts should be receptive to conditioning credit bidding to achieve such an outcome.

Moreover, it will be difficult for the Fund to demonstrate any prejudice resulting from a requirement, for example, that the bidding threshold begin at the price at which the debt was acquired. To the extent the Fund is in the auction to acquire the Company, it is free to bid against all comers—and to have normal bid protections and breakup fees. If the Fund chooses not to bid, it will nevertheless recover its actual investment and the breakup fee. On the other hand, if there is competitive bidding, the estate may receive cash beyond the Fund’s investment that can be distributed to unsecured creditors.

The bottom line is that the value of the Company that exceeds the discounted prepetition investment should inure to the benefit of the company’s unsecured creditors, not artificially accrete from the estate by defaulting to the face value for competitive bids.

B. **Equitable Subordination**

There are other potential arguments that can be used to demonstrate “cause” to limit or condition loan-to-own Fund’s credit bids.

Under section 510(c) of the Code, to the extent the Funds and/or Companies may have engaged in inequitable conduct which has injured other creditors, the claims of the investors could be equitably subordinated to the injured creditors’ claims. The requisite “inequitable conduct” could include: (i) fraud, illegality and breach of fiduciary duties, including improper dealings with an “insider”; (ii) undercapitalization; and (iii) use of the Company as a mere instrumentality or alter ego.

Although an equitable subordination claim is typically leveled against an “insider” (and thus may be stronger if the investors are also equity holders), non-insider claims may also be subject to equitable subordination. Moreover, equitable subordination may be granted even without creditor misconduct if necessary to prevent injustice and insure fairness for creditors. These arguments depend, of course, on the facts and could conceivably include a Fund having

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8 *e.g., In re Cutty’s-Gurnee, Inc.*, 133 B.R. 934, 958-959 (N.D. Ill. 1991) (citation omitted).
unduly exercised control over a Company to maximize a Fund’s own return and subsume other assets in its liens to the detriment of unsecured creditors.

C. Good Faith

Showing a breach of fiduciary duties by directors or officers could involve proving, among other things, inadequate consideration of options and lack of good faith. Creditors can object to confirmation of a Fund’s restructuring plan because the Fund has not proposed such plan in good faith. Under Section 1129(a)(3) of the Code, a “court shall confirm a plan only if . . . [i]he plan has been proposed in good faith and not by means forbidden by law.” The standard for meeting such good faith requirement, as stated by the court in *In re Johns-Manville Corp.*, requires a showing that “the plan was proposed with honesty and good intentions and with a basis for expecting that a reorganization can be effected.”

In other words, a court may determine good faith is lacking where a Fund has proposed a plan under the pretext of financially resuscitating a Company, but with the true motive of converting its debt position into a controlling equity position.

D. Recharacterization

Creditors can assert that debt owed to the Funds should be treated as equity, thus preventing the Funds from including such debt in a credit bid, an effect similar to equitable subordination. Recharacterization – one of the broad powers Section 105 of the Code confers to bankruptcy courts – is appropriate where the facts show that a debt transaction was actually an equity infusion. Courts often examine the following factors to determine whether to recharacterize debt: (i) the names given to the debt instruments; (ii) the presence of a fixed maturity date, interest rate and payment schedule; (iii) the repayment source; (iv) the adequacy of capitalization; (v) the identity of interest between the creditor and the lender; (vi) the loan security; (vii) the company’s ability to obtain alternative financing; (viii) any subordination of the advances; (ix) the use of the advances to acquire capital assets; and (x) the presence of a sinking Fund for repayments. Some courts have also looked to the ratio of shareholder loans to capital and the amount or degree of shareholder control as additional factors in a recharacterization action.

None of the above mentioned factors is decisive, however, and all such factors distill to one essential concept: the more a debt transaction reflects the characteristics and intent of an

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10 *In re Johns-Manville Corp.*, 843 F.2d 636, 649 (2d Cir. 1988).
11 See Section IV.A.(iii), infra.
13 See *In re Autostyle Plastics, Inc.*, 269 F.3d 726, 749-750 (6th Cir. 2001) (citing *In re Roth Steel*, 800 F.2d 625, 630 (6th Cir. 1986)).
arm’s length debt deal, the more likely it is that it will be treated as a debt, rather than equity, transaction.\footnote{Cold Harbor, 204 B.R. at 904, 915 (Bankr. ED VA 1997).}

E. Marshaling

To the extent the Fund has liens on non-debtor assets, creditors can argue that the equitable doctrine of marshalling precludes the credit bid.\footnote{Although unsecured creditors generally do not have standing to compel marshaling of assets, “some courts have allowed unsecured creditors this relief treating them under the doctrine as lien creditors . . . to prevent a senior creditor from arbitrarily destroying the rights of a creditor that has less security.” In re Hale, 141 B.R. 225, 227 (Bankr. N.D. Fla. 1992).} The doctrine of marshaling prevents a senior creditor that can satisfy its debt from either of two Funds from depleting a Fund on which a junior creditor relies exclusively to satisfy its debt. Instead, it compels the senior creditor to turn for satisfaction to the non-overlapping Fund.\footnote{See Meyer v. U.S., 375 U.S. 233, 237 (1963); In re Tampa Chain Co., 53 B.R. 772, 777 (Bankr. S.D.N.Y. 1985) (“The bankruptcy courts have long had the power to marshal the debtor’s assets in order to effectuate on [sic] equitable distribution of funds to creditors of the debtor’s estate.”).} Where the Fund has liens on other assets, a credit bid might implicitly constitute an attempt to recover their debt from the debtors’ assets, rendering the estate worthless and precluding recoveries by other creditors; all while the investors have other available collateral.

In addition, if any of the claims underlying the credit bid are subject to potential avoidance, for example as fraudulent transfers or preferences, the credit bid might not be valid as to the amount so avoidable.

F. Preferable Alternatives / Valuation

Creditors can also make a process-based argument against a restructuring plan by pointing out the procedural shortcomings of a Company’s management in selecting a Fund’s plan. Such shortcomings could include the Company’s failure to pursue alternative transactions and/or proposals, and restrictions limiting the scope of the search for transactions. These arguments, however, are inherently fact-specific and difficult to support. A Company might, for example, be desperate for immediate financing that allows it to pay short term obligations on which it would otherwise default.\footnote{See, e.g., In re Granite Broadcasting Corp., et al., 369 B.R. 120 (Bankr. S.D.N.Y. 2007).} Moreover, to the extent members of a Company’s management are interested parties, the Company can insulate its decision by having such interested officers or directors abstain from the decision-making process or by delegating to a wholly independent committee the task of evaluating restructuring plans.

Valuation arguments are also inherently fact-specific and unlikely to succeed. Courts often view such arguments as lacking in objective support, especially when the Fund’s valuation is based on information obtained through its status as a debt holder and the Fund’s opponents fail to back their arguments with their purses. In other words, courts prefer a market approach to
valuation, and a Fund’s valuation may be the most accurate indicator of fair market value of a Company.19

IV. Courts’ Treatment of Arguments Opposing Loan-to-own

A. Loan-to-own Cases

Recent court decisions involving challenges to credit bids in loan-to-own situations have favored the Funds, and include the following:

1. SubMicron

In *Cohen v. KB Mezzanine Fund II LP*,20 the Fund (“KB”) held secured debt of the debtor, SubMicron Systems Corp. (“SubMicron”) that was subordinated to a first lien lender. During the period leading up to SubMicron’s bankruptcy, KB made additional subordinated loans to SubMicron. In connection with a section 363 sale, KB contributed their subordinated claims to a proposed purchaser of the SubMicron assets in exchange for a 31 percent interest in the purchaser.

The bid consisted primarily of a credit bid based upon KB’s assigned claims, along with a relatively small amount of cash used to pay off the first lien lender and administrative claims. The bid did not provide for a payment to unsecured creditors. SubMicron received no other bids. The creditors’ committee objected to the sale, arguing that KB’s claims should be recharacterized as equity or equitably subordinated, and that Akrion should not be permitted to credit bid in the full amount of KB’s claims, because the actual value of the secured position was less than the claims. The Delaware district court rejected these arguments and approved the sale.

On appeal, the Third Circuit affirmed. The Third Circuit determined that the facts regarding the parties’ intent supported the district court’s decision. These facts included that the parties called the transfers at issue “debt,” the transfers had a fixed maturity date and interest rate and the obligations were recorded as secured debt on SubMicron’s 10-Q SEC filing and UCC-1 financing statements. The Third Circuit also held that KB did not dominate SubMicron’s board so as to support recharacterization. Furthermore, the Third Circuit held that the lack of documentation for certain fundings did not compel recharacterization of the transfer.

The Third Circuit also held that KB was entitled to bid the face amount of its claims, and were not limited to bid the value of the secured collateral. As a result, under the *SubMicron* reasoning, loan-to-own lenders may bid the full amount of their claim, even if it is greater than the value of the assets, and thereby usurp the debtor’s going concern value.

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19 *See, e.g., In re Oneida Ltd.*, 351 B.R. 79 (Bankr. S.D.N.Y. 2006).
20 *Cohen v. KB Mezzanine Fund II LP*, 432 F.3d 448 (3d Cir. 2006).
Finally, the Third Circuit rejected the committee’s equitable subordination argument, finding that KB’s transfers did not injure creditors, because without the loans, SubMicron would have had to liquidate without the possibility of a sale to an alternate purchaser.

2. Radnor Holdings

In The Official Committee of Unsecured Creditors of Radnor Holdings v. Tennenbaunz Capital Partners LLC et al., the loan-to-own fund (collectively, “TCP”) loaned the Radnor Holdings Corp. and its affiliates (“Radnor”), $95 million and purchased $25 million of Radnor’s preferred stock. Radnor also executed an investor rights agreement giving TCP the right to, among other things, appoint a board member and increase the board representation if Radnor missed an EBITDA target. Radnor provided TCP with solvency certificates in connection with the loan.

Radnor missed its EBITDA target for 2005 by $20 million and requested another equity investment from TCP to meet its liquidity needs, claiming that it still expected a higher EBITDA in 2006. TCP refused to make the equity investment, but instead loaned Radnor an additional $23.5 million with the prior consent of Radnor’s unsecured noteholders. Subsequently, Radnor continued to miss their projections and Radnor’s lenders ceased funding.

Radnor filed a chapter 11 petition, with TCP acting as the DIP lender and stalking horse bidder. The court established an expedited sale process, which permitted the creditors’ committee to bring a complaint against TCP and permitted TCP to credit bid the amount of its claim subsequently determined to be valid. The committee brought a variety of claims against TCP, including recharacterization, equitable subordination, breach of fiduciary duty, objection to claim, avoidance of lien and preference.

The bankruptcy court rejected the committee’s challenges. Focusing on the parties’ intent under the SubMicron decision, the court ruled that the transfers were not equity because: (i) the parties treated the advances as debt; (ii) it was appropriate for a lender to extend additional credit to a distressed borrower to protect its existing loans; (iii) despite the fact that Radnor missed its 2005 EBITDA target, there was no evidence that TCP “knew” Radnor could not meet its 2006 EBITDA target; and (iv) TCP did not have control over Radnor’s day-to-day operations so as to compel recharacterization. The court found that TCP did not engage in any misconduct, but rather acted in good faith with a view to maximize the debtors’ value, and thus equitable subordination was not appropriate. Finally, the court rejected the committee’s claims regarding breach of fiduciary duty, finding that the TCP loans actually increased Radnor’s solvency; Radnor’s corporate documents exculpated directors from liability for the duty of care and Radnor’s directors were entitled to attempt to continue to operate using loans to turn the company around.

3. Granite

*In re Granite Broadcasting Corp., et al.*,22 involved competing plans of restructuring for Granite Broadcasting Corporation and five of its wholly-owned subsidiaries (“Granite”) submitted by Silver Point Capital Finance LLC (“Silver Point”), holder of approximately 80% of Granite’s 9.75% senior secured notes (the “Secured Notes”), on the one hand, and by parties (the “Preferred Holders”) holding over 50% of Granite’s 12.75% cumulative exchangeable preferred stock (the “Preferred Equity”), on the other hand. The court had to determine whether Silver Point’s plan was proposed in good faith, and whether such plan undervalued Granite.

By the time of the confirmation hearing for Silver Point’s proposed plan of restructuring (the “Plan”) in April of 2007, Granite had sustained net operating losses for the previous three years. Moreover, Granite had been unable to make the $19.4 million interest payment on the Secured Notes in June of 2006 and entered into a credit facility with Silver Point to allow it to make such interest payment, a component of which was convertible into 200,000 shares of preferred equity. In addition, Silver Point provided Granite with a senior secured, superpriority revolving loan of up to $25 million pursuant to a DIP. The Preferred Holders objected to confirmation of the Plan on the grounds that the Plan lacked good faith and that it violated the “fair and equitable” rule of the Code.

The Plan provided, among others, (i) that Silver Point would receive $200 million in new secured notes, (ii) the balance of Granite’s debt to be converted into substantially all of Granite’s new equity, (iii) that unsecured creditors would receive a 100% recovery subject to a cap of $11 million, and (iv) that holders of the Preferred Equity would receive approximately 2% of the new equity and warrants, and (v) certain releases, exculpations and indemnifications to Granite’s officers and directors of claims by Granite. The Plan did not entail a change in Granite’s Board of Directors (the “Board”). The Preferred Holders’ competing plan included, among others, a preferred stock investment that would cover the $19.7 interest payment due Silver Point, referenced in general terms, but did not commit to, a subsequent recapitalization, permitted the Preferred Holders to assume immediate control of the Board, and contained provisions relating to Granite’s controlling shareholder and chief executive officer (“Cornwell”).

The Preferred Holders argued the Plan lacked good faith because Granite proceeded with the ulterior motive of “enriching and protecting Cornwell and absolving the other directors from their breaches of fiduciary duty.”23 The Preferred Holders’ good faith argument – based on an examiner’s report alleging possibly breach of fiduciary duties by Granite’s directors and officers – focused on the Board’s procedures in selecting the Plan, such plan being, from the Preferred Holders’ perspective, inferior to their own. According to the Preferred Holders, the Board selected the inferior Plan because the Board allowed itself to be dominated by Cornwell. Although it admitted that “better procedures should have been instituted to put [Granite’s] restructuring decisions into the hands of wholly independent Board members,” the court was

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23 *Id.* at 128.
convinced “not only of the basic good faith of [Granite] and [its] professionals but also of the lack of any damages as a result of the June 2006 transactions [with Silver Point.]”

In reaching this conclusion, the court pointed to the lack of a clear and feasible plan from the Preferred Holders that could have been effectuated given the time constraints, the Preferred Holders’ deliberate decision not to compete with Silver Point in submitting a plan that included a long term recapitalization, and the Preferred Holders’ demand of immediate control of the Board. In other words, the Board’s decision-making process – especially considering the lack of damages resulting therefrom – was more reasonable than the Preferred Holders claimed it was, such process having ended with the Board’s selection of a patently superior restructuring plan.

The court also addressed and summarily rejected a valuation challenge by the Preferred Holders, who alleged that the Plan “undervalued the new common stock and that the Plan will provide Silver Point and the other [holders of secured notes of the same class of Silver Point] with a recovery in excess of their allowed claims.” According to the court, the valuations posited by the Preferred Holders’ experts were based on (i) projections of Granite’s future performance for which there was no support, (ii) several unsupported assumptions, including an immediate reduction in corporate overhead in excess of 50%. The court also permitted the Preferred Holders to make a proposal to purchase Granite that would value in Granite beyond the debt, but the Preferred Holders’ offer established that they would not be willing even to pay the debt in full. Quite simply, the Preferred Holders’ plan was “patently unconfirmable” and had “no feasibility.”

B. Lessons to be Gleaned from the Court Decisions

Knowing that creditors will make the arguments discussed above in challenging Funds, there are procedures that Funds – and Companies that prefer the Funds’ plans to those of other creditors – employ to insure the success a loan-to-own investment. In other words, Funds can avoid creating, or stepping into a situation involving bad facts that make a loan-to-own strategy susceptible to attacks from other creditors. Moreover, to the extent the facts of a loan-to-own case support a Fund’s opponents, a lack of concrete damages resulting from the Fund’s inequitable conduct may have the effect of making such conduct moot.

The decision in the Granite case is indicative of the high burden creditors face in succeeding on a claim for breach of fiduciary duties and/or lack of good faith. Certainly, in the wake of Granite, any Company that prefers the plan of a Fund now knows to appoint a

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24 Id. at 133.
25 Id. at 134-136.
26 Id. at 140.
27 Id. at 142.
28 Id. at 144-145.
committee comprised of independent members of its board of directors to evaluate such plan and any alternatives. Taking steps to insure the decision-making process is free from defects will provide a Company’s board of directors the leniency afforded to corporate actions viewed under the business judgment rule. Likewise, Funds can nip arguments for equitable subordination in the bud in the same manner as with good faith arguments, i.e., avoiding inequitable conduct. As to the common argument of recharacterization, the lesson here seems to be “leave no smoking gun.” To the extent parties appropriately document loan transactions, such documentation will support a court’s determination that any financing purporting to be a loan is, in fact, a loan. On the other hand, failure to engage in the appropriate documentation process was not detrimental to the Fund in the Submicron decision.

**CONCLUSION**

Although the SubMicron and Radnor Holdings cases constitute wins for loan-to-own investors, the results of any challenge to limit credit bids of such lenders will depend on the facts of each case. So far, there have been very few reported challenges. In particular, the good faith of the lenders (including the degree to which they may have directed further advances to set up their credit bid) and the “arms-length” nature of the loan transaction as a true debt deal will be tested in connection with potential attacks on credit bids on recharacterization and equitable subordination grounds. Considering these matters will almost always be hotly contested, it is only a matter of time until a loan-to-own case with different facts (for instance where substantial unsecured creditors did not consent to loans as in Radnor Holdings) will result in a decision against the Fund.

The recent decision of the Granite case, however, further vindicates the loan-to-own strategy and inexorably leads to the conclusion that only a truly egregious set of facts will be enough for a Funds’ opponent to succeed in its objections.
The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”) made various changes to the provisions of the Bankruptcy Code (“Code”) governing claims in a chapter 11 proceeding. Two of these changes, in large part, relate to trade creditors.

First, BAPCPA established a new administrative priority claim under Section 503(b)(9) of the Code for those creditors that provide goods (as opposed to services) to a debtor in the ordinary course of business within 20 days prior to the commencement of the case. While the legislative history surrounding this section is scant, presumably Congress was concerned about providing a vehicle to enhance payment to creditors that shipped goods to a debtor in the ordinary course of business and on the eve of bankruptcy at a time when the debtor knew that bankruptcy was imminent and that it would not have the ability to pay for such goods. See 4 Collier on Bankruptcy, ¶ 503.16 at 503-79 (Alan N. Resnick et al. eds., 15th ed. Rev. 2006). The addition of this provision to the Code represents a “dramatic departure from bankruptcy precedent” as it treats similarly situated creditors differently based solely on having provided goods to the debtor during the 20-day period preceding the filing of the case. Id. at 503-79.

Second, BAPCPA expanded the scope and reach of reclamation claims under Section 546(c) of the Code for sellers who provide goods to an insolvent buyer. Under BAPCPA, amended Section 546(c) of the Code expands the reclamation remedy in at least two significant ways, namely: (i) by expanding the look-back period before bankruptcy during which goods may be subject to reclamation from 10 days to 45 days, and (ii) by expanding the grace period, which gives a seller additional time after a bankruptcy filing during which to file its notice of reclamation from 10 days to 20 days. In addition, BAPCPA eliminated the requirement that reclaiming creditors be given an administrative claim as an alternative to the return of their goods and further made clear that the rights of a secured creditor are superior to the rights of a reclaiming creditor.


2 Judith Greenstone Miller, Jay L. Welford and Paul Hage are all members of the Insolvency and Reorganization Group at Jaffe Raitt Heurer & Weiss, P.C., and in the Southfield, Michigan office.
What is a 503(b)(9) Claim?

Section 503(b)(9) creates an administrative priority claim for the value of any goods sold to the debtor in the ordinary course of such debtor’s business and received by the debtor within the 20 days before the commencement of the case. By its express terms, Section 503(b)(9) only applies to “goods” (not “services”). The term “goods” is not defined in Section 503(b)(9). As such, bankruptcy courts and practitioners have struggled to characterize the nature of the value provided to the debtor. See New Recent Developments on 503(b)(9) Claims, Section B, infra.

Section 503(b)(9) raises a number of issues, such as: (i) how does a supplier assert a 503(b)(9) claim, (ii) may Section 503(b)(9) claimants compel immediate payment of their claims, (iii) how is a Section 503(b)(9) claim calculated (i.e., is the value of the goods determined by the invoice price of the goods (exclusive of interest, freight and other charges) or should some other method be utilized), (iv) must the debtor actually receive physical possession of the goods and not just the value of the goods, (v) does Section 502(d) of the Code apply to Section 503(b)(9) claims, (vi) is a Section 503(b)(9) claim available to secured creditors, and (vii) what setoff rights do debtors have pursuant to Section 553 of the Code against 503(b)(9) claims.

Section 503(b)(9) also does not specifically indicate whether the goods shipped must remain unpaid (or otherwise unsatisfied) to qualify for treatment under Section 503(b)(9) even though to hold otherwise would appear to create a windfall for the creditor. For example, it is unclear whether Section 503(b)(9) claimants may obtain subsequent new value credit under Section 547(c)(4) of the Code for transfers made during the 20 day period to offset potential preference exposure. While this issue remains unresolved, a recent decision out of the Middle District of Tennessee in the context of a reclamation demand suggests that a reclamation creditor who reclaims the goods (or obtains an administrative claim for the value of such goods) is not entitled to use the value of those goods as new value to reduce potential preference exposure under Section 547(b) of the Code. See In re Phoenix Restaurant Group, Inc., 373 B.R. 541 (M.D. Tenn. 2007) (holding that goods shipped on the eve of bankruptcy that are subject to reclamation are not the same “money or money’s worth, as goods shipped free of the seller’s strings” because they do not, in fact, enhance the estate and therefore cannot be used as subsequent new value). Application of this ruling to Section 503(b)(9) would suggest and support the conclusion that 503(b)(9) claimants that receive payment or other satisfaction (i.e., in the form of subsequent new value) for goods shipped during the 20-day period are not entitled to a claim under Section 503(b)(9).

How Do I Assert a 503(b)(9) Claim?

Section 503 generally requires that administrative claims be asserted by motion. Since its enactment, a number of bankruptcy courts have established new local bankruptcy rules governing the manner and the timing for asserting claims under Section 503(b)(9). Some courts permit Section 503(b)(9) claims to be made by simply filing a proof of claim; while other courts require the filing of a motion. The local bankruptcy
rules also establish strict time lines for asserting such claims and, thus, practitioners must take care to carefully review the applicable local bankruptcy rules to determine if, how and when such claims must be asserted. Recognize, however, that not all bankruptcy courts have established local procedures to address the procedure for asserting claims under Section 503(b)(9). In such cases, a debtor will often file a motion seeking to establish a Section 503(b)(9) bar date and a specific process for creditors to assert such claims. Creditors must take care to carefully review all of the pleadings filed to ensure that they know when and if a process is established so that they timely and properly assert their claim under Section 503(b)(9). See e.g., Kunz, III, Carl N., “Section 503(b)(9) Claims and Bar Dates: Creditors Must Be Vigilant,” American Bankruptcy Institute Journal, Vol. XXVII, No. 6, at pg. 20 (2008); Stickles, J. Kate and Dean, G. David, “A Roadmap for Managing § 503(b)(9) Claims and Objections: The Debtor’s Perspective,” American Bankruptcy Institute Journal, Vol. XXVII, No. 8, at pg. 26 (2008); Wheeler, David B., “20-day Sales Claims Under § 503(b)(9): Finding Your Way Through Unchartered Territory, American Bankruptcy Institute Journal, Vol. XXVII, No. 9, at pg. 16 (2008).

### When May I Get Paid on the 503(b)(9) Claim?

Section 503(b) provides that an administrative creditor may request payment of its claim but it does not provide any specific mechanism regarding when such claim must be paid. Prior to the adoption of Section 503(b)(9), the courts generally held that the timing for payment of an administrative expense claim was left to the sound discretion of the court. Section 1129(a)(9)(A) of the Code sets an outside date for payment of administrative expense claims, requiring that they be paid in cash, in an amount equal to the allowed amount of such claim, on the effective date of any plan of reorganization, unless creditors agree to a different treatment.

In some recent cases, Section 503(b)(9) claimants have filed motions early in the case, well before a plan was filed, seeking immediate allowance and payment of their claims. For example, in In re Bookbinders’ Rest., Inc., 2006 WL 3858020 (Bankr. E.D.Pa. 2006) and In re Global Homes, Inc., 2006 Bankr. LEXIS 3608 (Bankr. D.Del. 2006), the claimants sought immediate payment of their administrative claims. The claimants argued, among other things, that if they were not paid immediately, in pari passu with the other ordinary course post-petition expenses, there might not be sufficient funds at the end of the case to pay their claims in full. Furthermore, the claimants argued that immediate payment was required because: (i) the goods they provided were being used by the debtor and were necessary and essential to the debtor’s ability to continue its business operations, (ii) by paying other post-petition trade creditors, the debtor was treating similar claims differently (i.e., an “equal protection” argument), and (iii) the debtor had sufficient cash to pay such claims.

In both cases, the courts denied the request for immediate payment of the Section 503(b)(9) claims and held that the timing of the payment is within the discretion of the court. The Global Homes Court noted that Section 503 “does not specify a time for payment of these expenses.” In re Global Home Products, 2006 WL 3791955 at *3. In
exercising its discretion in determining whether to allow immediate payment, the Court noted that one of the chief factors to consider is “bankruptcy’s goal of an orderly and equal distribution among creditors and the need to prevent a race to the debtor’s assets.” Id. As such, according to the Court:

Distributions to administrative creditors are generally disallowed prior to confirmation if there is a showing that the bankruptcy estate may not be able to pay all of the administrative expenses in full. Courts will also consider the particular needs of each administrative claimant and the length and expense of the case’s administration.

Id. Moreover, the Court noted that to qualify for “the exceptional remedy of immediate payment, a creditor must show that there is a necessity to pay and not merely that the Debtor has the ability to pay.” Id.

Ultimately, in denying immediate payment to the 503(b)(9) claimant, the Court relied on the 3-prong test used by courts to determine the timing of payment of an administrative claim pursuant to Section 503(a), as articulated in In re Garden Ridge Corp., 323 B.R. 136, 143 (Bankr. D.Del. 2005), to wit: (i) the prejudice to the debtor; (ii) hardship to the claimant; and (iii) potential detriment to other creditors. After applying these factors, the Court denied immediate payment finding that: (i) the claimant had not submitted any evidence of hardship, other than self-serving conclusory statements, (ii) there was no evidence that failure to pay this claim would put the claimant out of business, (iii) the debtors had presented evidence that they would suffer substantial hardship in their reorganization effort if immediate payment were required, and (iv) in balancing the relative hardships, the balance tipped in favor of the debtor. The Global Home decision suggests that absent demonstrating a necessity to pay, as opposed to the ability of the debtor to pay, an administrative claimant is not entitled to immediate payment.

Likewise, the Bookbinders’ Court recognized that “there may be circumstances in which it would be inequitable or inappropriate to permit a debtor to pay certain administrative expenses but not others.” In re Bookbinders’ Rest., Inc., 2006 WL 3858020 at *5. The Bookbinders’ Court agreed that the timing of the payment was within the bankruptcy court’s discretion and, in that case, elected to hold an evidentiary hearing on the matter before exercising such discretion.

The Court did, however, reject the 503(b)(9) claimant’s argument that it was entitled to immediate payment as a matter of law because the debtor had been paying other administrative expenses. According to the Court: “The text of § 503(b)(9) neither states nor even implies that allowance of the expense encompasses an unqualified right to immediate payment…. [H]ad Congress intended to provide § 503(b)(9) claimants with some type of enhanced right to payment after allowance of the expense, I am convinced that it would have made its intent express in the statute and it has not done so.” Id. at *5-6. Moreover, legislative policy would not otherwise trump the clear and unambiguous language of this section based on rules of statutory construction.
**Is Section 503(b)(9) Available for Secured Creditors? What Setoff Rights Do Debtors Have Against 503(b)(9) Claims?**

In *In re Brown & Cole Stores, LLC*, a decision by the Ninth Circuit BAP, the Court addressed two previously unanswered questions regarding Section 503(b)(9), namely: (i) whether a Section 503(b)(9) claim is available to secured creditors, and (ii) whether Section 503(b)(9) claims may be subject to setoff if the debtor possesses pre-petition claims against the creditor. *In re Brown & Cole Stores, LLC*, 375 B.R. 873 (B.A.P. 9th Cir. 2007).

With respect to the first question, the BAP held that the plain language of Section 503(b)(9) permitted a secured creditor to also seek payment as an administrative expense priority claimant. *Id.* at 877-78. The debtor had argued that the fundamental principle of statutory interpretation of enforcing a plain statute by its terms should be disregarded because at the same time Section 503(b)(9) was added by BAPCPA, Congress amended section 503(b)(1)(B)(i), a subsection of Section 503 dealing with tax claims, to clarify that it was available to creditors “whether secured or unsecured.” *Id.* In contrast, Congress did not include the words “secured claim” in Section 503(b)(9). Further, all of the other provisions of Section 503 provide for unsecured claims that are incurred by the estate after commencement of a case. *Id.*

The BAP rejected that argument stating:

The provision is not ambiguous; as such, we must enforce it according to its terms and should not inquire beyond its plain language. Apart from finding no ambiguity in § 503(b)(9), we note that Congress also declined to put the word “unsecured” into the same statute. The obvious conclusion, therefore, is that all claims arising from twenty-day sales are entitled to administrative priority.

*Id.* at 878. This result, the BAP held, was mandated by the statute regardless of whether giving priority to a secured creditor may be inequitable to other creditors.

With respect to the setoff question, the BAP reversed the denial of the debtor’s setoff request, holding that although prepetition claims held by the debtor against a creditor cannot generally be set off against administrative claims because of the mutuality requirement set forth in Section 553(a), here the administrative claim itself arose prepetition. Therefore, unlike other administrative priority claims, Section 503(b)(9) claims may be subject to setoff if the debtor possesses pre-petition claims against the claimant. *Id.* at 879. Ultimately, the BAP concluded that because: (i) there was insufficient evidence of inequitable conduct to deny a setoff, and (ii) the Debtor had not established that a right of setoff exists, “we must remand for application of the appropriate standards for determining whether to grant a setoff.” *Id.* at 880.
**New Recent Developments on 503(b)(9) Claims**

Until recently, there had been only a paucity of new cases discussing the issues related to the elements of a Section 503(b)(9) claim. Over the past few months, however, Judge Phillip J. Shefferly has released three of the most comprehensive opinions interpreting the language of Section 503(b)(9) in the *Plastech Engineered Products, Inc.* case. The following is a summary of these recent decisions.

**A. In re Plastech Engineered Products, Inc., et al., Case No. 08-42417 (Chapter 11) (Bankr. E.D.Mich. September 16, 2008) – Section 502(d) does not apply to Administrative Expenses under Section 503(b)(9) Claims.**

Plastech Engineered Products, Inc. and its related entities, a tier one automotive supplier, filed voluntary chapter 11 petitions on February 1, 2008 in the United States Bankruptcy Court for the Eastern District of Michigan. Various creditors asserted administrative priority claims for goods delivered to the debtors within 20 days of the filing pursuant to Section 503(b)(9) of the Code. The debtors objected to the allowance and payment of a number of these claims based on, among other things, the fact that the claimants had allegedly received voidable preferences during the 90 days prior to the commencement of the cases. The debtors contended that application of Section 502(d), which generally requires the return of all preferential transfers as a prerequisite to claim allowance, precluded payment on such claims until the claimants returned the voidable preferences to the estates. The debtors further contended that Section 502(d) applied regardless of whether the claims arose pre-petition or post-petition and irrespective of whether the claims arose under Section 501, 502 or any other section of the Code.

Conversely, the 503(b)(9) claimants argued that the Section 502(d) disallowance provision was inapplicable to their claims because, among other reasons, Section 502(d) does not apply to claims asserted under Section 503. Rather, Section 502(d) only applies to claims filed and asserted under Section 501 and allowed under Section 502 of the Code. Once the claimants had filed a motion on notice and opportunity seeking allowance and payment of their claims under Section 503, they argued, they had fulfilled the requirements of the Code and were entitled to be paid on their claims notwithstanding Section 502(d).

The Court held that Section 502(d) did not apply to claims asserted under Section 503(b)(9). The Court began its analysis by looking at the statutory framework governing claims under the Code. Section 501 governs the filing of proofs of claims or interests while Section 502 sets forth the process for allowance and disallowance of claims asserted under Section 501. Looking at these sections, the Court found that the process for allowance of administrative claims under Section 503(b) is completely separate and distinct from the process for addressing other claims under Sections 501 and 502 of the Code. Moreover, the disallowance provisions in Sections 502(d) expressly refer only to subsections (a) and (b) of Section 502, not to administrative claims determined under Section 503(b). The Court noted that if the drafters of the Code had meant to apply...
Section 502(d) to administrative claims arising under Section 503(b), qualifying language would and should have been provided in Section 503(b). No such qualifying language or reference was set forth in Section 503(b) and, therefore, the Court could not infer that there was any legislative intent to apply Section 502(d) to administrative claims under Section 503(b)(9). Citing Beasley Forest Products, Inc., v. Durango Georgia Paper Co. (In re Durango Georgia Paper Co.), 297 B.R. 326, 331 (Bankr. S.D.Ga. 2003), the Court reasoned: “Absent a qualifying clause, one mandatory statutory provision should not be presumed to trump another mandatory provision. To subject requests filed under § 503, which also provides for their allowance, to disallowance under authority of § 502 discounts the plain meaning of both sections and unnecessarily requires resolution of a “conflict” between sections 502 and 502.”

The Court next looked at the term, “claim,” finding that it broadly refers to both pre-petition and post-petition rights to payment. According to the Court, Section 502(d) only applies to those post-petition claims that are governed by either Sections 501 or 502. In reaching this determination, the Court did not conclude that a 503(b)(9) administrative expense cannot be a “claim,” but rather it held that it was not the type of “claim” that is subject to Section 502(d). In reaching this determination, the Court disagreed with the holdings in In re Triple Star Welding, Inc., 334 B.R. 778 (B.A.P. 9th Cir. 2005), MicroAge, Inv. v. Viewsonic Corp. (In re MicroAge, Inc., 291 B.R. 503, 508 (B.A.P. 9th Cir. 2002) and In re Georgia Steel, Inc., 38 B.R. 829, 839-40 (Bankr. M.D.Ga. 1984), wherein the courts, in the context of administrative expenses generally, had held that Section 502(d) applies to preclude payment until the creditor has returned the preferential property transferred. Those courts, in contrast to the Plastech Court, held that the definition of “claim” under Section 101(5) was broad enough to include administrative expenses and that Section 502(d) did not include any language to qualify this definition. Contra In re Lids Corp., 260 B.R. 680, 683 (Bankr. D.Del. 2001) (“administrative expense claims are accorded special treatment under the Bankruptcy Code and thus, are not subject to Section 502(d)”); Camelot Music v. MHW Advertising & Public Relations, Inc. (In re DM Holdings, Inc.), 264 B.R. 141, 158 (Bankr. D.Del. 2000) (because administrative claim did not arise prepetition, it is not a claim under Section 101(5), and thus, Section 502(d) does not apply).

Finally, the debtor attempted to distinguish the case law governing administrative claims because the claim at issue in this case – a Section 503(b)(9) claim – arose prepetition, as opposed to most claims under Section 503 which arise post-petition. Section 503(b)(9), the debtor argued, merely gave priority status to what was previously a general unsecured claim. The debtor suggested that to hold that Section 502(d) does not apply to claims under Section 503(b)(9) would result in disparate treatment to similar claims; in other words, other unsecured claims arising prepetition would be treated differently than 503(b)(9) claims that, absent the grant of this new priority, would simply be treated as general unsecured claims subject to Section 502(d). Again, the Court dismissed this argument holding that “if Congress only intended to make section 503(b)(9) a ‘special class’ of pre-petition claims and thereby continue to make them subject to the claims allowance provisions of section 501 and 502, it could have easily accomplished that.” However, by taking this “special class” of pre-petition claims and determining that they are administrative expenses, payable and allowable under Section
503(b), “Congress placed § 503(b)(9) administrative expenses beyond the reach of § 502(d).”

This decision is currently on appeal to the United States District Court for the Eastern District of Michigan. Appellate briefs have been submitted but no decision has yet been issued by the court.

**B. In re Plastech Engineered Products, Inc, et al., Case No. 08-42417 (Chapter 11) (Bankr. E.D.Mich. October 7, 2008)** — Section 503(b)(9) requires that the debtor receive the goods and not just the value of the goods.

In this case, a supplier asserted a claim under Section 503(b)(9) for goods that were shipped by the supplier to the debtors’ customer. Because the goods were shipped directly to the debtors’ customer, the debtors never took actual possession of the subject goods. Nevertheless, the claimant contended that it was entitled to a Section 503(b)(9) claim because the debtors had received the “value of the goods.” Alternatively, the claimant asserted that even if the goods were not actually received by the debtors, the requirement of receipt provided in Section 503(b)(9) could be met so long as the debtors had “constructive possession” of the goods.

The Court ultimately ruled, based on the plain meaning and language of the statute, that Section 503(b)(9) requires receipt of the “goods,” and not just the “value of the goods.” According to the Court:

> the word *received* modifies the word *goods* in § 503(b)(9). It is the *goods* and not the *value* that must be received by the debtor to trigger § 503(b)(9). The word *value* in the statute is merely the measure of the amount of the “allowed administrative expense” under § 503(b)(9). The statute does not say *value received*. Instead, it says *goods received*.

To rule otherwise, the Court held, “strain[s] and ignore[s] the plain meaning of the language used in the statute. If that was what Congress intended, then the language would or could have provided for allowance of an administrative claim for the value or the benefit received by the debtor, as opposed to the “goods received by the debtor.”

The Court declined to determine whether actual, as opposed to constructive, receipt was necessary to trigger rights under Section 503(b)(9). First, the Court held, the Code does not define “received.” Second, while the parties cited to various provisions of the Uniform Commercial Code (“UCC”) and case law construing “receipt”, the parties had not yet introduced or stipulated to the admission of any evidence regarding their relationship to allow the Court to ultimately determine the issue. Third, although the parties suggested that the holding in *In re Pridgen*, 2008 WL 1836950 (Bankr. E.D.N.C. 2008), the only reported decision discussing the word *received* in the context of Section 503(b)(9), provided the Court with a basis to interpret the meaning of *received*, the Court dismissed this argument because: (i) the case was an unpublished decision from another
circuit decided in the context of a motion for reconsideration after an evidentiary hearing, and (ii) the facts of that case were distinguishable in that the debtors in that case were required to take physical possession of the goods (gasoline) for title to transfer.

C. In re Plastech Engineered Products, Inc, et al., Case No. 08-42417 (Chapter 11) (Bankr. E.D.Mich. December 10, 2008) – Court addresses and considers what is a “good” under Section 503(b)(9).

In this opinion, the Court addressed the debtors’ objections to certain 503(b)(9) claims asserted for: (i) snow removal, salting and de-icing at the debtors’ various plants, (ii) turning the debtors’ own post-industrial scrap into plastic pellets that were subsequently sold back to the debtors to make automotive bumpers and facia panels, (iii) inspecting, repairing and cleaning electric motors for the debtors and obtaining such parts as were necessary to make such motors work, and (iv) providing the debtors with natural gas. In each of these instances, the debtors objected to the claims based on their contention that the claimants had provided services, as opposed to goods and, thus, were not entitled to administrative expense treatment under Section 503(b)(9).

To the extent that the claim related to a mixture of goods and services, the debtors contended, the “predominant purpose test” should be the standard by which the court should determine whether goods or services were provided to the debtor. Application of that standard, the debtors posited, meant that if the predominant purpose of a contract was a service, as opposed to a good, then the contract would be treated entirely as a service, i.e., “winner takes all.” Additionally, in the case of the natural gas provider, the debtors contended that the claimant’s rights, as a utility provider, were limited to those set forth in Section 366 of the Code and, thus, the claimant was not entitled to assert a claim under Section 503(b)(9).

The Court recognized that the Bankruptcy Code does not contain a definition of the term “goods.” Furthermore, there was no controlling case law within the Sixth Circuit governing the meaning of the term “goods.” The Court acknowledged that there is a line of case law adopting the predominant purpose test to determine whether a contract is for the sale of “goods.” However, such an approach, the Court held, was necessary in those cases so that the Court could determine whether the UCC was even applicable to the legal issues before it. Conversely, the Court reasoned:

there is nothing in § 503(b)(9) that requires that approach for the purposes of that section of the Bankruptcy Code. If a particular transaction provides for both a sale of goods and a sale of services, and the value of each can be ascertained, why shouldn’t the value of the services be relegated to an unsecured non-priority claim?

Put simply, the Court held, nothing in Section 503(b)(9) requires an “all or nothing” or “winner take all” approach.
The debtors suggested that application of the predominant purpose test “would avoid expensive, fact intensive inquiry in ascertaining the value of those items that are goods versus those items that are services in the case of contracts containing a mixture of good and services.” While the Court agreed that it may be more difficult to analyze a contract and to characterize its separate components, there is nothing in the Bankruptcy Code that suggests that a contract with a mixture of goods and services should be disqualified from treatment under Section 503(b)(9). As long as the value of the goods provided were capable of being calculated, the claimant is entitled to a claim for such value under Section 503(b)(9). Application of this analysis to the claims at issue in this particular case resulted in the portion of the claims deemed to be goods to be granted administrative priority under Section 503(b)(9).

The Court dismissed the debtors’ contention that if the items were not reclaimable, they could not be subject to treatment under Section 503(b)(9). According to the Court, “there is nothing in § 503(b)(9) that requires a claimant to also be entitled to a reclamation right under § 546.” Thus, the Court held, Section 546 does not limit or control in any way the rights that a claimant has under Section 503(b)(9).

The Court also dismissed the debtors’ contention that utility providers are not entitled to a Section 503(b)(9) claim for the value of goods provided to a debtor because such providers are entitled to other special protections set forth in Section 366 of the Code. The two Code sections, the Court held, are not mutually exclusive. One can be a seller of goods (and thus entitled to a claim under Section 503(b)(9) of the Code) and also simultaneously be entitled to the protections accorded to a utility in Section 366 of the Code. “The rights afforded by § 503(b)(9) to a seller of goods are not dependent either explicitly or implicitly upon either the availability or the lack of availability of other remedies under the Bankruptcy Code for such seller.”

Finally, in making this ruling, Judge Shefferly made reference to two other bankruptcy court decisions regarding the meaning of “goods” under Section 503(b)(9). In In re Samaritan Alliance, LLC, 2008 WL 2520107 (Bankr. E.D.Ky. 2008), a creditor sought allowance of an administrative claim for the value of electricity provided to the debtor during the 20-day period prior to the petition date. In that case, while recognizing that courts are divided on the issue of whether electricity is a good, the Court held that “for purposes of § 503(b)(9), electricity is ‘more properly characterized as a ‘service,’” Id. at *4. In another unreported case, In re Deer, No. 06-02460, slip op. at 2 (Bankr. S.D.Miss. 2007), after applying the definition of “goods” from the UCC, the Court held that advertising from Yellow Book did not constitute a good and thus, was not entitled to treatment under Section 503(b)(9).

Reclamation Claims under BAPCPA

Reclamation is the right of a seller to recover possession of goods delivered to an insolvent buyer. Specifically, Section 2-702(2) of the UCC permits a creditor to reclaim goods shipped to a buyer on credit if the seller discovers that the buyer was insolvent, provided that the seller makes a written demand within 10 days after receipt of the goods
by the buyer. Section 2-702(2) of the UCC also makes clear that a seller may not base a right to reclaim goods on the buyer’s fraudulent or innocent misrepresentation of solvency or of intent to pay unless the buyer makes a misrepresentation of solvency in writing to the particular seller within 3 months before delivery of the goods, in which case, the 10-day limitation does not apply. Moreover, Section 2-702(3) provides that the seller’s rights to reclaim are subject to the rights of a buyer in the ordinary course or other good faith purchaser under Section 2-403 of the UCC.

Section 546(c) of the Bankruptcy Code originally provided that creditors had the same 10-day period to make a written demand for reclamation unless the 10-day period expired after the petition was filed. In that case, the time for making the written demand for reclamation was extended until 20 days after the petition date. Prior to BAPCPA, a creditor could demand the goods back or request that it be allowed an administrative claim for the value of the goods.

With the enactment of BAPCPA, several changes were made with respect to the treatment of reclamation claims. First, the time for making a reclamation demand was extended from 10 days to 45 days if the debtor received the goods from a creditor when insolvent. The creditor, however, is still required to make a written request to the debtor identifying the goods subject to reclamation. Second, if such time period expires after the petition is filed, then the request must be made no later than 20 days after the petition date. Third, Section 546(c), as amended, makes clear that a reclaiming creditor is not entitled to an administrative claim for the goods it is seeking to reclaim. Rather, the creditor may only seek return of the subject goods (the creditor may, however, be entitled to an administrative claim under Section 503(b)(9)). Fourth, BAPCPA clarified a conflict that existed among various courts in making clear that the rights of a reclaiming creditor are subject and subordinate to the rights of a lien creditor. In other words, the reclaiming creditor does not have any rights in the subject goods unless there is equity in the goods.

*New Recent Developments on Reclamation Claims*

The Sixth Circuit Court of Appeals recently issued an opinion on reclamation claims entitled *Phar-Mor, Inc. v. McKesson Corp.*, 534 F.3d 502 (6th Cir. 2008). On first blush one might argue that the opinion is of limited relevance because it involved an interpretation of the pre-BAPCPA version of Section 546(c). However, a more extensive review and analysis of the decision suggests, unless the decision is limited to the facts of the case, that the opinion may have more far-reaching implications for secured creditors that provide inventory financing.

The creditor, McKesson, had sold goods to the debtor prior to the petition date. After the chapter 11 case was commenced, the creditor timely made a written demand for reclamation of the goods under Section 546(c) of the Code. Because the goods subject to the reclamation demand could not be taken back, the creditor was given an administrative claim for the value of such goods. Ultimately, the secured parties were paid off during the chapter 11 case and the remaining assets were utilized to pay creditors, including the administrative expense claim of McKesson.
The debtor objected to such treatment in part because at all relevant times all of the debtor’s assets, including those goods subject to the demand for reclamation, were part of the secured lender’s collateral (both prepetition and as part of the security interest in such assets granted to the DIP lender). Therefore, the debtor argued, McKesson actually had no reclamation rights and was not entitled to an administrative claim. The bankruptcy court overruled this objection.

On appeal, the Sixth Circuit concluded that McKesson was entitled to an administrative expense priority claim after the bankruptcy court had denied its rights to reclaim the goods subject to the written demand for reclamation. In reaching this conclusion, the Court analyzed reclamation rights under Section 2-702 of the UCC and acknowledged the limitations imposed under Section 2-702(3), which makes “the seller’s rights subject to the rights of a buyer in the ordinary course or other good faith purchaser.” The Court noted that secured creditors qualify as a purchaser under Section 1-201(b)(29) and (30) of the UCC.

Nevertheless, despite the apparent clarity of these provisions and prior Sixth Circuit law to the contrary, see In re Pittsburgh-Canfield Corp., 309 B.R. 277, 287 (B.A.P. 6th Cir. 2004) (when goods subject to a reclamation are sold to satisfy a secured creditor’s superior claim, the goods subject to the reclamation are gone and the vendor’s right to a priority claim is gone with them), the Court held that it would be unjust to deny the reclaiming creditor an administrative claim when an insolvent debtor obtained such goods fraudulently (i.e., the debtor obtained the goods under fraudulent promises to pay for such goods when it knew it was insolvent and unable to pay for such goods). In reaching this conclusion, the Court failed to take into account the fact that title to the goods may still pass upon delivery to a good faith purchaser even if fraud is committed by the seller. See Section 2-403 of the UCC.

Finally, perhaps the most disturbing aspect of the decision by the Sixth Circuit is the Court’s suggestion, in dicta, that “the property was still [the seller’s] even after it was delivered, at least for the ten day period provided for in § 2-702,” and “further that [the debtor] acquired ‘no rights in the collateral’ as required under [UCC § 9-204], in regard to the [goods].” In other words, the Court seems to hold that the seller’s rights are paramount and superior to that of the buyer and the seller may enforce such rights in equity to keep or, in this case, to reclaim such goods. Taken to its next logical extension, that would mean that if title to such goods does not transfer, the goods do not become part of the collateral base subject to the secured creditor’s liens (even though such goods were delivered to the buyer and upon receipt would normally become part of the lender’s inventory base).

Conclusion

These issues will continue to plague the courts particularly in the typical case where there are insufficient assets to pay creditors in full. Trade vendors will attempt to leverage their rights under Sections 503(b)(9) and 546(c) of the Code to obtain greater
distributions than they otherwise might be entitled to receive solely as unsecured creditors. While these sections may have been intended to enhance the rights of trade creditors, the benefits actually received from enforcing rights thereunder may be insignificant and minimal at best, and may lead to time-consuming and expensive litigation.
“Decoupling” Issues in Bankruptcy

By: Bradford J. Sandler and Kari Coniglio

In recent years, the structured credit markets have created derivative instruments in which economic rights can be decoupled from their governance rights. Decoupling is a term used to describe the separation of economic rights from voting rights in various instruments. More specifically, debt decoupling is “the unbundling of the economic rights, contractual control rights, and legal and other rights normally associated with debt, through credit derivatives and securitization [sic].” The most common, and perhaps simplest, derivative instrument is the credit default swap (“CDS”). A CDS permits parties to hedge against credit risk by transferring the inherent risk of purchasing a credit instrument to another party. The rapid growth of the CDS market has caused many to question the unintended consequences CDSs have, or at least may have, on financially distressed companies. This article provides a basic understanding of the mechanics of a CDS and touches on several issues that a CDS creates in bankruptcy and in out-of-court workouts.

A Basic Credit Default Swap

The mechanics of a CDS are straightforward. Under a CDS, one party, called the protection buyer, pays a periodic (usually biannual or quarterly) fee to another party, called the protection seller, for a certain term, in exchange for protection against the occurrence of a credit event of a reference entity. If a credit event occurs for the referenced entity, the protection seller agrees to make the protection buyer whole (less fees paid to the protection seller) in accordance with the terms of the CDS. Fundamentally, this transaction is designed to transfer the risk of the occurrence of a credit event of the reference entity from the protection buyer to the protection seller.

For example, suppose Debtor obtains a $10 million loan from Bank. Bank, as the holder of the loan, is entitled to payment over time according to the terms of the loan; however, Bank also bears the risk that Debtor will default under the terms of the loan. Therefore, to hedge against that risk, Bank may seek to enter in to a CDS with another

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3 The CDS market notional amount in 2001 was approximately $632 billion and was approximately $62 trillion in 2007, according to the International Swaps and Derivatives Association.
4 CDS contracts are typically, but not always, based upon the International Swaps and Derivatives Association (“ISDA”) 2002 Master Agreement and Credit Derivative Standard Terms.
5 Of course, the protection buyer is assuming the risk that the protection seller can satisfy the obligation underlying the CDS upon the occurrence of a credit event of the reference entity. If the protection buyer is concerned about the protection seller’s ability to satisfy the CDS, the protection buyer may require that the protection seller secure the CDS with collateral.
party (which we will refer to as the Mystery Group) to protect itself from a default on the loan.

In such a CDS transaction, Bank is the protection buyer because it is purchasing protection in the event of Debtor’s default on the loan. Mystery Group is known as the protection seller because it is selling the protection to Bank. Importantly, Debtor is not a party to the CDS and may be, and typically is, unaware of the transaction.

In exchange for the protection, Bank will pay Mystery Group a fee based upon the spread of the CDS. The spread is based upon the probability of a default by Debtor – therefore, the higher the probability Debtor will default, the higher the annual fee Bank will pay to Mystery Group as part of the CDS. Bank will continue to pay this fee until the CDS contract expires by its terms or until a credit event occurs.

Typically, CDS contracts provide that bankruptcy of the Debtor, the restructuring of the Debtor or the Debtor’s failure to pay in accordance with the underlying obligation, constitutes a credit event (although some CDSs exclude restructuring). Therefore, if Debtor becomes unable to pay its obligations under the loan from Bank, a credit event will occur which would permit Bank to recover from Mystery Group under the CDS. If the parties choose a physical settlement after the occurrence of a credit event, Bank will need to deliver the note or bond representing the loan to Mystery Group, who will then pay the par/stated value of the underlying obligation. Alternatively, if the parties choose a cash settlement, Mystery Group will pay Bank the difference between the par/stated value of the obligation and its market price.

In our example with $10 million in protection, if the underlying obligation were worth 12% upon a credit event, Mystery Group would have to pay Bank $8.8 million ($10 million \times (100\% - 12\%))

A CDS is an example of debt decoupling because the protection seller obtains the economic rights under the obligation, while the protection buyer maintains voting and all other rights. As is discussed below, this decoupling through a CDS changes the

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7 See Id.
8 See Id.
9 See Id.
11 Note that many credit events are public information, and readily confirmable – e.g., the filing of a bankruptcy petition. Additionally, the recovery from the protection seller depends on the solvency of the protection seller. In effect, while the protection buyer is shorting the underlying obligation upon which the CDS is based, the protection buyer is gambling that the protection seller will be able to satisfy its obligations under the CDS upon a credit event of the reference entity (i.e., in the above example, the Debtor).
13 While credit default swaps may be akin to an insurance policy, they are not insurance policies for several reasons: (i) a CDS does not require the protection buyer to actually own the underlying security, and (ii) the protection buyer does not have to incur an actual loss.
traditional debtor-creditor relationship and often leaves Debtor confused by what appears to Debtor as the irrational actions of the creditor.

**Implications of CDS on Distressed Companies**

In a typical debtor-creditor relationship, a creditor’s repayment depends upon the success of the debtor. Therefore, typical creditors have incentive to work with the debtor, extend repayment terms, waive default rates and do whatever it takes to keep the debtor afloat long enough to maximize the return to the creditor. Decoupling places debtors in the awkward position of not knowing the identity of the true creditor-in-interest. For example, if Debtor is aware that it will be unable to repay its obligation to Bank on the maturity date, Debtor will likely attempt to workout an extension with Bank. While in the typical debtor-creditor relationship, the creditor may be willing to discuss an accommodation for Debtor, in our situation, Bank may actually want to see Debtor fail; it might make more sense for Bank to try to force Debtor into bankruptcy (either alone or with others by filing an involuntary bankruptcy petition) so that it can trigger a credit event under the CDS and collect par value from Mystery Group.

If a credit event occurs and is followed by a physical settlement, the protection buyer with whom Debtor has been negotiating will be replaced at the proverbial table by the protection seller, who will likely be completely unknown to Debtor. The protection seller may have a very different agenda from the protection buyer, which no doubt will cause undue chaos for Debtor.

In our hypothetical situation, the relationship of the expiration date of the CDS and the date of a potential credit event also will likely impact the behavior of Bank. The closer to the expiration date of the CDS, the more likely the protection buyer will want to see Debtor fail. These apparently irrational acts, which are atypical to the traditional debtor-creditor relationship, are actually quite rational to Bank because upon the occurrence of the credit event, Bank will be paid in full by Mystery Group, and Debtor will be forced to deal with the consequences.

Within bankruptcy, Bank’s actions will likely continue to appear irrational to Debtor (and others) leaving Debtor clueless as to the motive behind these actions. Furthermore, within bankruptcy, Bank may gain an advantage over other creditors due to the apparent risk of loss Bank suffers. For example, bankruptcy law provides that a class

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14 “Both loan contracts and bankruptcy laws are premised on the assumption that creditors are averse to downside risk, but otherwise have an economic interest in the company’s success and will behave accordingly.” Debt, Equity and Hybrid Decoupling: Governance and Systemic Risk Implications, Henry T.C. Hu and Bernard Black, European Financial Management, Vol. 14, No. 4, 2008, 663-709. at 683.

15 See 11 U.S.C. § 303(b) (providing the requirements for commencement of an involuntary bankruptcy case against a debtor).

16 “[R]ecall that credit default swaps are often relatively short term instruments that expire without value to the protection buyer if no credit event occurs before maturity.” Credit Derivatives and the Future of Chapter 11, Stephen J. Lubben, American Bankruptcy Law Journal, Fall 2007, 81 Am. Bankr. L.J. 405, 427.

17 Since the debtor is generally unaware of the existence of a CDS transaction, what appears to be irrational from the debtor’s perspective may be quite rational from the protection purchaser’s perspective, and likely would seem rational to the reference entity if it had full information.

18 Note that under BAPCPA, credit default swaps, like other swap agreements, are treated favorably. See e.g., 11 U.S.C. Sections 101(53B)(A), 362(b)(17), and 560.
of creditors votes in favor of a Chapter 11 plan if “at least two-thirds in amount and more than one-half in number” of the particular class vote in favor of the plan.\textsuperscript{19} Although Bank faces no risk of loss due to the CDS, bankruptcy law gives Bank the power to vote all $10 million worth of its debt.\textsuperscript{20} The protection of the CDS may make Bank likely to vote in favor of a risky plan that places other unprotected creditors at a greater risk of loss, or perhaps not to vote at all and possibly make it more difficult for the debtor to confirm its plan.\textsuperscript{21} That is, unprotected creditors may wrongfully be assuming that each creditor in the class to which they have been assigned for plan purposes are in the same situation, only to be ultimately surprised to see the way a protected creditor voted.

Another interesting issue in bankruptcy arises with the formation of the creditors committee.\textsuperscript{22} In a complex Chapter 11 bankruptcy case, the United States Trustee appoints a creditors committee promptly after the bankruptcy filing. Typically the committee consists of the seven largest unsecured claims against the debtor.\textsuperscript{23} The committee has the authority to, among other things, perform an investigation of the debtor, and participate in formulation of a plan.\textsuperscript{24} Without knowledge that a protected creditor has no incentive to act in the best interests of the estate as a whole, the United States Trustee may select a protected creditor to be a member of the committee, even though such a creditors exposure is significantly less than the other unsecured creditors and even though such a creditor may wish a different, if not contrary, result from the other unsecured creditors.

There can be no doubt that the lack of transparency of CDS transactions can only make it more difficult for a debtor to reorganize efficiently.

\textbf{Disclosure}

Bankruptcy is intended to be a transparent process. Chapter 11 debtors are required by the Bankruptcy Code to file reports and maintain records documenting the flow of money during a case.\textsuperscript{25} Attorneys and professionals working for the debtor are required to disclose their compensation and apply for court approval before receiving payment during the case.\textsuperscript{26} Additionally, every entity or committee that represents more than one creditor is required to file a notice in the bankruptcy case.\textsuperscript{27} Each of these requirements is a part of the Bankruptcy Code and/or the Bankruptcy Rules because transparency is an important element of the bankruptcy process. The current ability of creditors to hedge their risk through CDS places the debtor and other creditors in an unfair position of not knowing with whom they are truly dealing and why they are behaving as they are. While those who would argue transparency is not critical because

\textsuperscript{19} 11 U.S.C. § 1126(c).
\textsuperscript{22} See 11 U.S.C. § 1102.
\textsuperscript{23} See 11 U.S.C. § 1102(b)(1).
\textsuperscript{24} See 11 U.S.C. § 1103(c).
the settlement procedure takes place shortly after the occurrence of a credit event, it is in the early days of a bankruptcy proceeding that debtor-in-possession financing and, more currently, 363 sale issues are addressed, and thus, transparency is important from the beginning of the bankruptcy proceeding so that a debtor has a fair ability to reorganize.

In order to level the playing field, the Bankruptcy Code and/or Rules should be amended to require an additional disclosure: disclosure of any CDS (or other like instrument in which rights have been decoupled). However, because it is likely that, due to cash settlements for CDS, the debtor and other creditors will never know of the CDS, the Code and/or Rules should also provide a penalty for failure to disclose. For example, failure to disclose could result in disallowance or subordination of a protected creditor’s claim. This solution, while it is merely one small solution for the host of bankruptcy issues as a result of a CDS, will at least give the debtor and other creditors an understanding of why the protected creditor is behaving in a particular manner, and give them the ability to formulate an appropriate strategy to level the playing field so the debtor can have a fair chance at reorganizing.

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28 Interestingly, the Financial Accounting Standards Board has issued FAS 161 that will require, beginning November 15, 2008, the disclosure of, among other things, the nature, extent and fair value of derivatives, to improve the transparency of financial reporting. See FAS 161 (2008).
INEQUITABLE INSUBORDINATION: THE SEVENTH CIRCUIT’S UNSATISFYING DECISION
IN RE KREISLER

By: Peter C. Bergan, Jr.1

In a case decided October 20, 2008, the Seventh Circuit held that a corporation formed by the debtors for the sole purpose of purchasing one of the claims in their own bankruptcy did not automatically subject the corporation’s claim to equitable subordination.2 The case of In re Kreisler illustrates the perverse events that can unfold in the unregulated area of claims trading; that is, the buying and selling of creditors’ claims in a bankruptcy proceeding. The Seventh Circuit’s opinion reveals that equitable subordination will not be easily granted and that inequitable conduct, without harm to the other creditors, is not enough to deprive a scheming claimant of his “piece of the pie.”

Barry Kreisler (“Barry”) and Marsha Erenberg (“Marsha”) owned separate interests in two pieces of real property located in Chicago, Illinois.3 Each property was encumbered by several mortgages. One such junior mortgage secured two notes to Community Bank of Ravenswood (“Community Bank”).4

In June 2002, Barry and Marsha filed separate bankruptcy petitions for Chapter 11 protection.5 The cases were jointly administered and eventually converted into a Chapter 7 case.6 In each case, Community Bank filed a proof of claim for the two notes for about $900,000.7 After filing its claims, Community Bank decided that it would rather not ride out the bankruptcy storm, and instead went looking for a buyer for its claims.8 It approached the Chapter 7 Trustee about a sale, but no agreement was ever reached.

Perhaps knowing that Community Bank was looking for a buyer, in June of 2003 Barry formed a new corporation, Garlin, to purchase Community Bank’s claims.9 The owners, officers and directors of this new corporation were Barry’s sister and a close friend of Marsha.10 On October 16, 2003, in one of its only meetings, Garlin passed a corporate resolution to purchase Community Bank’s claim for $16,500.11 Being an attorney himself, Barry represented Garlin and handled the negotiations with Community Bank.12 In order to fund the purchase, Garlin

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1 Peter C. Bergan, Jr. is a third year student at Loyola University Chicago School of Law.
2 In re Kreisler, 2008 WL 4613880 (7th Cir. 2008).
3 Id. at *1.
4 Id.
5 Id. at 372-73.
6 Id. at 372-73.
7 Id. at 372-73.
borrowed $25,000 from K&E Investments, a company owned and controlled by Barry and Marsha.\(^{13}\)

Garlin successfully negotiated the purchase of Community Bank’s claim for $16,500. Thereafter, Community Bank assigned its junior mortgage on the property to Garlin.\(^{14}\) All documentation was properly provided and recorded.\(^{15}\) The sale of the encumbered property closed on August 16, 2004.\(^{16}\) After the sale, the first mortgage, held by another bank, was paid in full, leaving $105,443.76 to the Trustee in sale proceeds.\(^{17}\) Garlin filed a proof of claim in the amount of $92,936.78 plus interest and attorney fees and costs.\(^{18}\) The Trustee argued to the Bankruptcy Court that such claim should be disallowed for a variety of reasons.\(^{19}\) The most important issue, and the one ultimately decided by the Seventh Circuit, was whether Garlin’s claim should be equitably subordinated.\(^{20}\)

The Bankruptcy Code generally permits a debtor or a party in interest, which would include another creditor, to seek to have creditors’ claims equitably subordinated to the claims of other creditors. Section 510(c) of the Bankruptcy Code provides that the Bankruptcy court, may, after notice and a hearing:

(1) under the 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; or

(2) order that any lien securing such a subordinated claim be transferred to the estate.

The Fifth Circuit, in Mobile Steel, the seminal case on equitable subordination, sets forth the three conditions that need be met before a court may equitably subordinate a claim in bankruptcy. The theory underlying the doctrine of equitable subordination is that a bankruptcy court, being a court of equity, need not be bound by the priority scheme in the Bankruptcy Code when to do so would allow a creditor to benefit from inequitable acts at the expense of innocent creditors.\(^{21}\) Referred to the Lifschultz test by the Seventh Circuit, three elements must ordinarily be satisfied before equitable subordination is appropriate:

(i) the claimant must have engaged in some type of inequitable conduct;

(ii) the misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; and

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\(^{13}\)\textit{Id.} at 373.

\(^{14}\)\textit{Id.}

\(^{15}\)\textit{Id.}

\(^{16}\)\textit{Id.}

\(^{17}\)\textit{Id.}

\(^{18}\)\textit{Id.}

\(^{19}\)\textit{Id.} at 374.

\(^{20}\)\textit{In re Kreisler}, 2008 WL 4613880 at *2.

(iii) equitable subordination must not be inconsistent with the provisions of the Bankruptcy Act.\(^{22}\)

Equitable subordination may be appropriate whether or not the creditor’s inequitable conduct is related to the acquisition or assertion of the claim.\(^{23}\) Moreover, a claim should be subordinated only to the extent necessary to undo the harm caused by the inequitable conduct.

The Bankruptcy Court, although invoking the doctrine of equitable subordination, used a different standard after determining that Garlin was an insider of the debtor.\(^{24}\) Where a creditor is an insider of the debtor, a greater degree of scrutiny is applied to determine whether equitable subordination is appropriate.\(^{25}\) The term “insider” is specifically defined in the Bankruptcy Code in section 101(31). It was no stretch to determine that Garlin was an insider of both Barry and Marsha. Quite simply, Garlin was formed and very much controlled by the debtors.

The Bankruptcy Court properly held that Garlin was indeed an insider of the debtors and then proceeded to utilize the \textit{Lifschultz} test to determine whether equitable subordination was appropriate.\(^{26}\) Although the Bankruptcy Court accurately described the test, it did not properly apply the test.

The three-pronged test first requires that the “claimant engaged in some type of inequitable conduct.”\(^{27}\) The Bankruptcy Court first finds that the manner of and motivation for Garlin’s formation were in and of themselves evidence of inequitable conduct. Because Garlin was formed for the sole purpose of obtaining Community Bank’s claim, and because Garlin was ultimately controlled by Barry and to a lesser extent Marsha, the Bankruptcy Court concluded that Garlin conducted itself inequitably.\(^{28}\)

The second element of the test requires that the creditor utilize its power to its own advantage \emph{or} to the detriment of the other creditors.\(^{29}\) With this disjunctive it would seem that injury to the other creditors is not even required, as long as the claimant creditor received some sort of advantage. The Bankruptcy Court states that “Garlin was formed and used to enhance Barry’s and Marsha’s positions at the expense of their unsecured creditors.”\(^{30}\) This alone would then seem to meet the requirement for this second element. As long as the claimants both engaged in some sort of inequitable conduct and that conduct resulted in a benefit to that claimant, because the elements of the \textit{Lifschultz} test would seemingly be satisfied, equitable

\(^{22}\) \textit{In re Lifschultz Fast Freight}, 132 F.3d 339, 341 (7th Cir. 1997) (citing \textit{In re Mobile Steel Co.}, 563 F.2d 692, 701 (5th Cir. 1977)).

\(^{23}\) \textit{Joy Recovery Technology Corp.}, 286 B.R. 54, 84 (Bkrtcy. N.D. Ill. 2002).

\(^{24}\) \textit{In re Kreisler}, 331 B.R. at 382-83.

\(^{25}\) Id. at 382.

\(^{26}\) \textit{In re Kreisler}, 331 B.R. at 383.

\(^{27}\) \textit{Lifschultz}, 132 F.3d at 344.

\(^{28}\) \textit{In re Kreisler}, 331 B.R. at 383.

\(^{29}\) \textit{Lifschultz}, 132 F.3d at 344.

\(^{30}\) \textit{In re Kreisler}, 331 B.R. at 384.
subordination is proper. Nonetheless, the Bankruptcy Court goes into an analysis of whether the conduct of Barry and Marsha caused injury to the unsecured creditors of the debtors’ estates.\textsuperscript{31} The second part of the Lifschultz test merely requires that the “[t]he misconduct must have resulted in injury to the creditors of the bankrupt OR conferred an unfair advantage on the claimant.”\textsuperscript{32} The test, then, only requires one or the other, yet the the Bankruptcy applied both.

Without analysis, the Bankruptcy Court improperly finds that the debtors’ actions harmed the unsecured creditors and subordinated Garlin’s claim.\textsuperscript{33} If Community Bank had not sold its claim, it would have received the exact amount that Garlin was claiming. The claim in either party’s hands exhausted what was left from the property sale leaving nothing for the unsecured creditors.

Garlin subsequently appealed the Bankruptcy Court’s decision, and the U.S. District Court affirmed.\textsuperscript{34} The District Court decision has very little analysis. It stated that there “can be no doubt” that the Lifschultz factors were all satisfied.\textsuperscript{35} It is interesting that in its holding the District Court misstates the second element of the test declaring that one must show “the misconduct resulted in injury to other creditors and conferred some unfair advantage on the claimant” (emphasis added),\textsuperscript{36} while, earlier in the opinion, it correctly cites the Lifschultz test using the disjunctive “or” in the second element.

Garlin again appeals to the Court of Appeals for the Seventh Circuit on the issue of whether the Bankruptcy Court properly subordinated Garlin’s claim. The Seventh Circuit also correctly recognized the disjunctive of the second element but performed an analysis as though both injury to creditor and unfair advantage to the claimant were required.

The Appellate Court states that “[o]nly misconduct that harms other creditors will suffice” for equitable subordination.\textsuperscript{37} The Court ignores the aspect of the second element of the test that refers to an unfair advantage to the claimant. Its analysis relies almost entirely on the fact that the other creditors were not affected at all by the transfer of the claim from Community Bank to Garlin. “[The other creditors] were not affected at all and would be in the same position regardless of whether it was Community Bank or Garlin asserting the junior lien against the Western Avenue properties.” As noted above, this statement is correct, however insufficient.

The Seventh Circuit then fails to properly apply the Lifschultz test, as it ignored the requirement of an unfair advantage to the claimant. The claimant here, Garlin, certainly received an advantage as a result of this transaction. It is unclear, however, whether this advantage was “unfair.” If the term “unfair” simply refers to harm to the other creditors, then the Seventh Circuit was correct in stating that Garlin did not receive an unfair advantage. This, however, would render this part of test was superfluous. This second element of the test presents two

\textsuperscript{31} Id.
\textsuperscript{32} Mobile Steel, 563 F.2d at 700.
\textsuperscript{33} Id.
\textsuperscript{34} In re Kreisler, 352 B.R. 671, 673 (N.D.Ill. 2006).
\textsuperscript{35} Id. at 677.
\textsuperscript{36} Id.
\textsuperscript{37} In re Kreisler, 2008 WL 4613880 at *3.
options: (1) either harm to the other creditors; or (2) unfair advantage to the claimant. The Seventh Circuit failed to distinguish between the two.

Equitable subordination is a remedial doctrine and not intended to punish the subordinated claimant. That being said, it would seem that subordinating a claim simply because the claimant obtained an unfair advantage, albeit with no harm to the other creditors, would simply be punishing the claimant.

Given the current economic climate and the likely rise of claims trading in bankruptcy, the clever scheme in *Kreisler* will surely be repeated, and with more ingenuity. The courts, therefore, need to scrutinize claims trading involving the debtors much more closely to ensure that the goals and policies surrounding bankruptcy protection are not abused to the detriment of the other creditors or for the unfair advantage of the trading claimant.

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38 Braas Sys., Inc. v. WMR Partners (In re Octagon Roofing), 157 B.R. 852, 857 (N.D. Ill. 1993); see also Mobile Steel, 563 F.2d 692, 700-01 (5th Cir. 1977).
Legislative Update

By: Lisa P. Sumner and Jill C. Walters

Between the recession in the United States and the changes in Congress and the White House, 2009 promises to bring a host of legislation changing sections of the Bankruptcy Code or related laws. Here is a summary of recently enacted and pending bills of interest:

National Guard and reservists Debt Relief Act of 2008
Signed by President Bush and became law on October 20, 2008
Amends Bankruptcy Code Section 707(b). Prohibits the Bankruptcy Court from dismissing or converting a case based on means testing if the Debtor was a reserve member of the Armed Forces or National Guard on active duty or performing a homeland security defense for 90 days and during the 540 days following the end of such service.
Only applies to personnel called to active duty after September 11, 2001.

Helping Families Save Their Homes in Bankruptcy Act of 2009 (H.R. 200)
Proposed January 6, 2009
Would amend 11 U.S.C. § 109 to change debtor eligibility for chapter 13 as follows:
By excluding debts secured by the debtor’s principal residence from the computation of debts if the current value of the residence is less than the secured debt limit;
By excluding debts secured or formerly secured by real property that was the debtor’s principal residence from the computation of debts if the residence was sold in foreclosure or the debtor surrendered the residence if the current value of such property is less than the secured debt limit; and
Would add to the list of prohibited claims in 11 U.S.C. § 502(b) claims subject to any remedy for damages or rescission due to noncompliance with TILA or any other provision of State or Federal consumer protection law that was in force when the noncompliance took place.
Would authorize modification of the rights of the holder of a claim for a loan secured by a security interest in the debtor’s principal residence that is the subject of a notice that foreclosure may be commenced by:
providing for payment of the amount of the secured claim as determined under § 506;
prohibiting, reducing or delaying adjustments to any adjustable rate of interest;
modifying the loan to extend the repayment period up to 40 years less the period the loan has been outstanding;
providing for payment of post-petition interest at a fixed APR equal to the most recently published annual yield on conventional mortgages published by the Board of Governors of the Federal Reserve, plus a risk premium; and

1 Lisa P. Sumner and Jill C. Walters practice in the Bankruptcy and Creditors’ Rights section of Poyner Spruill’s Raleigh office. Richard M. Kremen of DLA Piper’s Baltimore office contributed to this report by sharing his analysis from a prior report to the ABA. Questions regarding pending legislation may be directed to Judith Greenstone Miller, Chair of the Legislation Subcommittee, Business Bankruptcy Committee, ABA Section of Business Law and a member of the Bankruptcy and Insolvency Group in the Southfield, Michigan office of Jaffe Raitt Heuer & Weiss, and to Lisa P. Sumner, Vice-Chair of the Subcommittee.
providing for payments directly to the claim holder.

Would amend 11 U.S.C. § 1322(c) by relieving the debtor and the debtor’s property for liability from a fee, cost or charge incurred while the case is pending and arising from a debt secured by the debtor’s principal residence, except to the extent the claim holder files notice of such fee, cost or charge within certain time limits, such charge is lawful, reasonable and provided for in the security agreement, and is secured by property of a value greater than the amount of such claim. In addition, a plan may provide for waiver of any prepayment penalty on a claim secured by the debtor’s principal residence.

Would amend 11 U.S.C. § 1325(a) to allow confirmation if the plan provides that the holder of a modified claim secured by the debtor’s principal residence will retain the lien until the later of payment of the secured claim or discharge under section 1328.

Emergency Homeownership and Equity Protection Act (H.R. 225)
Proposed January 7, 2009
Would make the same amendments as Helping Families Save Their Homes in Bankruptcy Act of 2009 (H.R. 200) (see above) but does not include the proposed amendments to 11 U.S.C. § 502(b) relating to claims arising from violations of consumer protection laws.

Emergency Home Ownership and Mortgage Equity Protection Act of 2007 (H.R. 3609)
Proposed September 20, 2007
Would amend 11 U.S.C. § 1322(b)(2) as follows:
- By prohibiting the holder of a claim secured by debtor’s principal residence from adding fees, costs, or charges during the case without notice;
- By allowing a chapter 13 plan to modify a claim secured only by the debtor’s principal residence and provide for payment over an extended period of time;
- By excluding the claim from discharge until paid in full; and
- By eliminating the pre-petition credit counseling requirement for the chapter 13 debtor if the debtor submits a certification to the court that the holder of the claim has initiated foreclosure on that residence.

Homes Act (H.R. 3778)
Proposed October 9, 2007
Would amend federal bankruptcy law by authorizing modification of a mortgage secured only by the debtor’s principal residence that was initiated prior to September 26, 2007 and allow the principal amount of the mortgage to be lowered to the fair market value at the time of the debtor’s plan and allow for the waiver of any applicable early repayment or prepayment penalties;

Would also eliminate the pre-petition credit counseling requirement if the debtor submits a certification to the court that the holder of the claim has initiated foreclosure on that residence.
Un-named (H.R. 5138)
Proposed January 28, 2008
Would amend federal bankruptcy law by allowing a medically distressed debtor to exempt up to $250,000.00 of the debtor’s interest in specified real or personal property that the debtor or a dependent use as a residence, in a cooperative, or in a burial plot.
Would prohibit the dismissal or conversion to chapter 11 or 13 if the debtor is medically distressed or economically distressed caregiver.
Would add to Section 101 of the Bankruptcy Code a definition of a “medically distressed debtor” to mean a person who has more than $10,000.00 of medical debt not paid by insurance in a 12 month period in the past three years or lives in a household with someone who was out of work for four weeks in 12 months.

Un-named (S. 1561)
Proposed June 7, 2007
Would revise federal bankruptcy law to make (1) loans made under any program funded in whole or in part by a governmental unit or nonprofit institution and (2) any other qualified education loan incurred by the debtor on behalf of the taxpayer, the taxpayer’s spouse, or any dependent, including indebtedness used to refinance a qualified education loan, non-dischargeable in bankruptcy.

Helping Families Save Their Homes in Bankruptcy Act of 2007 (S. 2136)
Proposed October 3, 2007 (Last hearing by the Senate Committee on the Judiciary on 11/19/08)
Would amend federal bankruptcy law by allowing a plan to modify a loan secured by a nontraditional or sub-prime mortgage and any lien subordinate to such a claim on a chapter 13 debtor’s principal residence.
Would provide for the payment of such a loan, at a fixed annual percentage rate, for a period that is the longer of thirty years or the remaining term of such a loan, beginning at the date of the order for relief.
Would provide that if a loan has been modified to an amount below the original principal, and the debtor’s principal residence is sold during the term of the plan, the holder of the claim will be entitled to receive, in addition to the unpaid portion of the allowed secured claim, the net proceeds of the sale, or the amount of the holder’s allowed unsecured claim, whichever is less.
Would eliminate the pre-petition credit counseling requirement if the debtor submits a certification to the court that the holder of the claim has initiated foreclosure on that residence.
Would exempt from the estate up to $75,000.00 of the debtor’s interest in his principal residence if the debtor is age 55 or older.

Consumer Credit Fairness Act (S. 3259)
Proposed July 14, 2008
Would amend federal bankruptcy law to subordinate to all other claims any claims arising from a high cost consumer credit transaction. High cost consumer credit transactions include those that exceed the lesser of 15% and the yield on U.S. Treasury securities having a 30 year period of maturity or 36%.
Additionally, would amend Section 707(b) and make the Means Test inapplicable to a debtor who files bankruptcy due to high cost consumer transactions.
SPOTLIGHT ON SHARON WEISS
First Recipient of the
Kathryn R. Heidt Memorial Award

At the Fall Meeting of the ABA Section of Business Law Business Bankruptcy Committee in Scottsdale, Arizona, Michael St. Patrick Baxter, Chair of the Committee, awarded the first annual Kathryn R. Heidt Memorial Award to Los Angeles attorney Sharon Z. Weiss. Weiss is a partner with the law firm of Richardson & Patel LLP and has been active in the ABA’s Section of Business Law and the Committee for many years.

Ms. Weiss joined Richardson Patel as its first female Partner in 2008. Prior to joining the firm she was a Partner with Weinstein, Weiss & Ordubegian, LLP, which she joined as an associate in 1997. Ms. Weiss has extensive experience in a wide area of insolvency matters from various perspectives, including representation of trustees, individual and corporate debtors, creditors and creditors’ committees. In April 2007, Ms. Weiss was profiled as an Outstanding Woman Bankruptcy Lawyer by Bankruptcy Law360 and has been named by the Los Angeles Magazine as a Southern California “Superlawyer” since 2005. Ms. Weiss was also appointed to the Bankruptcy Mediation Program Panel for the United States Bankruptcy Court, Central District of California in 2006 and appointed in 2007 as an Attorney Settlement Officer for the United States District Court, Central District of California.

Ms. Weiss’ involvement in the Business Bankruptcy Committee has been significant. Currently she serves as Co-Chair of the Programs and Publications Subcommittee and is Co-Chair of the Woman Business Law Network of the Diversity Committee within the Section. Her previous leadership roles in the ABA include Chair of the Law Student and Young Lawyer Involvement Subcommittee; Co-Chair of the Membership: Minorities, Women & Young Lawyers Subcommittee; Vice Chair of the Executory Contracts Subcommittee and Vice Chair of the Litigation Committee. She is also a member of the Board of Directors of the Los Angeles Bankruptcy Forum and is a co-founding member of the Restructuring and Insolvency Professionals of Southern California. Ms. Weiss is an active member of the American Bankruptcy Institute, American Bar Association, California Bankruptcy Forum, Financial Lawyers Conference, International Woman’s Insolvency and Restructuring Confederation and the Los Angeles County Bar Association.

Ms. Weiss displays universal generosity of spirit with all those with whom she comes in contact. One example is her participation as a member of the Hurricane Katrina Working Group and role in the preparation of a business bankruptcy primer to assist lawyers in advising their clients in the devastated areas. Ms. Weiss is also the co-founder of the Nancy H. Newman Memorial Scholarship Fund, which provides financial assistance to worthy students at Southwestern University School of Law in Los Angeles. She has authored or contributed to numerous ABA articles or other work related to bankruptcy law.

When presenting Ms. Weiss with the award, Mr. Baxter remarked that “if Kate had selected the recipient, she would have selected Sharon.” After receiving the award, Ms. Weiss stated, “I am honored to be the first recipient of this distinguished award in memory of Kate Heidt, someone who I deeply respected. I feel very fortunate to be a contributing member of the
Section of Business Law and am honored to be a part of Kate’s legacy. I hope to continue her legacy by recruiting young lawyers to join the Business Bankruptcy Committee and by encouraging senior lawyers to become more involved.”

**Background of the Award**

Kate died unexpectedly in May of 2005 at the age of 51. At the time of her death, she was the chair of the ABA Section of Business Law’s Business Bankruptcy Committee. This memorial award honors Kate’s memory. Kate was a tenured member of the faculty at the University of Pittsburgh School of Law. She was an accomplished author, scholar, teacher, lawyer, and administrator. In addition to her leadership roles at the ABA, she served in leadership capacities at the American Association of Law School’s Section on Creditors’ and Debtors’ Rights. She was a counselor in the truest sense of the word -- a wonderful mother, a friend to many, a dedicated mentor to students and young lawyers, and a trusted voice of wisdom. She left us too soon. This Award is designed to serve as a lasting tribute to all she was and all for which she stood and to recognize the importance of bankruptcy education and scholarship to the ABA Business Bankruptcy Committee and the bankruptcy profession.

In order to be eligible to receive the Kathryn R. Heidt Memorial Award, individuals must meet the following criteria:

- Be an attorney or law student;
- Be a member of the ABA;
- Be under age 40;
- Either have published a recent article on a bankruptcy related topic in an ABA sponsored publication or have produced a significant report, study, or other work product in conjunction with service on the ABA Business Bankruptcy Committee, a subcommittee of the ABA Business Bankruptcy Committee, or task force of the ABA Business Bankruptcy Committee;
- Have demonstrated leadership potential within the ABA or the larger legal community; and
- Have displayed generosity of spirit.