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## **EQUITABLE SUBORDINATION OF A CREDITOR'S SECURED CLAIM WHEN SUCH SECURED CREDITOR IS, ITSELF, IN BANKRUPTCY**

In a majority opinion dated December 15, 2009, the Ninth Circuit Bankruptcy Appellate Panel held that a chapter 11 debtor may not equitably subordinate a creditor's claim and transfer the lien securing that claim, when such creditor is, itself, in bankruptcy, before first obtaining relief from the automatic stay under section 362 of the U.S. Bankruptcy Code in such creditor's bankruptcy case. *Lehman Commercial Paper v. Palmdale Hills Prop. (In re Palmdale Hills Prop., LLC)*, 2009 Bankr. LEXIS 4294 (B.A.P. 9th Cir. Dec. 15, 2009).

It is well established that a bankruptcy court has the power to reorder the priority of allowed claims based on equitable grounds. Indeed, under section 510(c) of the Bankruptcy Code, if the principles of equity so dictate and after appropriate notice and a hearing, the bankruptcy court may subordinate all or part of an allowed claim, and transfer any lien securing such subordinated claim to the bankruptcy estate. The decision in the *Palmdale Hills* case adds a wrinkle to this process when the creditor is in bankruptcy. According to *Palmdale Hills*, if the subject creditor happens to be in bankruptcy, relief from the automatic stay applied in such creditor's case upon filing must first be obtained before such creditor's secured claim can be equitably subordinated.

The debtors in the *Palmdale Hills* case were integrated companies formed as part of a joint venture to develop residential real estate projects with affiliates of Lehman Brothers, Inc. Lehman and its affiliates, including Lehman ALI, Inc. ("Lehman ALI") and Lehman Commercial Paper Inc. ("Lehman Commercial"), provided the financing for the projects through a series of loan agreements and equity arrangements on the debtors' projects. The debtors contended that the structure of these financing arrangements constituted manipulative lending practices and fraudulent conveyances, and that Lehman's complete control over the use of the funds created their significant debt burdens and eventually forced them to file bankruptcy.

Soon after filing bankruptcy in California, the debtors sought blanket relief from the automatic stay in Lehman Commercial's bankruptcy case pending in New York. The purpose of this relief was to allow the *Palmdale Hills* debtors to administer their California bankruptcy cases without the need to file repeated motions for relief from the automatic stay in Lehman Commercial's New York bankruptcy cases. However, the New York bankruptcy court denied the broad relief requested by the debtors without prejudice to the

debtors' rights to refile specific requests for stay relief.

Eventually, the debtors proposed a chapter 11 plan based principally on equitably subordinating the claims of Lehman ALI (an entity not in bankruptcy) and Lehman Commercial (who is in bankruptcy, together with Lehman ALI, the "Lehman Lenders"). The debtors also filed an adversary proceeding against Lehman ALI to equitably subordinate its claim, which they later proposed to amend to include a request to equitably subordinate Lehman Commercial's claim and transfer its lien to the estate if the California bankruptcy court determined that such action would not violate the automatic stay applicable in Lehman Commercial's bankruptcy case.

The Lehman Lenders filed a motion for relief from stay in the debtors' California case arguing that they were owed more than \$649 million on their loans to the debtors, and that the properties securing these loans lacked equity and were declining in value. The Lehman Lenders also argued that the debtors' reorganization would fail because it was based on equitably subordinating Lehman Commercial's claim, which Lehman Commercial argued violated the automatic stay applicable in its bankruptcy case.

The California bankruptcy court did not, however, grant the Lehman Lenders' stay relief motion, and instead treated it as an informal proof of claim. The court also ruled that the debtors could pursue equitable subordination, through either an adversary proceeding or a plan, as a defense to Lehman Commercial's stay relief motion without violating the automatic stay imposed in Lehman Commercial's bankruptcy case. Lehman Commercial appealed, challenging the California bankruptcy court's decision regarding the scope and application of Lehman Commercial's automatic stay.

The BAP reversed, holding that the California bankruptcy court erred in finding that the debtors could pursue equitable subordination of the Lehman Commercial's claim and transfer its lien to the estate without first obtaining relief from the automatic stay in Lehman Commercial's New York bankruptcy case. While the BAP agreed that equitable subordination could be asserted as a defense to a motion seeking relief from the automatic stay without the necessity for seeking relief from the automatic stay, the BAP concluded that, under the facts of the case, equitable subordination was not merely a defense to the relief from stay motion. According to the BAP, when the California bankruptcy court permitted the debtors to pursue equitable subordination of Lehman Commercial's claim, it conflated equitable subordination as a defense to a relief from stay motion with equitable subordination as an objection to a claim. Because the adjudication of the debtors' equitable subordination of Lehman Commercial's claim sought affirmative relief and was not merely a defense, it rose to the level of violating Lehman Commercial's stay.

The BAP also rejected the debtors' contention that, because a complete disallowance of a claim through a claim objection could be achieved without a stay violation, their "lesser defensive remedy" of claim subordination could not possibly violate the automatic stay. The BAP noted that when a claim is disallowed,

the creditor effectively never had the right to payment under that claim and the debtor did not recover any property from the creditor; whereas under equitable subordination, the creditor has a right to payment, but that right is modified based on equitable grounds and, if the claim is secured by a lien, that lien is transferred to the estate. According to the BAP, it was this key difference that transformed the debtors' claim of equitable subordination from a proper defense to Lehman Commercial's stay relief motion into an offensive action against Lehman Commercial's estate.

Finally, the BAP also noted that if the debtors were allowed to subordinate Lehman Commercial's claim in the California bankruptcy court without first moving for a stay relief in Lehman Commercial's New York bankruptcy case, Lehman Commercial's creditors would be deprived of notice and the chance to challenge the subordination action even though their rights would be affected.

One judge dissented in the *Palmdale Hills* case and disagreed with the majority's principal holding (as characterized by the dissent) that a debtor may not, in its own bankruptcy, unilaterally defend against a lender's inequitable claim if that lender is also a bankruptcy debtor. According to the dissent, the majority's distinction between claim disallowance and claim subordination is a distinction without a difference and does not constitute a good reason to require a debtor to seek permission of its creditor's bankruptcy court to avoid an equitable result in its own case. Alternatively, according to the dissent, Lehman Commercial waived its right to raise automatic stay issues once it filed its proof of claim.

Ultimately, the *Palmdale Hills* decision represents a warning sign for a debtor in bankruptcy to tread carefully when dealing with claims filed in its own case. In light of the large number of bankruptcy filings in recent months, it may behoove such a debtor intending to equitably subordinate a creditor's claim, to first check the bankruptcy status, if any, of such creditor and avoid violating the creditor's automatic stay if it happens to be in bankruptcy itself.

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