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Equitably Subordinate its Debt to a Lower-Priority Creditor**

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Introduction

Title 11 of the United States Code (the “Bankruptcy Code”) implements a basic priority system under section 507 to determine the order a bankruptcy court will distribute the assets of an estate.¹ The classic hierarchy begins with secured creditors, then “[s]pecial classes of creditors, such as those [holding] certain claims for taxes or wages . . . [then] low-priority creditors, including general unsecured creditors . . . [followed by] equity holders . . . [who] receive nothing until all previously listed creditors have been paid in full.”² Section 510(c) of the Bankruptcy Code authorizes disturbing the fundamental distribution scheme for secured and unsecured claims through the common law doctrine of equitable subordination.³ Equitable subordination grants a bankruptcy court discretion to subordinate all or part of an allowed claim to all or part of another allowed claim where justice so requires.⁴

¹ 11 U.S.C. § 507 (2018).

² *Czyzewski v. Jevic Holding Corp.*, 580 U.S. 451, 457 (2017) (citations omitted).

³ 4 COLLIER ON BANKRUPTCY, ¶ 510.05 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2009).

⁴ 11 U.S.C. § 510(c)(1) (2018).

Many circuits, including the Third Circuit, require a plaintiff to satisfy the following three conditions before determining whether to grant equitable subordination: (1) a higher-priority creditor engaged in inequitable conduct; (2) such conduct unfairly advantaged them or injured a lower-priority creditor; and (3) subordination is consistent with the Bankruptcy Code.⁵ There is much debate within the circuits on whether satisfying the first factor is a formal requirement.⁶ The Third Circuit formally requires sufficiently pleading inequitable conduct.⁷

This article examines whether a lower-priority creditor in the Third Circuit must establish inequitable conduct by a higher-priority creditor whose debt is sought to be equitably subordinated. Part I explores the circuit split on formally requiring a plaintiff to establish inequitable conduct for an equitable subordination claim and discusses the factors a court may consider when determining whether a plaintiff sufficiently pleads inequitable conduct. Part II discusses the current formal requirement of establishing inequitable conduct of the Third Circuit for equitable subordination claims and examines how the Third Circuit determines sufficient proof of inequitable conduct.

Discussion

I. There is a Circuit Split over whether Inequitable Conduct is a Formal Requirement for Equitable Subordination Claims.

A. The Three-Condition Approach for Determining Appropriateness of Permitting Equitable Subordination.

The circuits have developed a three-part analysis to determine whether equitable subordination is appropriate because Congress did not provide specific criteria for the doctrine. In 1977, the Fifth Circuit adopted three conditions a lower-priority creditor must satisfy before a

⁵ Knox. v. Lion Hendrix Cayman Ltd. (*In re* John Varvatos Enters.), No. 21-2766, 2022 U.S. App. LEXIS 17293, at *5 (3d Cir. June 23, 2022).

⁶ 4 COLLIER ON BANKRUPTCY, ¶ 510.05.

⁷ *In re* John Varvatos Enters., 2022 U.S. App. LEXIS 17293, at n.2.

court may determine whether granting equitable subordination is appropriate.⁸ First, “[t]he claimant must have engaged in some type of inequitable conduct.”⁹ Second, “[t]he misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant.”¹⁰ Third, “[e]quitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Act.”¹¹

In *In re Mobile Steel*, the Fifth Circuit held the inequitable conduct of a higher-priority creditor directed against the debtor or its creditors may satisfy the first condition, even if it is unrelated to the “acquisition or assertion of [the] claim.”¹² The *Mobile Steel* court rejected other courts’ narrow reasoning that misconduct is only inequitable when “acquiring or asserting” the specific claim challenged.¹³ Misconduct unrelated to “acquiring or asserting” a particular claim has frequently formed the basis, at least in part, for the subordination of that claim.¹⁴

i. The Supreme Court Recognizes the Three Conditions as Influential Among the Circuits.

The Supreme Court recognizes *Mobile Steel* as an influential opinion by the Fifth Circuit.¹⁵ The Court offered that Congress included no explicit criteria for what warrants equitable subordination, but legislative history indicates Congressional intent to leave the development of the doctrine to the courts.¹⁶ The Court observed that the application of the doctrine of equitable subordination is “generally triggered by a showing that the creditor had

⁸ Benjamin v. Diamond (*In re Mobile Steel Co.*), 563 F.2d 692, 699 (5th Cir. 1977).

⁹ *Id.* at 700 (citations omitted).

¹⁰ *Id.* (citations omitted).

¹¹ *Id.* (citations omitted).

¹² *Id.* at 700.

¹³ *Id.* at 700–01.

¹⁴ *Id.* at 700.

¹⁵ *United States v. Noland*, 517 U.S. 535, 538 (1996).

¹⁶ *Id.* at 539.

engaged in ‘some type of inequitable conduct.’”¹⁷ Most circuits have adopted the *Mobile Steel* factors.¹⁸

B. There is a Circuit Split regarding whether the First Mobile Steel Condition of Inequitable Conduct must be Established.

i. Many Circuits View the Inequitable Conduct Requirement on a Case-by-Case Basis.

Many circuits consider if inequitable conduct is required on a case-by-case basis since the Supreme Court has not formally required inequitable conduct for equitable subordination claims. Although *Noland* acknowledges that many courts continue to require inequitable conduct, the Supreme Court expressly reserved the decision to require inequitable conduct for equitable subordination.¹⁹

The First Circuit holds *Noland* permits courts to determine the fairness of subordinating a debt based upon the totality of the circumstances in a particular case.²⁰ The First Circuit considers the three *Mobile Steel* conditions a non-exclusive list that may be considered.²¹ The Seventh Circuit notes establishing inequitable conduct is not always required, although it is still the general rule for the doctrine.²² The Eighth Circuit has held that inequitable conduct is not a

¹⁷ *Id.*

¹⁸ See *Merrimac Paper Co. v. Harrison (In re Merrimac Paper Co.)*, 420 F.3d 53, 59 (1st Cir. 2005) (“This court has adopted *Mobile Steel* as the gold standard for section 510(c) cases.”); see also *In re Kreisler*, 546 F.3d 863, 866 (7th Cir. 2008) (acknowledging equitable subordination generally requires satisfaction of the three conditions); *Henry v. Lehman Com. Paper, Inc. (In re First All. Mortg. Co.)*, 471 F.3d 977, 1006 (9th Cir. 2006); *Sender v. Bronze Grp., Ltd. (In re Hedged-Invs. Assocs.)*, 380 F.3d 1292, 1300 (10th Cir. 2004); *Bayer Corp. v. MascoTech, Inc. (In re Autostyle Plastics, Inc.)*, 269 F.3d 726, 744 (6th Cir. 2001) (adopting the three *Mobile Steel* conditions, which permits, not requires, a court to equitably subordinate a claim); *In re ASI Reactivation, Inc.*, 934 F.2d 1315, 1321 (4th Cir. 1991); *Lehman Bros. Holdings, Inc., et al. v. JPMorgan Chase Bank, N.A. (In re Lehman Bros. Holdings, Inc.)*, 541 B.R. 551, 582 (S.D.N.Y. 2015); *Wells Fargo Home Mortg., Inc. v. Dietz*, No. 04-3061, 2005 U.S. Dist. LEXIS 5679, at *15 (D. Minn. Mar. 30, 2005).

¹⁹ 4 COLLIER ON BANKRUPTCY, ¶ 510.05[2]. (“The Court made clear what it was not deciding: ‘[W]e need not decide today whether a bankruptcy court must always find creditor misconduct before a claim may be equitably subordinated.’”).

²⁰ *Id.* (questioning the viability of *Mobile Steel* after *Noland*).

²¹ See *In re Merrimac Paper Co.*, 420 F.3d at 60.

²² See *In re A.G. Financial Serv. Ctr., Inc.*, 395 F.3d 410, 414 (7th Cir. 2005).

prerequisite and granting equitable subordination should be on a case-by-case basis.²³ The Tenth Circuit provides *Noland* did not prohibit lower courts from approving equitable subordination on a case-by-case basis “in the absence of inequitable conduct.”²⁴

ii. Conduct by an Insider is Subject to Higher Scrutiny for Equitable Subordination Claims.

Courts focus on the status of the higher-priority creditor at the time of the alleged act when analyzing the three generally considered categories of inequitable conduct. Inequitable conduct includes lawful conduct that is contrary to “equity and good conscience . . . [i]nclud[ing] a secret or open fraud, lack of good faith by a fiduciary, unjust enrichment, or enrichment brought about by unconscionable, unjust or unfair conduct or double-dealing.”²⁵ There are three generally accepted categories of inequitable conduct recognized by the circuits: (1) fraud, illegality, and breach of fiduciary duties; (2) undercapitalization; and (3) claimant's use of the debtor as an alter ego or mere instrumentality.²⁶ However, the status of a higher-priority creditor, specifically whether the creditor is an “insider” of the debtor, shapes a court’s analysis of the factors.²⁷

Section 101 of the Bankruptcy Code defines an “insider” of a debtor-corporation as a: “(i) director of the debtor; (ii) officer of the debtor; (iii) person in control of the debtor; (iv) partnership in which the debtor is a general partner; (v) general partner of the debtor; or (vi) relative of a general partner, director, officer, or person in control of the debtor”²⁸

Additionally, the Bankruptcy Code provides that an “affiliate” or an “insider” of an “affiliate” is

²³ See *Schultz Broadway Inn v. United States*, 912 F.2d 230, 232–34 (8th Cir. 1990).

²⁴ See *Sender v. Bronze Grp., Ltd. (In re Hedged-Invs. Assocs.)*, 380 F.3d 1292, 1301 (10th Cir. 2004).

²⁵ *In re Verestar, Inc.*, 343 B.R. 444, 461 (Bankr. S.D.N.Y. 2006).

²⁶ See *Redmond v. Jenkins (In re Alternate Fuels, Inc.)*, 789 F.3d 1139, 1154 (10th Cir. 2015).

²⁷ See *Lehman Bros. Holdings, Inc., et al. v. JPMorgan Chase Bank, N.A. (In re Lehman Bros. Holdings, Inc.)*, 541 B.R. 551, 582 (S.D.N.Y. 2015) (citations omitted).

²⁸ 11 U.S.C. § 101(31)(B) (2018).

also deemed an “insider” of the debtor.²⁹ The Bankruptcy Code defines “affiliate” as “an entity that controls 20 percent or more of the outstanding voting securities of the debtor, or is controlled by the debtor to the same extent.”³⁰

The conduct of an “insider” is subject to higher scrutiny, as insider status or control alone does not provide a sufficient basis for equitable subordination.³¹ Several circuits loosely apply the term “insider” to include any person or entity who has a sufficiently close relationship with the debtor that any transactions between them are subject to closer scrutiny than those occurring at arm's length.³²

“Insiders” must use their power to control a debtor or use their position of trust to their advantage or other creditors’ detriment.³³ Clear inequitable conduct by “insider” creditors can include “underhanded behavior . . . [including attempts] to convert their equity interests into secured debt in anticipation of bankruptcy.”³⁴

However, it is insufficient for non-insider creditors to merely establish “some unfair conduct.”³⁵ The degree of non-insider inequitable conduct that warrants subordination must rise to the level of “gross and egregious, tantamount to fraud, misrepresentation, overreaching or spoliation, or involving moral turpitude.”³⁶

iii. “No Fault” Equitable Subordination may be an Exception to the Inequitable Conduct Requirement for Equitable Subordination Claims.

Most courts acknowledge “no fault” equitable subordination where a showing of misconduct is not required and is limited to tax penalties, stock redemption claims, and punitive

²⁹ *Id.* at § 101(31)(E).

³⁰ 4 COLLIER ON BANKRUPTCY, ¶ 510.05[3][a].

³¹ 4 COLLIER ON BANKRUPTCY, ¶ 510.05[3].

³² *See In re Dan-Ver Enters., Inc.*, 86 B.R. 443, 449 (Bankr. W.D. Pa. 1988) (citations omitted).

³³ *See In re Missionary Baptist Found. of Am.*, 818 F.2d 1135, 1144 (5th Cir. 1987).

³⁴ *In re Optim Energy, LLC*, 527 B.R. 169, 177 (D. Del. 2015).

³⁵ *Redmond v. Jenkins (In re Alternate Fuels, Inc.)*, 789 F.3d 1139, 1155 (10th Cir. 2015).

³⁶ *Id.* (noting a majority of courts require a high degree of inequitable conduct for non-insiders).

damages. Courts have used section 510(c) of the Bankruptcy Code to equitably subordinate holders of tax penalty claims and stock redemption claims in the absence of wrongdoing by the claimants at issue.³⁷ *Noland* provides that many circuits continue to require inequitable conduct for equitable subordination of most claims, as some courts have “done away with the requirement when the claim in question [is] a tax penalty.”³⁸ However, the Fifth Circuit rejects “no fault” equitable subordination and requires proof of actual harm to creditors.³⁹

The Tenth Circuit acknowledges “[S]ection 510(c)(1) does not require a finding of claimant misconduct to subordinate nonpecuniary loss tax penalty claims.”⁴⁰ *Sender* provides that the exception is granted on the theory that giving priority in bankruptcy to punitive fines owed to the government and punishing the debtor’s innocent creditors fails to serve the purpose of the fine.⁴¹ The First Circuit has held that claims arising from stock redemption notes should be subordinated if subordination would be fair based on the totality of the circumstances of a particular case, not solely due to their intrinsic nature.⁴²

II. Inequitable Conduct is a Formal Requirement for Equitable Subordination Claims in the Third Circuit.

A. The Third Circuit Adopts Mobile Steel Conditions.

In 2009, the Third Circuit adopted the three conditions outlined in *Mobile Steel*.⁴³ Therefore, a claimant must sufficiently plead inequitable conduct by a higher-priority creditor when seeking to equitably subordinate its debt. The Third Circuit adopted the three general

³⁷ See Steven L. Schwarcz, *The Inequities of Equitable Subordination*, 96 AM. BANKR. L.J., 29, 40 (2022).

³⁸ *United States v. Noland*, 517 U.S. 535, 539 (1996) (citing *In re Fabricators, Inc.*, 926 F.2d 1458, 1464 (5th Cir. 1991)).

³⁹ *SI Restructuring, Inc. v. Faulkner (In re SI Restructuring, Inc.)*, 532 F.3d 355, 361 (5th Cir. 2008).

⁴⁰ *Sender v. Bronze Grp., Ltd. (In re Hedged-Invs. Assocs.)*, 380 F.3d 1292, 1300–01 (10th Cir. 2004).

⁴¹ *Id.* (noting punitive fines are intended to punish a company and its owners for their wrongdoing).

⁴² *Merrimac Paper Co. v. Harrison (In re Merrimac Paper Co.)*, 420 F.3d 53, 62–63 (1st Cir. 2005).

⁴³ *Shubert v. Lucent Techs. Inc. (In re Winstar Commc'ns)*, 554 F.3d 382, 411–13 (3d Cir. 2009); see also *In re HH Liquidation, LLC*, 590 B.R. 211, 298 (Bankr. D. Del. 2018) (noting the Third Circuit requires a movant to establish all three elements); *In re Optim Energy, LLC*, 527 B.R. 169, 177 (D. Del. 2015) (dismissing equitable subordination claim due to creditor's failure to allege inequitable conduct sufficiently).

categories of inequitable conduct as well.⁴⁴ However, the Third Circuit does not hold the three categories as exclusive.⁴⁵ The status of the creditor in relation to the debtor at the time of the act is the most important factor when determining the existence of inequitable conduct.⁴⁶

i. Sufficiency of Pleading Inequitable Conduct Depends on Creditor Status in the Third Circuit.

The status of a higher-priority creditor whose debt is sought to be equitably subordinated determines the level of inequitable conduct a lower-priority creditor must plead. The Third Circuit holds “insider” status as a mixed question of law and fact, although the Fifth Circuit holds this issue as a question of fact.⁴⁷ The Third Circuit reviews a bankruptcy court’s findings for clear error and exercises “plenary review of the lower court’s interpretation and application of those facts to legal precepts” when determining “insider” status.⁴⁸

The Third Circuit rigorously scrutinizes claims arising from the dealings between an “insider” creditor and a debtor.⁴⁹ A Third Circuit plaintiff bears the burden of presenting “material evidence of only unfair conduct” by an “insider” creditor due to the level of scrutiny the court applies.⁵⁰ Determination of inequitable conduct by an “inside” creditor is on a case-by-case basis because the Third Circuit notes there is no “bright-line test” when determining what constitutes inequitable conduct.⁵¹ For dealings between a debtor and a non-insider, the Third

⁴⁴ See *Atlas Uluslararası Kumanyacılık Tic. A.Ş. v. M/V Arica*, 590 F. Supp. 3d 749, 753 (D. Del. 2022) (citations omitted).

⁴⁵ See *In re Zohar III, Corp.*, 639 B.R. 73, 91 (Bankr. D. Del. 2022), *appeal dismissed sub nom, In re Zohar III, Corp.*, No. 22-2695, 2022 WL 19038638 (3d Cir. Nov. 10, 2022).

⁴⁶ *Id.* (noting the degree of sufficient inequitable conduct to justify applying equitable subordination is dependent on the claimant’s status).

⁴⁷ See *In re Winstar Commc’ns*, 554 F.3d at 394–95 (citations omitted)

⁴⁸ *Id.* at 395 (citations omitted).

⁴⁹ See *In re Zohar III, Corp.*, 639 B.R. at 91.

⁵⁰ *Id.*

⁵¹ See *id.*

Circuit follows the majority of circuits and requires “more egregious conduct such as fraud, spoliation or overreaching”⁵²

B. The Standard of Review for Equitable Subordination Claims in the Third Circuit.

i. The Third Circuit Requires a Direct Nexus between the Alleged Inequitable Conduct and the Creditor at Issue.

The Third Circuit requires sufficient proof of inequitable conduct by the higher-priority creditor to equitably subordinate their debt. Lower-priority creditors in the Third Circuit must establish legitimate evidence of unfair conduct, as probable inequitable conduct is insufficient to permit the rare remedy of equitable subordination.⁵³ In the Third Circuit, equitable subordination is appropriate only if it is “supported by findings that justify the remedy chosen by reference to equitable principles.”⁵⁴

The Third Circuit holds “[t]he inequitable conduct underlying equitable subordination may be ‘unrelated to the acquisition or assertion of the particular claim whose status [is] at issue.’”⁵⁵ Inequitable conduct can arise from “any unfair act by the creditor as long as the conduct affects the bankruptcy results of the other creditors.”⁵⁶ A claim for equitable subordination is insufficient if it—in the absence of alleging the defendant engaged in misconduct—alleges an affiliate engaged in inequitable conduct and argues such conduct should be imputed to the defendant.⁵⁷

ii. The Third Circuit Acknowledges “No Fault” Equitable Subordination in Special Cases.

⁵² *Id.*

⁵³ *See Redmond v. Jenkins (In re Alternate Fuels, Inc.)*, 789 F.3d 1139, 1156 (10th Cir. 2015).

⁵⁴ *Citicorp Venture Cap., Ltd. v. Comm. of Creditors Holding Unsecured Claims*, 160 F.3d 982, 991 (3d Cir. 1998) (providing if there is an absence of sufficient findings, the Third Circuit cannot review the claim).

⁵⁵ *Shubert v. Lucent Techs. Inc. (In re Winstar Commc'ns)*, 554 F.3d 382, 412 (3d Cir. 2009).

⁵⁶ *Citicorp Venture Cap., Ltd. v. Comm. of Creditors Holding Unsecured Claims*, 323 F.3d 228, 234 (3d Cir. 2003).

⁵⁷ *See In re HH Liquidation, LLC*, 590 B.R. 211, 300 (Bankr. D. Del. 2018) (dismissing equitable subordination claim because the claimant failed to proffer any direct evidence of the defendant engaging in inequitable conduct).

The Third Circuit acknowledges “no fault” equitable subordination and waives requiring establishing inequitable conduct for certain cases. The Third Circuit has found that “no fault” equitable subordination involves “tax penalties, stock redemption claims, and punitive damages claims.”⁵⁸ However, the Third Circuit has refused to answer whether inequitable conduct is required in stock redemption claims.⁵⁹ The Third Circuit provides circuits that equitably subordinate stock redemption claims do not restrict subordination solely to cases that establish creditor misconduct.⁶⁰

iii. Examples of Failure by a Lower-Priority Creditor to Provide Sufficient Proof of Inequitable Conduct by a Higher-Priority Creditor.

The failure to establish a direct nexus between the defendant and the alleged inequitable conduct is fatal to equitable subordination claims in the Third Circuit.⁶¹ For example, in *Varvatos*, while applying the *Winstar* test, the court held the plaintiff failed to establish inequitable conduct by the defendant through a single piece of insufficient evidence.⁶² The plaintiff could not proffer any evidence of a direct nexus between its alleged harm and the defendant engaging in inequitable conduct.⁶³ In *Zohar*, the court held the plaintiffs failed to establish any misconduct by the defendant, “let alone the sort of egregious behavior required of non-insiders.”⁶⁴ The *Zohar* court concluded the additional issues raised in the amended complaint failed to attribute the misbehavior to the defendants.⁶⁵

⁵⁸ *In re NTP Marble, Inc.*, 491 B.R. 208, 214 (Bankr. E.D. Pa. 2013); see also *In re Burden v. United States*, 917 F.2d 115, 120 (3d Cir. 1990) (noting persuasive precedent determined inequitable conduct is not the exclusive basis for subordinating tax penalties under the Bankruptcy Code).

⁵⁹ *Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Sys. Corp.)*, 432 F.3d 448, 462 (3d Cir. 2006) (refusing to adopt inequitable conduct as a formal requirement because plaintiffs failed to establish any injury).

⁶⁰ See *In re Montgomery Ward Holding Corp.*, No. 97-1409, 2000 WL 33712303, at *3 (Bankr. D. Del. 2000).

⁶¹ See *In re John Varvatos Enters.*, 2022 U.S. App. LEXIS 17293, at *2.

⁶² *Id.* at *5 (holding testimony by a former employee of the defendant was unrelated to the misconduct by the defendant).

⁶³ See *Id.* at *2.

⁶⁴ *In re Zohar III, Corp.*, 639 B.R. 73, 98 (Bankr. D. Del. 2022).

⁶⁵ *Id.*

Conclusion

A majority of circuits, including the Third Circuit, have adopted a three-part conditional analysis to determine whether equitably subordinating a debt is appropriate. While most circuits have adopted the *Mobile Steel* conditions, there is a circuit split on formally requiring a plaintiff to establish inequitable conduct. The Third Circuit requires a lower-priority creditor to sufficiently plead inequitable conduct by a higher-priority creditor to equitably subordinate its debt. Also, the Supreme Court favorably cited *Mobile Steel* but reserved ruling on whether a bankruptcy court must find inequitable conduct in an equitable subordination claim. Additionally, because Congress did not provide explicit criteria for courts to warrant equitable subordination, most circuits have adopted a case-by-case approach and apply rigorous scrutiny to claims arising from dealings between an “insider” creditor and a debtor. The Third Circuit follows the majority approach and determines the sufficiency of pleaded inequitable conduct on a case-by-case basis, dependent on creditor status. Any future equitable subordination claims brought within the Third Circuit must plead a sufficient level of inequitable conduct by a higher-priority creditor, depending on their status at the time of the alleged act, to subordinate their debt.