

EQUITABLE SUBORDINATION

Equitable subordination is a remedy developed under common law to penalize misconduct that results in injury to creditors or shareholders.

As a court of equity (as distinct from a court of law), the bankruptcy court is empowered to grant a broader spectrum of relief in keeping with fundamental notions of fairness, as opposed to principles of black-letter law. The Court can use its discretion to produce fair and just results "to the end that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done."

The Bankruptcy Code expressly authorizes only equitable subordination.

Section 510(c) Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may --

(1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or

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

Such litigation would take place under Rule 7001 (8).

Under the Mobile Steel standard, a claim can be subordinated if

the claimant engaged in some type of inequitable conduct (or conferred an unfair advantage on the claimant); **and**

the inequitable conduct must have resulted in either injury to the other creditors or an unfair advantage to the creditor engaged in such inequitable conduct; **and**

equitable subordination of the claim is consistent with the provisions of the bankruptcy code

In practice this means the following:

Equitable subordination requires some sort of misconduct

A claim or interest will be subordinated only to the necessary to redress it

Many make a distinction between insiders and non-insiders in assessing the level of misconduct necessary to warrant subordination

When the claims involve a non-insider and non-fiduciary, the inequitable conduct must have been gross and egregious

If a claim is a general one with no particularized injury arising from it and if that claim could be brought by any creditor of the debtor, then the trustee is the proper person to assert the claim.

An individual creditor has standing to pursue a claim if (1) the individual creditor makes a demand upon the trustee or debtor-in-possession; (2) the bankruptcy trustee or debtor-in-possession refuses to assert the claim; and (3) the bankruptcy court authorizes the creditor to file the claim.

In order to establish that an individual creditor is authorized to pursue such a claim, the individual creditor must demonstrate that the claim is colorable and that the refusal of the trustee or debtor-in-possession is unreasonable.

An action is colorable if it is apparently right or credible.

Under the Twombly decision in 2007 from the Supreme Court, a new general pleading standard was established. This is a plausibility standard.

A complaint will now survive a motion to dismiss under Rule 12(b)(6) if it contains "enough facts to state a claim for relief that is plausible on its face." The complaint need not plead sufficient facts to establish a prima facie case, so long as it alleges "enough to raise a right to relief above the speculative level, on the assumption that the allegations are true (even if doubtful in fact)," and it contains something more than "labels, conclusions or a formulaic recitation of the elements of a cause of action."