

INEQUITABLE INSUBORDINATION: THE SEVENTH CIRCUIT'S UNSATISFYING DECISION
IN RE KREISLER

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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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² *In re Kreisler*, 2008 WL 4613880 (7th Cir. 2008).

³ *Id.* at *1.

⁴ *Id.*

⁵ *In re Kreisler*, 331 B.R. 364, 372 (Bkrcty. N.D. Ill. 2005).

⁶ *Id.*

⁷ *Id.*

⁸ *In re Kreisler*, 2008 WL 4613880 at *1.

⁹ *In re Kreisler*, 331 B.R. at 372.

¹⁰ *Id.*

¹¹ *Id.*

¹² *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

¹³ *Id.* at 373.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.* at 374.

²⁰ *In re Kreiser*, 2008 WL 4613880 at *2.

²¹ See *Matter of Mobile Steel Co.*, 563 F.2d 692 (1977).

- (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 *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 *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 *Lifschultz* test would seemingly be satisfied, equitable

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

²³ *Joy Recovery Technology Corp.*, 286 B.R. 54, 84 (Bkrtcy. N.D. Ill. 2002).

²⁴ *In re Kreisler*, 331 B.R. at 382-83.

²⁵ *Id.* at 382.

²⁶ *In re Kreisler*, 331 B.R. at 383.

²⁷ *Lifschultz*, 132 F.3d at 344.

²⁸ *In re Kreisler*, 331 B.R. at 383.

²⁹ *Lifschultz*, 132 F.3d at 344.

³⁰ *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.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."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.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.³⁴ The District Court decision has very little analysis. It stated that there "can be no doubt" that the *Lifschultz* factors were all satisfied.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),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.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

³¹ *Id.*

³² *Mobile Steel*, 563 F.2d at 700.

³³ *Id.*

³⁴ *In re Kreisler*, 352 B.R. 671, 673 (N.D.Ill. 2006).

³⁵ *Id.* at 677.

³⁶ *Id.*

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.³⁸ 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 *Kreiser* 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.

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).

