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From the Bankruptcy Courts: Equitable Subordination of the Postpetition Financer and the Use of Shareholder Guarantees to Escape the Absolute Priority Rule: Lessons from the Seventh Circuit

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EQUITABLE SUBORDINATION OF THE POSTPETITION FINANCER AND THE USE OF SHAREHOLDER GUARANTEES TO ESCAPE THE ABSOLUTE PRIORITY RULE: LESSONS FROM THE SEVENTH CIRCUIT

The cramdown provisions of chapter 11 of the Bankruptcy Code are designed to enable the debtor to achieve confirmation of a reorganization plan notwithstanding its inability to obtain the necessary acceptances of all classes of impaired creditors and interest holders. However, cramdown may not be accomplished unless the plan is "fair and equitable" to the nonaccepting classes, which means that the plan must follow the "absolute priority rule" set forth in Code Section 1129(b). If a class of creditors is to receive less than full payment and does not accept the plan, a cramdown is not possible if the plan permits shareholders to receive or retain anything on account of their equity interests.[1]

Imagine a debtor who attempts a cramdown confirmation with a plan that seeks to subordinate its postpetition priority financer, and which offers creditors (including the postpetition financer) less than full payment while permitting the shareholders to keep their shares. The only justification offered for permitting shareholders to keep their shares is that shareholders' guarantees constitute a new capital investment in the debtor corporation. Should such a plan be confirmed?

Kham & Nate's Shoes No. 2

A case of this nature was *Kham & Nate's Shoes No. 2*,[2] involving a debtor (the Debtor) that operated retail shoe stores in Chicago. The Debtor had been in chapter 11 since 1984 and had submitted a plan of reorganization that had been confirmed by the bankruptcy court. The district court affirmed the confirmation order. First Bank of Whiting (the Bank), one of its creditors, appealed to the court of appeals on the grounds that the order not only

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[1] See 11 U.S.C. § 1129(b).

[2] Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351 (7th Cir. 1990) (*Reh'g* and *Reh'g en banc denied*).

reduced the Bank's priority claim to general unsecured status, but also allowed the debtor's two shareholders (the Shareholders) to retain their equity interests despite the plan's failure to pay creditors in full.

The financing of the Debtor by the Bank commenced in July 1981, at which time Kham & Nate's owned four retail shoe stores. A loan of $50,000 was reduced to $42,000 by 1983, at which time the Bank issued several letters of credit in favor of the Debtor's customers. The Debtor issued a note to the Bank to support the letters of credit and gave the Bank a security interest only in the goods furnished by the suppliers.

In late 1983, the Debtor experienced cash-flow problems and asked the Bank for additional financing, which the Bank agreed to provide on condition that the loan could be made secure. However, it was difficult to satisfy the Bank that new financing would be secure in view of the Debtor's tax liability of $440,000, a hurdle that could not be overcome as the parties considered that "any new loan from Bank would stand behind the back tax liabilities."[3]

The parties considered two ways of securing the Bank: a guarantee by the Small Business Administration (SBA) or the filing of a bankruptcy petition after which an order could be procured giving the Bank a postpetition loan superpriority. The second alternative was used.

[3] 908 F.2d at 1353.

The Debtor filed its petition under chapter 11 in January 1984 and the bankruptcy court granted its application for an order under Section 364(c)(1) of the Bankruptcy Code, giving the Bank's postpetition financing priority over administrative expenses incurred in the case.[4] The Debtor and the Bank then signed their loan agreement, which opened a $300,000 line of credit. The contract also provided for cancellation on five days' notice, "and adds for good measure that 'nothing provided herein shall constitute a waiver of the right of the Bank to terminate financing at any time.' "[5]

The contract was signed on January 23, 1984, and the Debtor immediately took $75,000. Suppliers also began drawing on the letters of credit issued by the Bank. On February 29, the Bank mailed the Debtor a letter stating that it would make no additional advances after March 7, 1984. Although the note underlying the line of credit was payable upon demand, the Bank did not make the demand, and continued honoring draws on the letters of credit. The Debtor's ultimate indebtedness to the Bank was approximately $164,000: $42,000 on the prepetition loan made in 1981, $47,000 on the letters of credit, and $75,000 on the postpetition line of credit. The Debtor paid $10,000 against the line of credit in April 1985. The court observed that the Debtor did not ask the court "to order Bank to make

[4] See 11 U.S.C. § 364(c)(1).

[5] 908 F.2d at 1353.

further advances or to grant superpriority to another creditor to facilitate loans from another source."[6]

In the spring of 1988, four years after filing its petition, the Debtor proposed its fourth plan of reorganization. Although the previous three plans had called for the Bank to be paid in full, the fourth plan proposed to treat the Bank's claims as general, unsecured claims to receive less than full payment, while allowing the Shareholders to keep their stock in exchange for guaranteeing new loans to the Debtor.

> [The Bankruptcy Judge] held an evidentiary hearing on the fourth plan and concluded that Bank had behaved inequitably in terminating the line of credit and inducing Debtor's suppliers to draw on the letters of credit. These draws, the judge concluded, converted Bank from an unsecured lender (the position it held before the bankruptcy) to a super-secured lender under [the bankruptcy judge's] financing order.[7]

The bankruptcy judge vacated the financing order and equitably subordinated the Bank's debt pursuant to Section 510(c) of the Code.[8] The plan of reorganization, including the provision allowing the Stockholders to retain their interest, was confirmed. The guarantees were found to be "new value" equivalent to the worth of the interest that the Stockholders would retain. The Bank appealed to the district court, which affirmed.[9]

The question of appellate jurisdiction was raised by the Bank even though it had filed the appeal. After an extensive discussion on appellate jurisdiction, the court of appeals held that a "confirmation order is always appealable" as a final order.[10]

Equitable Subordination

Turning to the issue of subordination of the Bank's claim, the court stated that such equitable subordination required two steps: (1) setting aside the bankruptcy judge's financing order and (2) the application of Section 510(c). The court commented, however, that there was an "intermediate step," suggested by Section 364(e), which provides that the reversal or modification of a financing order on appeal "does not affect the validity of any debt so incurred, or any priority or lien so granted, to an entity that extended such credit in good faith."[11]

Clarifying the operation of Section 364(e), the court stated:

> In other words, a lender that extends credit in reliance on a financing order is entitled to the benefit of that order, even if it turns out to be legally or factually erroneous. Although

[6] 908 F.2d at 1354.

[7] *Id.*

[8] See 11 U.S.C. § 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. . . ."

[9] See 104 Bankr. 909 (N.D. Ill. 1989).

[10] 908 F.2d at 1355.

[11] 11 U.S.C. § 364(e).

> § 364(e) speaks only of modification on appeal, it instantiates the principle that bankruptcy judges may make *binding* commitments to give priority to new credit. If creditors fear that the rug will be pulled out from under them, they will hesitate to lend. So § 364(e) and companion provisions, e.g., 11 U.S.C. § 363(m) . . . disable courts from backtracking on promises in the absence of bad faith, which is a very narrow exception.[12]

The court clearly indicated that the bankruptcy judge's financing order under Section 364(e) was a binding commitment to the lender and that modification of the order

> poses the same risks as does reversal on appeal. Accordingly, although 364(e) does not apply by its own terms, its principle applies through the law of the case. A judge lacks the power to undo the priority granted by a financing order without first finding that the creditor acted in bad faith.[13]

The lack of this finding by the bankruptcy judge, however, appeared to be caused by the Bank's own failure to make the Section 364(e) argument. "Even in this court, Bank ignores the principle behind § 364(e) and is content to argue that Debtor did not meet the criteria for subordination under 510(c)."[14] However, since the Bank's appeal ignored the application of Section 364(e), the court of appeals addressed the issue of subordination of the Bank's claim. "We take commercial cases as the parties frame them, so we shall press on to the application of § 510(c) without implying that this is the proper way to proceed in future cases."[15]

The bankruptcy court gave two reasons for subordinating the Bank's claim. One was that notwithstanding the Bank's awareness of the Debtor's plight and its reliance upon the letter of credit, the Bank disregarded the consequences to the Debtor and its creditors of terminating its financing. The other reason was that the Bank obtained an unfair advantage by inducing suppliers to draw on the letters of credit after the financing order, "thus promoting its position on these advances from unsecured to supersecured."[16]

The Bank made the analysis of the second reason easy by disclaiming priority status for the $47,000 advanced postpetition to satisfy the letters of credit that were issued prepetition, and for the $42,000 balance outstanding on the prepetition loan made in 1981.

> These are, and always have been, unsecured loans. Orders under § 364(c) do not allow a creditor to boost the priority of existing loans [citations omitted]. Section 364(c) speaks of "*obtaining* of credit or the *incurring* of debt" (emphasis added); prior loans and sums disbursed on prior firm commitments fit neither

[12] 908 F.2d at 1355, citing *In re* Chicago, Milwaukee, St. Paul and Pac. RR, 799 F.2d 317, 329–330 (7th Cir. 1986).

[13] 908 F.2d at 1355.

[14] *Id.*

[15] *Id.* at 1356.

[16] *Id.*

> category. Sums paid out after bankruptcy on letters of credit issued before bankruptcy are pre-bankruptcy loans, to which § 364(c) cannot apply, because the bank is committed before the bankruptcy to honor sight drafts tendered with conforming draws. Priority under § 364 is not necessary to obtain this credit for the debtor. So although the financing order appears to give Bank priority on all of its loans, pre- and post-filing, "Bank wisely concedes that the order could not properly have done so. The 1981 loan and the advances in 1984 to honor the letters of credit always were unsecured. The plan of reorganization properly treats them as unsecured.[17]

Therefore, subordination was relevant only with regard to the $65,000 balance due under the line of credit authorized by the financing order. The court of appeals noted that section 510(c) authorized bankruptcy judges to subordinate claims but did not provide criteria for the exercise of the power.

> Absence of statutory criteria commits the subject to the courts, to be worked out in the common law fashion [citations omitted]. Equitable subordination usually is a response to efforts by corporate insiders to convert their equity interests into secured debt in anticipation of bankruptcy [citations omitted]. Courts require the insiders to return to their position at the end of the line. *Virtual Network* extends principles of equitable subordination to a penalty created by operation of law, where delay in collecting the penalty injured other creditors. But Bank, however, was neither an insider nor a person seeking to collect a penalty, and it has not delayed without justification. It contributed new value under a contract, and it wants no more than the priority [the bankruptcy judge] promised as the lure.[18]

Observing that cases subordinating the claims of creditors that dealt at arm's length with the debtor were few, the court noted that under existing case law subordination depends upon a combination of inequitable conduct, unfair advantage to the creditor, and injury to other creditors.[19] The Debtor argued that conduct may be unfair and inequitable for this purpose even though the creditor complies with all the contractual requirements. The court of appeals disagreed. "[W]e are not willing to embrace a rule that requires participants in commercial transactions not only to keep their contracts but also do 'more'—just how much more resting in the discretion of a bankruptcy judge assessing the situation years later."[20]

> "Inequitable conduct" in commercial life means breach *plus* some advantage-taking, such as the star who agrees to act in a motion picture and then, after $20 million has been spent, sulks in his dressing room until the contract has been renegotiated

[17] *Id.*

[18] *Id.* The court referred to *In re* Virtual Network Servs. Corp., 902 F.2d 1246 (7th Cir. 1990).

[19] The court cited Benjamin v. Diamond, 563 F.2d 692 (5th Cir. 1977).

[20] 908 F.2d at 1356.

> [citations omitted]. Firms that have negotiated contracts are entitled to enforce them to the letter, even to the great discomfort of their trading partners, without being mulcted for lack of "good faith." Although courts often refer to the obligation of good faith that exists in every contractual relation, e.g., UCC § 1-201 [citation omitted], this is not an invitation to the court to decide whether one party ought to have exercised privileges expressly reserved in the document. "Good faith" is a compact reference to an implied undertaking not to take opportunistic advantage in a way that could not have been contemplated at the time of drafting and which therefore was not resolved explicitly by the parties. When the contract is silent, principles of good faith—such as the UCC's standard of honesty in fact, UCC § 1-201(19), and the reasonable expectations of the trade, UCC § 2-103(b) (a principle applicable, however, *only* to "merchants," which Bank is not)—fill the gap. They do not block use of terms that actually appear in the contract.[21]

The Bank did not break a promise at the time that the Debtor was vulnerable because of financial difficulties and then use the costs and delay of obtaining legal enforcement of the contract as "levers to a better deal."[22] The contract expressly allowed the Bank to cease making further advances; it made a clean break after loaning the Debtor $75,000 and did not demand improved terms. "It had the right to do this for any reason satisfactory to itself."[23]

The Debtor asserted that the Bank's conduct left it with great difficulty in its search for funds. The court commented that the Bank did not create the Debtor's need for funds and it was not contractually obliged to satisfy its customer's desires. The court disagreed with the decision in *KMC, Inc. v. Irving Trust Co.*[24] to the extent that it held that a bank must loan more money or give more advance notice of termination than its contract requires. "First Bank of Whiting is not an eleemosynary institution. It need not throw good money after bad, even if other persons would catch the lucre."[25]

The court also discarded the Debtor's argument, and the bankruptcy judge's finding, that the Bank would have been secure in making additional advances. The contract did not obligate the Bank to make all advances for which it could be assured of payment. Moreover, the court of appeals addressed the bankruptcy court's finding that the Bank acted inequitably in agreeing to extend additional credit only if Kham & Nate's first filed a bankruptcy petition or obtained a guarantee from the SBA. This condition, the Debtor argued, forced the firm into bankruptcy, and having pro-

[21] 908 F.2d at 1356–1357.

[22] 908 F.2d at 1257.

[23] *Id.*, citing *In re* Prima Co., 98 F.2d 952, 965 (7th Cir. 1938); CTS Truss, Inc., 868 F.2d 146 (5th Cir. 1989).

[24] 757 F.2d 752, 759–763 (6th Cir. 1986).

[25] 908 F.2d at 1358.

pelled it there, the Bank was then obliged to help.

> This is insufficient on two levels—first because filing for bankruptcy often helps rather than injures the firm (the automatic stay keeps the wolves and tax collectors from the door), and second because linking an offer of extra credit to a bankruptcy petition does not 'force' a firm to file one. A bank may insist on security before lending; bankruptcy followed by an order under § 364 was one device for providing it.[26]

The court also rejected the argument that subordination was justified because the Bank's termination of advances frustrated the Debtor's efforts to secure advances from other sources and propelled it downhill. These allegations, if true, are legally irrelevant. As to the Bank's breach of the agreement by failing to give telephonic notice of termination, which the court characterized as trivial, the court of appeals concluded that "[e]quitable subordination under § 510(c) is not a device to magnify the damages available for inconsequential breaches of contract."[27]

Shareholder Guarantees are not New Value

Having concluded that the Bank's claim could not be the subject of equitable subordination under Section 510(c) of the Bankruptcy Code, the court then faced the issue of whether the Debtor's plan of reorganization was properly confirmed under Section 1129(b). The court noted that Section 1129(a) provides for confirmation upon the approval of each impaired class, but that Section 1129(b)(1) provides that a "fair and equitable" plan may be "crammed down the throats of objecting creditors."[28] The Bankruptcy Code provides that a plan treats a class of unsecured creditors who are not receiving full payment of their claims fairly and equitably if the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property. "This is the 'absolute priority rule.' An objection to the plan may be overridden only if every class lower in priority is wiped out."[29]

The bankruptcy court, however, approved a cramdown plan although unsecured creditors, including the Bank, would not be paid in full, while shareholders retained equity interests. The Bank's objection to the plan was overruled by the bankruptcy court after finding that the plan would be fair and equitable. The bankruptcy court "allowed the stockholders to retain their interests, reasoning that by guaranteeing a $435,000 loan to be made as part of the plans, [the stockholders] contributed 'new value' justifying the

[26] *Id.*
[27] *Id.*
[28] *Id.*
[29] *Id.*

retention of their stock. The size of the new debt made the risk of the guarantees 'substantial,' the court found.''[30]

The bankruptcy court allowed the stockholders to keep their stock because the risk of the guarantees also exceeded the value of the retained stock. Considering the history of the Debtor and the various risks associated with the Debtor's business, the stock would have only minimal value. ''[The stockholders] thus would contribute more than they would receive, so the court allowed them to keep their stock.''[31]

The court of appeals was puzzled by this anomaly:

> There is something unreal about this calculation. If the stock is worth less than the guarantees, why are [the stockholders] doing it? If the value of the stock is 'minimal,' why does Bank object to letting [the stockholders] keep it? Is *everyone* acting inconsistently with self-interest, as the court's findings imply? And why, if the business is likely to fail, making the value of the stock 'minimal,' could the court confirm the plan of reorganization? Confirmation depends on a conclusion that the reorganized firm is likely to succeed, and not relapse into 'liquidation, or the need for further financial reorganization.' 11 U.S.C. § 1129(a)(11). If, as the bankruptcy court found, the plan complies with this requirement, then the equity interest in the firm *must* by worth something—as [the stockholders] and Bank all appear to believe.[32]

The court of appeals, citing the *Ahlers* case,[33] noted that stock is property for the purposes of Section 1129(b)(2)(B)(ii) even if the firm has a negative net worth. The court indicated that the stockholders received an option to purchase stock, which they could exercise if they thought that the shares were worth more than the risk created by the guarantees. ''Whether we characterize the stock or the option to buy it as the 'property,' the transaction seems to run afoul of § 1129(b)(2)(B)(ii) for it means that although a class of unsecured creditors is not paid in full, a junior class (the stockholders) keeps some 'property.' ''[34]

''Only the 'new value exception' to the absolute priority rule could support this outcome.[35] Court opinion prior to enactment of the Bankruptcy Code contained dicta saying that investors who supplied new capital may retain interests equal to or lower in value than the new contribution. ''These interests are not so much 'retained' as purchased for the new value (the 'option' characterization of the transaction). Some firms depend for success on the entrepreneurial skills or special knowledge of managers who are also shareholders.''[36] If these man-

[30] *Id.*

[31] *Id.*

[32] *Id.*

[33] Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988).

[34] 908 F.2d at 1360.

[35] *Id.*

[36] *Id.*

agers are not retained, they may leave the firm and reduce its value. If they may contribute new value and retain an interest, this may tie them to the firm and so improve its prospects."[37]

The court of appeals recognized that the exchange of stock for new value may make sense, but pointed out that "[W]hen there is value to be gained by allowing a lower class to kick in new value and keep its interest, the creditors should be willing to go along."[38] The court of appeals defined a "new value exception" to the absolute priority rule as a power in the judge to sell stock to the managers even when the creditors believe that the transaction will not increase the value of the firm. "To understand whether the Code gives the judge this power, . . . it is necessary to examine the genesis of the doctrine."[39]

The court analyzed several of the cases under the former Bankruptcy Act. In *Case v. Los Angeles Lumber Products Co.*,[40] the bankruptcy judge allowed shareholders to retain an interest in exchange for their promise to contribute value in the form of continuity of management and their influence in the community that would enable the debtor to raise new money. The plan allowed shareholders to retain their interests even though a class of senior creditors objected. The Supreme Court reversed, however, holding that new value must mean "money or money's worth."[41]

The Bank argued that the new value exception vanished in 1978, but the court of appeals refused to go that far. "We stop short of the precipice, as the Supreme Court did in *Ahlers* . . . for two reasons: First, the consideration for the shares is insufficient even if the new value exception retains vitality; second, although Bank vigorously argues the merits of the new value exception in this court, it did not make this argument in the bankruptcy court." Notwithstanding the Bank's failure to preserve its argument, the history and limits of the rule before 1978 were pertinent in that *Ahlers* held that "at a minimum the Code forbids any expansion of the exception beyond the limits recognized in *Case*."[42]

Ahlers reinforced the message of *Case*, holding that "a promise of future labor coupled with the managers' experience and expertise, also is not new value."[43] The court then held that the guarantees were no different: "They are intangible, inalienable, and unenforceable by the firm. [The shareholders] may revoke their guarantees, or render them valueless by disposing of their assets. . . . Guarantees have 'no place in the asset column' of a balance sheet . . . [T]he record does not reveal whether [the shareholders]

[37] *Id.*

[38] *Id.*

[39] *Id.*

[40] 308 U.S. 106 (1939).

[41] *Id.* at 212–222.

[42] 908 F.2d at 1362.

[43] *Id.*

have substantial unencumbered assets that the guarantees would put at risk.''[44]

[44] *Id.*

The court of appeals concluded that the plan of reorganization should not have been confirmed over the Bank's objection, vacated the order, and remanded the case.