Alert

Tenth Circuit BAP Limits Insider Claims

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Insider creditors "waived [the] right to charge default interest on" their claims and "failed to prove" their claim for non-default interest, held the U.S. Bankruptcy Appellate Panel for the Tenth Circuit ("BAP") on Nov. 6, 2015. *In re Autterson*, 2015 WL 6789168, at *4 (10th Cir. BAP, Nov. 6, 2015). Because the insiders were "separate legal entities"; their pre-bankruptcy dealings with the debtor had been "carefully and appropriately documented"; and their cash transfers to the debtor had "always been treated as loans," they still held "legitimate unsecured" claims against the debtor. *Id.* at *1. Nevertheless, because a creditor had "objected that the [insider] claims … would be allowed for more than [the debtor] actually owed, to the prejudice of the other unsecured creditors," the BAP affirmed the bankruptcy court's allowance of the claims in an amount reduced "by approximately 26%." *Id.*

Relevance

Creditors ordinarily seek the equitable subordination of insider claims based on misconduct. *See, e.g.*, *In re Herby's Foods, Inc.*, 2 F.3d 128, 134-35 (5th Cir. 1993) (debtor undercapitalized; insider's loans "neither accurately nor timely reflected" on debtor's records or by any loan agreement; during deception, trade debt increased dramatically; insiders not allowed to receive 75 percent of estate assets; inequitable conduct warranted equitable subordination of insider claims); *In re Lifschultz Fast Freight*, 132 F.3d 339, 354 (7th Cir. 1997) ("Any misconduct by an insider may be invoked to subordinate" insider's claim; case remanded for finding as to whether insiders were guilty of misconduct by inflating salaries via "retroactive raises"). In *Autterson*, equitable subordination was not the issue. Rather, the issue was whether the insiders, controlled by the debtor, had, by their conduct, waived their right to default interest under applicable Colorado law. *Lifschultz*, 132 F.3d at 343 ("The dominant theme of U.S. bankruptcy law for a business debtor is preservation of the state-law rights of claimants and their relative ordering."). Although not explicitly stated, the outcome in *Autterson* was also affected by the debtor's self-dealing. *See Lifschultz*, 132 F.3d at 344 ("A loan from a corporate insider muddles [the] conceptual clarity [distinguishing debt from equity]. The relationships start to add up: the same person can be an owner of a company, its creditor … . So do the opportunities for self-dealing [that] would violate the insider's fiduciary duty to the corporation.").

Facts

The individual debtor had created "Partnership" and "Trust" legal entities as part "of his tax and estate planning." 2015 WL 6789168, at *1. He had "always acted as the Partnership's general and managing partner," and later amended the partnership agreement "to make the Trust an additional general partner." *Id.* Limited partners of the Partnership included two other trusts also controlled by the debtor.

The debtor had borrowed $2 million from the Partnership, providing for interest at 6 percent annually and a default rate of 12 percent in the event of a default. This Partnership claim was held in part by a debtor-controlled Trust, which held "one of the three claims at issue on [the] appeal." *Id.* at *2. As a result of later amendments, the contract non-default interest rate became 4.48 percent, and the default interest rate remained at 12 percent. In his bankruptcy schedules, the debtor listed the amount due the Trust "as an uncontested debt in the amount of $933,393.00." The Trust, nevertheless, claimed $857,648.60 as of the date of bankruptcy. After a two-day trial, the bankruptcy court found that the Trust "had failed to prove entitlement to any interest on the … principal," allowing the claim for principal only, in the amount of $597,074. *Id.* at *2.

The Partnership also held two notes, a 2008 note and a 2010 note. The debtor listed the 2008 note as "uncontested," and the Partnership claimed $3.449 million. The bankruptcy court, though, held that the Partnership "failed to prove entitlement to default interest," allowing the claim for "principal and non-default interest" in the reduced amount of $2.517 million. *Id.* at *3.

The debtor similarly scheduled a 2010 Partnership note for $1.9 million as "uncontested," but the bankruptcy court allowed it in the amount of $1.488 million. In its view, the Partnership "failed to prove that it [was] owed interest." *Id.* at *4.

The BAP's Analysis: Waiver

The bankruptcy court stated no legal rationale for its conclusions, but the BAP relied on the bankruptcy court's "oral findings." According to the BAP, the parties' "course of conduct" showed that "the parties repeatedly ignored the express terms of the Notes over the course of several years." "Specifically, the Partnership waived its right to charge default interest on the 2008 and 2010 Notes, and failed to prove its claim for non-default interest under the 2010 Note. The Trust … similarly failed to prove its claim for non-default interest." *Id.* Also, because the debtor was "both the borrower and his lenders' representative, no communication whatsoever between the 'parties' was the norm." *Id.* at *5. The debtor never issued "default notifications to himself, nor did he directly express an intent to waive the Notes' provisions … . [H]e simply paid or did not pay his obligations as he saw fit." Accordingly, the debtor's "conduct on both sides of the transactions" constituted "a waiver of the express terms of the written agreements." *Id.*

The objecting creditor argued that the advances to the debtor by the Partnership and Trust "were equity payments due to lack of any creditor/debtor relationship." *Id.* at *6. Because "the formalities of a debtor/creditor relationship have been honored," however, the bankruptcy court properly declined to invalidate "any of the principal of the Notes." *Id.* According to the BAP, the "record on appeal" also supported the bankruptcy court's fact findings regarding waiver.

First, the debtor included only regular accrued interest, not a default rate, despite prior defaults on the Trust note. In financial statements prepared for the objecting creditor and others, the debtor failed to include interest in amounts due to the Partnership and Trust. Nor did the debtor's accountant "calculate the amounts due under the Notes until [the debtor] was preparing to file bankruptcy." Indeed, the accountant "inflated the amounts [the debtor] owed by prematurely triggering interest accrual whenever a payment was made so that the payment would be applied to interest rather than principal," contrary to the terms of the Notes allowing principal to "be prepaid without penalty." Also, neither the Partnership nor the Trust had charged default interest when the Notes were in default for several years. *Id.*

The record confirmed the Partnership and Trust's waiver of their "rights to hold [the debtor] in default and to charge him interest on his loans." *Id.* at *8. Under Colorado law, a creditor's waiver of a default "may be shown by accepting payment after default, by accepting payment after giving notice of an election to accelerate, *or by mere inaction*." *Id.*, quoting *Goodwin v. District Court*, 779 P.2d 837, 843-44 (Colo. 1989) (en banc) (emphasis added). The debtor here "chose not to make required payments and to forego the enforcement of penalties. Indeed, he chose to keep advancing Partnership funds to himself with full knowledge that the Note under which the advances accrued was already in default. He cannot now avoid the consequences of his conduct by simply asserting that he didn't know. His conduct, on his own behalf and on behalf of his entities, plainly and definitively indicates that there was no intention to enforce the default provisions of the Notes." *Id.*

Comment

The debtor's affiliates avoided equitable subordination of their claims. From the stated facts, the objecting creditor apparently could not support an equitable subordination claim against the insiders with tangible evidence of misconduct. The debtor may have been undercapitalized, requiring advances by its insiders, but "undercapitalization alone, without evidence of deception about the debtor's financial condition or other misconduct, cannot justify equitable subordination of an insider's debt claim." *Lifschultz*, 132 F.3d at 349. Moreover, if there is no misconduct, "then a bankruptcy court cannot subordinate a claim … . The creditor must have done something inequitable — a wrong or an unfairness, or at the very least, a masquerade of something for what it is not." *Id.* at 344.

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