Court File No. CV-21-00659187-00CL

ONTARIO
SUPERIOR COURT OF JUSTICE
COMMERCIAL LIST

B E T W E E N:

IN THE MATTER OF THE *COMPANIES' CREDITORS ARRANGEMENT ACT*, R.S.C. 1985, c. C-36, AS AMENDED

AND DOMENICO SERAFINO AS A PERSON INTERESTED IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT OF HYDRX FARMS LTD., CANNSCIENCE INNOVATIONS INC. AND SCIENTUS PHARMA INC.

Applicant

BOOK OF AUTHORITIES

June 23, 2021

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TAB 1

Canadian Business Corporations Law

SECOND EDITION

Kevin P. McGuinness

LexisNexis

(b) General Disclosure Statements

§10.43.1 In the 2001 amendments to the CBCA, the general disclosure provisions of section 120 of the OBCA were amended to require a director or officer who files a general notice of an interest in another party to advise the corporation where there is any material change in the nature of that interest. To date, this change has not been carried forward into section 132 of the OBCA, although the Ministry of Government Services has raised the prospect that it may. Since the effect of filing a notice is to require the director or officer to abstain from any role in the approval of the transaction, it is not clear what further purpose is served by requiring the filing of this additional information. Although the additional requirement to notify of a change may seem innocuous, it must be balanced against the risk that an ill-informed director or officer may simply not know of (or forget) to notify the corporation of the change. Since that director or officer should already be excluded from the decision-making process with respect to the transaction, simply by virtue of the original declaration. This new requirement seems excessive.

(c) Single Director Corporations

§10.44 The OBCA does not specify what must be done where there is only one director of the corporation. Single director corporations obviously pose special problems in the case of any disclosure requirement. In most such cases, the director is likely to be the only person who has a direct interest in the corporation, and therefore the problem is usually of academic than practical interest. There seems to be little point in a director disclosing to himself, and if the director is the only person who can act on the part of the corporation, it is difficult to see how a contract might be made if the director refrains from acting with respect to that contract. Where there is only one director of a corporation, but that corporation has other shareholder interests, the better view is that director should disclose to the other shareholders and seek their approval of any contract in which the director has a material interest, since in such a case disclosure to the board is meaningless.[132] If, on the other hand, there are no (minority) shareholder interests in the corporation, and the corporation remains solvent at the time when the contract is made, and there is no reason to believe that it will become insolvent by reason of the contract, then disclosure would not appear to be required.[133] In cases in which the corporation is insolvent, and a director decision respecting some aspect of corporate operations, its business or affairs affects or is likely to have an adverse effect upon the interests of creditors, workers or some other identifiable worker group, at least some consideration should be given to consultation with those affected stakeholders, before proceeding with a transaction in which the director has a self-interest or other conflict. In all cases, the exis-

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[132] See, generally, *Movitex Ltd. v. Bulfield*, [1986] 2 B.C.C. 99,403 at 99,428-29, *per* Vinelott J.; but compare *Neptune (Vehicle Washing Equipment) Ltd. v. Fitzgerald (No. 2)*, [1995] B.C.L.C. 1000.

[133] See, generally, *Runciman v. Walter Runciman plc*, [1992] B.C.L.C. 1084 at 1097, *per* Simon Brown J.

tence of the conflict should be recorded in the director's minute book, so as to comply with section 132(4).[134]

(2) Material Contracts and Material Interests

§10.45 The OBCA and the CBCA do not define either the term "material contract" or the term "material interest". Presumably a transaction is material where it represents a significant dealing of the corporation, such as one which would have a significant effect upon the profitability, financial strength or operations of the corporation. There can be little doubt that the materiality of the transaction is determined by reference to its effect upon the corporation, rather than upon the director, officer or other corporation in which the director or officer has an interest.

§10.46 The meaning of the term "material interest" is less clear, but it would seem to suggest that the director's or officer's interest must be of a sufficient magnitude that the contract would have some significant effect upon the value of the director's or officer's interest in the other corporation. If the director has only a small interest in the corporation, it is unlikely that his or her interest would be material, even if the contract or transaction is significant both to the corporation of which he or she is a director, and to the second corporation in which he or she has the interest. The size of that interest would be a relative matter, involving a full consideration of the circumstances of the corporations. A $1 share will be a material interest if that share is the only share in the other corporation, for it means that all profit will flow to the director. Paradoxically, a $1 million share interest may be immaterial if the corporation is so widely held that the profit attributable to any particular shareholder from any particular transaction is negligible to the point of being unmeasurable.[135] Suppose, for instance, that a director of A Ltd. owns $1 million worth of shares in one of Canada's major chartered banks. Even a $100 million line of credit between that bank and A Ltd. might well fail the materiality test, for the benefit to the director of the contract would be so slight as to be below measurement. In such a case, it would well be prudent to disclose; it does not follow that disclosure must necessarily be made.

(3) Disclosure Procedure

§10.47 Section 132 of the OBCA also specifies the procedure in which disclosure is to be made by officers and directors. In the case of directors, subsection 132(2) provides that the disclosure required under subsection 132(1) shall be made:

(*a*) at the meeting at which a proposed contract or transaction is first considered;

(*b*) if the director was not then interested in a proposed contract or transaction, at the first meeting after he or she becomes so interested;

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[134] See, generally, *Neptune (Vehicle Washing Equipment) Ltd. v. Fitzgerald*, [1996] Ch. 274; *Guinness plc v. Saunders*, [1988] 2 All E.R. 940 at 944 (C.A.), *per* Fox L.J. but *cf. Lee Panavision Ltd. v. Lee Lighting Ltd.*, [1992] B.C.L.C. 22 at 33 (C.A.), *per* Dillon L.J.

[135] *Cf. Foster v. Oxford, etc. Rlwy. Co.* (1853), 13 C.B. 200, 138 E.R. 1174 (C.P.).

TAB 2

1998 CarswellOnt 3960
Ontario Court of Justice (General Division) [Commercial List]

Liddell v. Leung

1998 CarswellOnt 3960, 77 O.T.C. 398, 83 A.C.W.S. (3d) 49

Michael Liddell and GFX Technologies Inc. and Joseph Leung

Lax J.

Heard: October 13, 1998
Judgment: October 14, 1998
Docket: 98-CL-2364

Counsel: none given.

Subject: Corporate and Commercial

APPLICATION by shareholder for leave to commence derivative action and for interim order staying bankruptcy proceedings of corporation.

***Lax J.*:**

1 This application is by Liddell, a shareholder, officer and director and GFX for leave to commence a derivative action against Leung under s. 246(1) of the O.B.C.A. and for an interim order staying bankruptcy proceedings of GFX. The petitioning creditor in the proposed bankruptcy is Leung who is also majority shareholder, officer and director of GFX. At the time of incorporation of GFX in April 1997, there were two other shareholders who together with Liddell were each issued 24% of the common shares, while Leung was issued 29% of the common shares. In August 1997, the other shareholders, apart from Liddell, conveyed their shares to Leung in exchange for a release for any outstanding liability. The only written agreement among the original shareholders is an agreement dated May 16, 1997 whereby Leung loaned the company $200,000, was to be paid interest and received Class A preference shares and control of the company until April 22, 2000. The agreement is silent as to the terms and conditions of the repayment of the loan which now amounts to about $250,000. There is a dispute about whether the loan is payable in 2000 or on demand.

2 The company was formed to develop and market a golf grip product. It would appear that the company got underway in May 1997, but by the end of August, it was evident that the initial capitalization, all provided by Leung, was insufficient. At a meeting of shareholders held at the end of August, Leung was asked and refuse to advance further funds. The other shareholders were unwilling or unable to do so. It was at this time that the two shareholders tendered their shares for a release, but Liddell did not. The company has no money, and apart from a pending patent application (which will cost $10,000 to complete) and some inventory, it has no assets. What it seems to have is the enthusiasm of Liddell for the product and some scant evidence that, although not unique, the product was well-received in the market during the 1997 golf season.

3 Leung is not a golfer. He invested in the company on the basis of financial forecasts which proved to be far too optimistic. He anticipated recovering some of his investment within 6-12 months. However, at the end of three months, the product had generated only $10,000 in sales and none of the shareholders were prepared to invest further funds. This is where matters stand to-day.

4 The petition for Receiving Order was made in December 1997 and this application was commenced in February 1998, but it was only in August 1998 that Mr. Liddell swore his affidavit and the application was perfected. By this time, the 1998 golf season had largely passed. There have been no cross-examinations. At the core of this dispute is Liddell's speculation that the

petition, if successful, will permit Leung to walk away with what he believes is GFX's only real asset, which is the incomplete patent for the golf grip. There is no evidence, apart from Liddell's belief, that the patent has any value. If this is a valuable asset, there is, of course, nothing to prevent Liddell from purchasing it from the Receiver, should a Receiving Order be granted, or, for that matter, finding another investor who is prepared to adequately capitalize GFX, after satisfying its creditor. There is some evidence of interest from a Mr. Tung, but his offer, which comes in August 1998, more than a year after the company's financial difficulties were evident, would neither sufficiently capitalize GFX, nor pay off its creditor. So, what this comes down to is an enthusiastic shareholder with no ability to capitalize the company and a disinterested shareholder who is principal creditor to an apparently insolvent corporation. Is this a sufficient basis for granting leave to commence this action?

5 My function is not to try the action, but to determine if it appears that the intended action is frivolous and vexatious or is bound to be unsuccessful: *Marc-Jay Investments Inc. v. Levy* (1974), 5 O.R. (2d) 235 (Ont. H.C.) at p. 237. To be resolved is whether or not Liddell is acting in good faith and whether or not this action is in the best interests of the corporation. Liddell has the onus to satisfy both. On the record before me, I cannot say that either is satisfied. The proposed Statement of Claim claims no monetary relief. It seeks a declaration that Leung is in breach of fiduciary duties to GFX and an Order removing him as director and officer and vesting control in Liddell. The act complained of is the institution of bankruptcy proceedings, which Liddell says places Leung in a conflict between his duty to GFX and his self-interest in collecting his debt. But, Leung's dual role as creditor and as director was evident from the outset. It is not evident that Leung, as primary creditor of GFX, is prevented, by virtue of his director's role, from exercising his debtor's rights in the ordinary course. If his debt is in fact not due until the year 2000, this can be determined in the bankruptcy proceedings on *viva voce* evidence. In this event, the petition may be refused, with the result that Liddell will buy himself some further time to find investors.

6 Mr. Leung's fiduciary duty is to the company and not to Mr. Liddell: *Brant Investments Ltd. v. KeepRite Inc.* (1991), 3 O.R. (3d) 289 (Ont. C.A.) at p. 301. It seems that what Liddell wants is control of the company. But, where is the evidence that this is in the best interests of the company? Mr. Leung played no role in operating GFX. He provided the financing for a start-up venture, which turned out to be under capitalized. Liddell and the other shareholders, but not Mr. Leung drew salaries. They spent over $200,000 in three months and generated sales of $10,000. There is no credible evidence that giving Liddell control is in the best interests of GFX. In any event, it is contrary to the shareholder's agreement. The application for leave is dismissed. Costs may be spoken to, if not agreed.

Application dismissed.

End of Document

TAB 3

KeyCite Blue Flag – Appeal Notification
Appeal Filed by KELLY BEAUDIN STAPLETON v. NEWKEY GROUP, LLC, ET AL, 7th Cir., July 6, 2017

2017 WL 2683686
Only the Westlaw citation is currently available.
United States District Court, N.D. Illinois, Eastern Division.

IN RE: SGK VENTURES, LLC, Debtor.
Kelly Beaudin Stapleton, solely in her capacity as Trustee of the SGK Ventures, LLC Liquidating Trust, Appellee and Cross-Appellant,
v.
NewKey Group, LLC, and NewKey Group II, LLC, Appellants and Cross-Appellees,
and
J. Mark Lozier; KCL Management Corp.; Joel D. Tauber; Michael Rosenberg; Michael C. Sheffieck; Karen A. Beninato; Thomas P. Bertrand; Amy Fleissner; Kluska Family Limited Partnership; Loganberry, LLC; Lawrence Plant; Platt Family Limited Partnership; Bernard E. Platt Trust Uad 12/20/95; Michael J. Pugliese; Anne Rizzo; Rosenberg Family, LLC; Tamarack LP; Tauber-keywell Family LLC; Tauber-keywell II, LLC; Joel D. Tauber Trust; John A. Toth Trust; Dennis C. Trostle; Linda A. Trostle; Michael C. Sheffieck Trust; Louis E. Wagner, Jr.; Ken Kluska; Kluska Family Limited Partnership; Bernard E. Platt, Jr.; Philip Rosenberg; Tauber Enterprises LLC, Cross-Appellees.

Nos. 15 C 11224, 15 C 11226, 15 C 11253
|
Signed 06/20/2017

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MEMORANDUM OPINION AND ORDER

Honorable Thomas M. Durkin, United States District Judge

***1** NewKey Group LLC and NewKey Group II LLC (the "NewKeys") were entities created to facilitate loans to an industrial scrap metal recycling company called Keywell, LLC. Keywell is the Debtor in this action, and is now known as SGK Ventures, LLC, although the Court will continue to refer to it as "Keywell." The NewKeys were created and funded by Keywell insiders.[1] Despite the loans Keywell received from the NewKeys, Keywell eventually declared bankruptcy. Kelly Beaudin Stapleton is the Trustee appointed by the bankruptcy court on behalf of Keywell. During the proceedings in bankruptcy court, the Trustee filed an adversary complaint alleging multiple counts against the NewKeys and the Keywell insiders, including, among others, counts for: recharacterization of the NewKey loans as equity (Count III); equitable subordination of the NewKey loans (Count VII); avoidance of interest payments on the NewKey loans (Counts IV-VI); breaches of fiduciary duties by various Keywell insiders (Counts VIII and IX); and recovery of two distributions Keywell made to its members as fraudulent transfers (Counts I and II). After a trial, the bankruptcy court held that the NewKey loans should not be recharacterized as equity, but should be equitably subordinated to the claims of Keywell's unsecured creditors, and denied the rest of the Trustee's claims. The NewKeys appeal the bankruptcy court's equitable subordination holding, and the Trustee appeals the other holdings enumerated above. For the following reasons, the bankruptcy court's equitable subordination holding is reversed, but its recharacterization holding, as well as its holdings on all the other counts, are affirmed.

Legal Standard

The Court reviews the bankruptcy court's conclusions of law, and mixed questions of law and fact, de novo. *See* *Stamat v. Neary*, 635 F.3d 974, 979 (7th Cir. 2011); *see also* *In re Ebbler Furniture and Appliances, Inc.*, 804 F.2d 87, 89 (7th Cir. 1986) ("[T]he manner in which ... factual conclusions implicate [a] legal definition ... is subject to a de novo review."). The Court will not reverse the bankruptcy court's factual findings unless they were "clearly erroneous," giving " 'due regard ... to the opportunity of the bankruptcy court to judge the credibility of the witnesses.' " *Mungo v. Taylor*, 355 F.3d 969, 974 (7th Cir. 2004) (quoting Fed. R. Bankr. P. 8013).

Background

Keywell has been in the scrap metal business since the 1920's. *See* R. 48 at 3; *see also* Keywell Metals website, www.keywell.com (last visited June 14, 2017). Most recently, during the time period relevant to this case, Keywell's primary business involved buying scrap metal from "scrap yards, industrial plants, governmental agencies, and large mills," sorting and processing it, and reselling it to specialty steel producers and the aerospace industry. R. 49-1 at 7. The "bulk" of Keywell's business was in stainless steel. *Id.* at 7. The stainless steel market is tied to the price of nickel, one of stainless steel's components. *Id.* As a result, Keywell's profitability was largely tied to fluctuations in the price of nickel. *Id.* Keywell could have limited the impact of nickel price fluctuations on its profitability by hedging; i.e., purchasing contracts to sell nickel in the future at the price prevailing when it purchased the scrap. *Id.* at 10. Instead, Keywell's strategy was to sell its inventory quickly to avoid significant price decreases that would result in Keywell having to sell its inventory at a loss. *Id.*

***2** Keywell kept only a "small amount" of its assets in cash. *Id.* at 13. In order to purchase new scrap and cover operating expenses and distributions, Keywell relied on regular collection of accounts receivable. *Id.* at 14. When Keywell experienced insufficient cash flow, it relied on a revolving line of credit it maintained with LaSalle Bank and later Bank of America. *Id.* at 13. The credit line's limit was a percentage of Keywell's accounts receivable and inventory, subject to a cap imposed by the loan agreement, which was frequently amended. *Id.* Keywell's revolving credit line was secured by all its assets. *Id.*

Defendants J. Mark Lozier and Joel D. Tauber had the largest ownership positions in Keywell. *Id.* at 5. An LLC controlled by Lozier owned 46% of Keywell, and a trust and other LLCs controlled by Tauber owned another 24%. *Id.* Lozier served as Keywell's president, but Tauber never had an operational role with Keywell. *Id.* Lozier and Tauber also jointly owned KCL Management Corporation (the "Keywell Manager") which was Keywell's manager and as such was responsible for making Keywell's executive and strategic decisions. *Id.* at 4-5. The Keywell Manager was controlled by its board, which included Lozier, Tauber, and Michael Rosenberg. *Id.* Rosenberg also served as Keywell's senior vice president, primarily responsible for buying inventory. *Id.* at 5. The bankruptcy court made the following findings with respect to Keywell's management:

> The Keywell Manager board met once a quarter, though the board members regularly communicated about the business between meetings. The Keywell Manager board meetings generally consisted of two parts: the board would first hear presentations from Keywell's executive committee—the officers and key managers of the company—and then there would be private discussions among the three board members. Presentations to the board were compiled in packages distributed to board members before the meeting.
>
> The testimony and documentation produced at the trial established that Lozier and Tauber were the principal decision makers for Keywell. Although Rosenberg participated in the meetings of the Keywell Manager board and had private discussions with Lozier on Keywell matters ... there is no [documentary evidence] indicating that Rosenberg actively participated in any of the relevant decisions and Rosenberg's own testimony reflected a lack of familiarity with much of the decision-making.

Id. (internal record citations omitted).

Keywell's operating agreement provided for the firm to make cash distributions to its members to the extent that it had "available cash." *Id.* at 14. Cash availability was determined in the sole discretion of the Keywell Manager. *Id.* The bankruptcy court made the following findings about Keywell's practice with respect to distributions:

> The [operating] agreement provided for distributions from Available Cash to assist members in paying their income tax liabilities [associated with their Keywell ownership], but only to the extent that Keywell Manager found that such tax distributions were necessary. Although these provisions made all distributions discretionary, Keywell treated tax distributions as mandatory, and regularly made distributions to its members in an amount equal to 45% of the taxable income that Keywell generated.

Id. at 14 (internal record citations omitted).

In the years 2004-2007, Keywell generated substantial income: $25.6 million in 2004; $19.6 million in 2005; $50 million in 2006; and $58.6 million in 2007. *Id.* at 15. In that time span, Keywell also made the following distributions to its members: a $4,640 tax distribution in 2004; a $14.7 million tax distribution, and a $30 million special distribution in 2005; and a $10.4 million tax distribution in 2006. *Id.* None of these distributions were challenged during the bankruptcy proceedings. On May 2, 2007, the Keywell Manager board approved another special distribution of $39.8 million. *Id.* The Trustee challenged this distribution, but the bankruptcy court found that the May 2 distribution was "supported" by "Keywell's financial condition at the time," *id.*, despite the fact that "all of the funds Keywell distributed to its members in 2007 were from loans," because it had insufficient cash on hand. *Id.* at 16. Despite this lack of cash, the bankruptcy court found that as of June 2007 Keywell had "availability of over $65 million under its revolver, and was at no risk of being unable to conduct its business due to a lack of capital." *Id.*

***3** Then in March 2008, the Keywell Manager board approved a tax liability member distribution of $26.5 million. R. 49-1 at 17. Despite this distribution, the Trustee's expert found that as of March 28, 2008, Keywell's assets exceeded is liabilities by $3.4 million. *See* R. 52-3 at 53. In the second quarter of 2008, the Keywell Manager board approved a second tax liability member distribution of $2.8 million. R. 49-1 at 17. The bankruptcy court found that although "Nickel prices had fallen sharply in the second half of 2007 ... and rebounded only slightly in the first quarter of 2008 .... Keywell's operations remained profitable." *Id.* Despite this finding of Keywell's continued profitability, the bankruptcy court also noted that as of March 2008, Keywell's management was aware that Keywell's debt to equity ratios did not meet Dun & Bradstreet's benchmarks for adequate capitalization. *Id.* at 18. The bankruptcy court concluded, however, that "at the end of March 2008, Keywell still had loan availability of more than $49 million, and there is no evidence in Keywell's business documents suggesting any need for additional capital at the time." *Id.*

However, "immediately after the 2008 tax distributions, Keywell's financial condition plummeted. Nickel prices and sales volumes both declined sharply, Keywell suffered months of net income losses, and its loan availability shrank to dangerously low levels." *Id.* at 19. By "the end of December 2008, Keywell had breached one of the covenants in its loan agreement. [Bank of America] could have ceased lending money to Keywell, and there were no other sources of financing available." *Id.*

Keywell initially planned to raise additional equity to remedy its precarious financial condition. A $20 million equity offering was presented to Keywell's members on December 18, 2008. *Id.* at 20. The shares were offered to the members in proportion to their existing membership interests in Keywell. *Id.* The plan also included payroll cuts of 10 to 32%. *Id.* at 21.

The offering was never commenced. Keywell's CFO noted that there were "significant concerns in December 2008 about [Keywell's] viability [which] required a capital raise structured in a fashion that would provide better collectability in the event [Keywell] were to have declared bankruptcy." *Id.* at 20. The bankruptcy court noted that the "original idea" to address these concerns "was to have the contributions sent to an escrow account ... with the cash paid into Keywell only after the [breach of the Bank of America loan agreement was] resolved." *Id.* at 21. Keywell's CFO explained that the "purpose[ ] of the escrow was to obscure from [Bank of America] the amount raised[;] allow refund to the investors to the raise amount not needed[;] and allow refund of the entire raise in the event [Bank of America] acts precipitously in the near future." *Id.* Keywell's counsel advised, however, that the escrow plan would not work to make funds available to Keywell, while at the same time protecting the funds from Bank of America. *Id.*

Keywell then contacted new counsel specializing in bankruptcy. Keywell's CFO sent an email to the new bankruptcy counsel asking, "how do we legally keep the money from [Bank of America] but accessible to [Keywell]? Can we achieve all of the purposes of the escrow [plan]?" *Id.* at 22. In response, bankruptcy counsel advised Keywell to discard the equity and escrow approach and replace it with a "corporate restructuring that would not involve adding equity." *Id.* at 23. The proposed corporate "restructuring" called for creation of a new LLC in which Keywell's members would buy membership interests. The new LLC would then loan money to Keywell. *Id.*

Keywell took this advice. A new entity called NewKey was created and funded with $12.7 million from Keywell members on January 28, 2009. *Id.* at 25. The membership "purchases largely, but not completely," tracked Keywell ownership percentages. *Id.* Bank of America also eventually agreed to amend the agreement underlying Keywell's line of credit. *Id.* at 25-26. The amendment contemplated the NewKey loan, which was made on March 20, 2009 in the amount of $3.5 million. *Id.* Of the

$3.5 million, $2 million was used to reduce Keywell's Bank of America loan balance. *Id.* at 26. The NewKey loan was secured by Keywell's assets, so although the debt was subordinate to Bank of America and other prior secured lenders, it was prior to Keywell's unsecured creditors. *Id.* at 26. A UCC-1 financing statement for the NewKey loan was publicly filed with the Illinois Secretary of State. R. 48 at 13 (citing record documents). The remaining NewKey funding was returned to the members on June 30, 2009. *Id.* at 26. Notably, the NewKey members used these funds to purchase additional equity shares in Keywell. *Id.*

***4** Keywell lost $22.4 million in 2008. *Id.* at 15. Its financial condition somewhat stabilized after the NewKey loan and amendment to the Bank of America credit agreement, but Keywell still lost $942,000 in 2009. *Id.* In 2010, however, Keywell returned to profitability with net income of $6.4 million. *Id.*

Keywell's performance again took a turn for the worse in 2011. That year, Keywell was forced to extend the maturity date of the NewKey loan, and again defaulted on its Bank of America credit agreement. *Id.* at 27. Keywell attributed this default and its poor performance in 2011 to "a continuous decline in nickel pricing and falling customer volumes." *Id.*

To address its flagging business, Keywell first sought an agreement with an industry broker and trader, called Trafigura, that would have lent Keywell $10 million to build out its operations in California and would have acted as Keywell's agent in Asia. *Id.* But Keywell was unable to reach a deal with Trafigura. *Id.*

As a result, Keywell again sought internal financing. *Id.* at 26. Another LLC, NewKey II, was formed to facilitate another loan to Keywell from its members. *Id.* In October 2011, NewKey II had been funded with $5 million. *Id.* at 28. Keywell used those funds to reduce the debt on its line of credit with Bank of America. *Id.* NewKey I also agreed to another extension of the maturity date of its loan until 2014. *Id.* at 29. Keywell did not consult with Bank of American prior to establishing NewKey II. *Id.* Nevertheless on November 21, 2011, Bank of America agreed to forbear exercising any default rights on Keywell's credit agreement, and recognized the NewKey II loan and the amended NewKey I agreement. *Id.* Despite this agreement, both events remained events of default under the Bank of America credit agreement. *Id.* As with the NewKey I loan, UCC-1 financing statement for the NewKey II loan was publicly filed with the Illinois Secretary of State. R. 48 at 16 (citing record documents).

The year 2011 resulted in another loss of $5.3 million for Keywell, *id.* at 15, despite additional payroll reduction. *Id.* at 29. Keywell lost another $6.1 million in 2012. *Id.* at 15. Keywell continued to lose money through 2013. In late May 2013, a company called Prophet Equity offered to purchase a controlling ownership interest for $15 million. *Id.* at 32. The deal would have left current equity holders with a 30% ownership interest in the company. *Id.* The deal also required that the NewKey loans be converted into preferred shares. *Id.* The bankruptcy court found that "[i]t appears that [Keywell's CFO and minority shareholder] was willing to accept conversion of the NewKey debt into preferred shares. After consulting with Tauber, however, Lozier [the largest Keywell shareholder] declined to accept conversion of the NewKey debt, and Prophet withdrew its offer on June 18." *Id.* (internal record citation omitted).

On July 1, 2013, Keywell closed three of its facilities and suspended payments for all goods received on or before June 26. *Id.* But it continued to do business and make payments for goods received after June 26. *Id.* By simultaneously operating at a decreased level and liquidating "unnecessary assets," Keywell generated enough cash to pay its debt to Bank of America in full. *Id.* at 33. Keywell filed for bankruptcy on September 24, 2013. *Id.*

***5** The Trustee brought an adversary complaint against the NewKeys and the Keywell insiders including the following counts: Counts I and II for fraudulent transfers with respect to the special and tax distributions of 2007 and 2008; Count III for recharacterization of the NewKey loans; Counts IV through VI seeking to avoid interest payments made on the NewKey loans; Count VII for equitable subordination of the NewKey loans to unsecured creditors; Counts VIII and IX for breaches of fiduciary duty by the Keywell insiders; and additional counts not at issue in this appeal. *See* R. 51-13. After trial, the bankruptcy court reached the following legal conclusions: (1) the special and tax distributions Keywell made in 2007 and 2008 were not fraudulent transfers; (2) the NewKey loans should not be recharacterized as equity; (3) Keywell cannot avoid the interest payments on the NewKey loans; (4) the NewKey loans are equitably subordinated to unsecured creditors; and (5) none of the individuals involved in Keywell's management breached fiduciary duties. *See* 49-1 (*In re SGK Ventures, LLC,* 2015 WL 7755525 (Bankr. N.D. Ill. Nov. 30, 2015)).

Analysis

I. Recharacterization & Equitable Subordination

Primarily at issue here are the bankruptcy court's decisions not to recharacterize the NewKey loans but to equitably subordinate them. "Recharacterization is a theory ... that bankruptcy courts may place the proper label of 'claim' (generally, debt) or 'interest' (equity) on an advance of funds, regardless of what the parties call it." *In re Airadigm Commc'ns, Inc.*, 616 F.3d 642, 653 (7th Cir. 2010). Whether or not a claim is recharacterized is significant because "allowed claims in bankruptcy receive better treatment than equity interests," in that "[e]quity holders receive nothing unless all creditors are paid in full." *Id.* at 658 (quoting *In re Insilco Techs., Inc.*, 480 F.3d 212, 218 & n. 10 (3d Cir. 2007)). By contrast, "[i]n an equitable subordination action, the analysis focuses on the behavior of a creditor, knocking down the status of a claim where a creditor engages in inequitable conduct." *Airadigm*, 616 F.3d at 658.

"Determining whether a claim should be recharacterized as an interest thus comes logically prior to determining whether a claim should be subordinated: equitable subordination presumes that the claim is in fact a 'claim' within the meaning of the Code. Recharacterization occurs when one has mislabeled a transaction." *Id.* In other words, "when a claim is equitably subordinated, a court disregards a party's formal rights; when a claim is recharacterized, a court determines what those formal rights are in the first instance." *Id.* Whether a claim should be recharacterized, and whether a creditor's conduct merits equitable subordination, are both questions of law to be reviewed de novo. *See* *In re Alternate Fuels, Inc.*, 789 F.3d 1139, 1146 (10th Cir. 2015) ("We review the bankruptcy court's factual findings for clear error, but the application of our legal test for recharacterization to those facts is a question of law which we review de novo."); *Matter of U.S. Abatement Corp.*, 39 F.3d 556, 559 (5th Cir. 1994) ("the question of whether a creditor's conduct is so egregious as to require the remedy of equitable subordination is a question of law, over which an appellate court may exercise plenary review").

A. Recharacterization (Count III)

The Trustee argues that the bankruptcy court erred by not recharacterizing the NewKey loans as equity interests. The Trustee contends that "while nominally called 'notes,' " Keywell and [the NewKeys] "otherwise failed to ... adhere to a normal, arm's length borrower-lender relationship." R. 50 at 46.

The parties dispute whether federal or Illinois law provides the relevant standard for the Trustee's recharacterization claim. Although not expressly provided for in the Bankruptcy Code, the Seventh Circuit has noted that the "overwhelming weight of authority supports the proposition that bankruptcy courts act within their equitable powers when they recharacterize loans as infusions of equity." *Airadigm*, 616 F.3d at 657 (citing cases). Circuits are split regarding which provision of the bankruptcy code grants courts authority to recharacterize debt claims as equity. The Third, Fourth, Sixth, and Tenth Circuits have held that the authority derives from the equitable powers granted by section 105(a), thus implicating federal law. This is the authority the Seventh Circuit referenced when it noted that "[r]echaracterization [has been] adopted by the overwhelming majority of courts to have considered the question." *Airadigm*, 616 F.3d at 653. By contrast, the Fifth and Ninth Circuits have held that courts may recharacterize debt only pursuant to section 502(b), which provides that claims in bankruptcy should be allowed to the extent they are "enforceable," thus implicating the relevant state law.

***6** The bankruptcy court held that the equitable powers granted by section 105(a) do not encompass recharacterization, and for this reason applied Illinois law to the Trustee's recharacterization claim. *See* R. 49-1 at 35 (*SGK Ventures*, 2015 WL 7755525, at *20 (citing *Law v. Siegel*, 134 S. Ct. 1188, 1195 (2014) (holding that a bankruptcy court order was "unauthorized if it contravened a specific provision of the Code"))). However, as Judge Pallmeyer has noted, this debate is somewhat academic in cases where Illinois law applies, because the standards for recharacterization under both Illinois law and section 105(a) of the bankruptcy code "turn[ ] on whether the transactions have the characteristics of loan or equity contributions." *In re Emerald Casino, Inc.*, 2015 WL 1843271, at *11 (N.D. Ill. Apr. 21, 2015). Thus, the bankruptcy court's decision to apply Illinois law is inconsequential as both federal and Illinois recharacterization law are instructive here.

In addressing a claim for recharacterization, "courts should look to the [underlying] substance rather than the form of transactions." *Airadigm*, 616 F.3d at 658 (citing cases). Courts have looked to a number of factors to determine the substance of a transaction, including:

> (1) the names given to the certificates evidencing indebtedness; (2) the presence or absence of a fixed maturity date; (3) the source of payments; (4) the right to enforce payment of principal and interest; (5) participation in management flowing as a result; (6) the status of the contribution in relation to other corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) the identity of interest between the creditor and stockholder; (10) the source of interest payments; (11) the ability of the corporation to obtain loans from outside lenders; (12) the extent to which funds were used to acquire capital assets; and (13) the failure of the debtor to repay on the due date or to seek postponement.

Alternate Fuels, 789 F.3d at 1149; *see also* *In re Outboard Marine Corp.*, 2003 WL 21697357, at *5 (N.D. Ill. July 22, 2013). However, as the Third Circuit has reasoned,

> [w]hile these tests undoubtedly include pertinent factors, they devolve to an overarching inquiry: the characterization as debt or equity is a court's attempt to discern whether the parties called an instrument one thing when in fact they intended it as something else. That intent may be inferred from what the parties say in their contracts, from what they do through their actions, and from the economic reality of the surrounding circumstances. Answers lie in facts that confer context case-by-case.

In re SubMicron Sys. Corp., 432 F.3d 448, 455-56 (3d Cir. 2006). Courts in Illinois have similarly described the appropriate inquiry as determining true intent from the circumstances of the transaction at issue. *See* *Estate of Kaplan*, 384 N.E.2d 874, 882 (Ill. App. Ct. 1st Dist. 1978) ("Although management intent is an important factor, it is not the only one, especially where the substance of the transaction does not conform to the expressed intent."); *Emerald Casino*, 2015 WL 1843271, at *13 ("To succeed on her recharacterization claim ... the Trustee must ... present specific evidence that the particular transactions she challenges were intended as capital contributions.").

Although no one factor is dispositive, "[w]here a transaction is documented as a loan, the more the transaction seems like an arms-length deal, the more likely [it] is a loan and not an equity contribution." *In re Gluth Bros. Const., Inc.*, 424 B.R. 379, 395 (Bankr. N.D. Ill. 2009); *see also* *Outboard Marine*, 2003 WL 21697357, at *5. A review of the relevant case law shows that courts generally recharacterize purported loans as equity when no loan documents exist, and interest was not actually paid. *See* *Kaplan*, 384 N.E.2d at 881; *In re River West Plaza-Chicago, LLC*, 2011 WL 1357144, at *1 (N.D. Ill. Apr. 11, 2011); *In re Repository Techs., Inc.*, 381 B.R. 852, 865-66 (N.D. Ill. 2008), *later reversed as moot by* 601 F.3d 710 (7th Cir. 2010). Conversely, where a loan is properly documented, and interest is paid, courts generally deny recharacterization claims. *See* *Alternate Fuels*, 789 F.3d at 1149-50; *SubMicron*, 432 F.3d at 457; *In re AutoStyle Plastics, Inc.*, 269 F.3d 726, 750 (6th Cir. 2001); *Emerald Casino*, 2015 WL 1843271, at *4; *In re MSP Aviation*, LLC, 531 B.R. 795, 806 (Bankr. D. Minn. 2015); *In re Franklin Equip. Co.*, 418 B.R. 176, 203 (Bankr. E.D. Va. 2009); *In re Kids Creek Partners, L.P.*, 212 B.R. 898, 932 (Bankr. N.D. Ill. 1997). Nevertheless, other circumstances evincing equity can overcome the existence of loan documents. For instance, the Illinois Supreme Court concluded that a promissory note was unenforceable because it was granted to a limited partnership at the time of its formation indicating that it was a capital contribution in substance, and because the purported lender took a loss on his tax return that was only possible if the transfer to the limited partnership was intended as equity. *See* *Kramer v. McDonald's Sys., Inc.*, 396 N.E.2d 504, 508 (Ill. 1979). The court concluded that these circumstances demonstrated that the transfer in question was "intended" as a capital contribution, not a loan. *Id.*

***7** The bankruptcy court denied the Trustee's recharacterization claim because "[b]oth the NewKey I and II loans were thoroughly documented, with detailed interest and payment terms, and with the full expectation that they would be paid. Interest consistent with the note terms was paid." R. 49-1 at 36 (*SGK Ventures*, 2015 WL 7755525, at *20). The bankruptcy court, however, went on to hold that the "factors the [Trustee] cites as supporting recharacterization, including the initial plan for the NewKey I cash infusion to have been a purchase of stock in Keywell, is not a consideration consistent [with or] supported by [Illinois law]." *Id.* This is an incorrect assessment of the relevant law, because the factors the Trustee cited are those other courts *have* considered in analyzing recharacterization claims. The Court will examine whether the other factors the Trustee cited, but the bankruptcy court failed to consider, indicate that the NewKey loans should be recharacterized.

The Trustee makes the following factual contentions in support of recharacterization: (1) "NewKey regularly ignored the terms of the NewKey notes relating to interest, maturities, and defaults"; (2) "Keywell arbitrarily accelerated NewKey interest payments"; (3) Keywell never "market-tested the notes"; (4) NewKey failed to perfect liens on Keywell property in connection with the loans; (5) "despite Keywell's numerous defaults, NewKey never issued formal default notices until August 28, 2013," on the eve of bankruptcy; (6) "[i]n light of Keywell's financial condition and Keywell's precarious situation with [Bank of America] at the time of the loans, it is unclear how the Keywell/NewKey members could have viewed the 'loans' as anything other than a 'donation' "; (7) "the ownership percentages of Keywell and NewKey were intentionally almost identical, with the aim of avoiding 'dilution' of Keywell interests in the event NewKey exercised its right to convert its debt to equity"; (8) "Keywell could not obtain alternative financing from any outside sources"; and (9) "repayment was entirely contingent on Keywell's success." R. 50 at 47-52. The Court addresses these contentions below.

The Trustee contends that "the ownership percentages of Keywell and NewKey were intentionally *almost* identical." (emphasis added). But the fact that the percentages were *not* identical weighs against a finding that the NewKey loans were actually capital contributions. The Trustee also argues that the terms of the NewKey notes were "ignored," R. 60 at 12, but there is no dispute that Keywell paid interest on the notes. To the extent the NewKeys permitted maturity dates to be extended, "that is not surprising" considering the close connection between Keywell and the NewKeys. *See Emerald Casino*, 2015 WL 1843271, at *12. Based on their inside information, the NewKeys knew that enforcing a maturity date with which Keywell was unable to comply would only ensure Keywell's bankruptcy and further imperil the NewKey's claims. "[I]t is legitimate for [a] lender to take actions to protect its existing loans, including extending additional credit or granting forbearance." *In re Moll Indus., Inc.*, 454 B.R. 574, 583 (Bankr. D. Del. 2011). These circumstances do not push the NewKey loans into the realm of equity.

Similarly, the fact that Keywell had the option to convert the NewKey loans to equity is not a basis for recharacterization. "It is not unusual for investors to structure their investments using hybrid instruments that have elements of equity and debt." *Emerald Casino*, 2015 WL 1843271, at *13. "Recharacterization turns on what the parties intended at the time the agreements were executed and whether the transaction bears the earmarks of a capital contribution rather than a loan." *Id.* at 14. The fact that the NewKey loan agreements contemplated *conversion* to equity at a future date indicates that the parties intended to create a debtor-creditor relationship at the time the loan agreements were executed. *See Emerald Casino*, 2015 WL 1843271, at *13 ("To succeed on her recharacterization claim, however, the Trustee must also present specific evidence that the particular transactions she challenges were *intended* as capital contributions) (emphasis added). If this were not the case, there would be no need to convert the debt to equity. Moreover, after the undistributed NewKey I funds were returned to the members, they used those funds to purchase equity in Keywell. At the time of the NewKey I loan the members were unwilling to contribute equity, but they were later when Keywell's fortunes looked brighter. This is further support for the bankruptcy court's finding that the NewKey I loan is properly characterized as debt.

***8** Contrary to the Trustee's contention that NewKey regularly ignored the terms of the NewKey notes, she does not dispute that the NewKey loans were properly documented, and that Keywell made interest payments on the loans. (Notably, in arguing that the NewKey loans should be equitably subordinated (addressed below), the Trustee highlights the existence of interest payments by arguing that they were a vehicle for moving capital out of the company to its members.) The Trustee argues that the Court should look past the documentation and interest payments indicating intent to create a debt, "in light of Keywell's financial condition." *See* R. 50 at 51 ("it is unclear how the Keywell/NewKey members could have viewed the 'loans' as anything other than a 'donation' "). But while the factors describing Keywell's financial condition are relevant to whether a purported loan should be recharacterized as equity, in Keywell's case they just serve to highlight the fact that Keywell was a close corporation in financial distress. On the Trustee's logic, recharacterization would be appropriate for any purported loan from insiders of a financially struggling company. But the Seventh Circuit has suggested that such circumstances alone are insufficient to justify recharacterization, because if that were the law it would have the undesirable effect of "discourag[ing] those most interested in a corporation from attempting to salvage it through an infusion of capital." *Matter of Lifschultz Fast Freight*, 132 F.3d 339, 347 (7th Cir. 1997).[2] As the Third Circuit has noted, "when existing lenders make loans to a distressed company, they are trying to protect their existing loans and traditional factors that lenders consider (such as capitalization, solvency, collateral, ability to pay cash interest and debt capacity ratios) do not apply as they would when lending to a financially healthy company." *SubMicron*, 432 F.3d at 457 (quoting *In re SubMicron Sys. Corp.*, 291 B.R. 314, 324 (D. Del. 2003)). Likewise, insiders must be permitted to make loans to their company even when the company could not have secured similar loans from anyone else, and even when the insiders are consciously aware that they might not ever recoup their investment. The law does not limit insiders to equity contributions as a means to save a flagging enterprise. *See* *Lifschultz*, 132 F.3d at 347 ("The insiders here contributed fresh working capital. They were under no obligation to do so. Assuming there was no deception, we see no reason to treat an insider's loan to a company more poorly than that of a third party's."). To justify recharacterizing as equity what is apparently a loan, the Trustee needed to identify more than Keywell's financial distress and the insider status of the NewKey members. Since the Trustee failed to do so, the bankrtupcy court's denial of her recharacterization claim is affirmed.

B. Equitable Subordination (Count VII)

The NewKeys seeks reversal of the bankruptcy court's decision to equitably subordinate the loans they made to Keywell. "Courts will subordinate a claim under 11 U.S.C. § 510(c) when [1] the claimant creditor engaged in inequitable conduct that [2] injured other creditors or conferred an unfair advantage on the claimant, but [3] not when subordination is inconsistent with the Bankruptcy Code." *In re Sentinel Mgmt. Grp., Inc.*, 728 F.3d 660, 669 (7th Cir. 2013). "Typically, the misconduct that courts have deemed sufficiently inequitable to merit this remedy has fallen within one of three areas: A (1) fraud, illegality, breach of fiduciary duties; (2) under-capitalization; [or] (3) claimant's use of the debtor as a mere instrumentality or alter ego." *Id.* (quoting *Lifschultz*, 132 F.3d at 345). The Seventh Circuit has clarified, however, that "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. "Extraordinary circumstances might provide an exception, but we believe that almost any such exception would arguably also involve other misconduct of some sort." *Id.*

The Seventh Circuit also has held that courts should "hesit[ate] to invoke the doctrine of equitable subordination" for two primary reasons: "(1) the upsetting of a claimant's legitimate expectations, and (2) the spawning of legal uncertainty that courts will refuse to honor otherwise binding agreements on amorphous grounds of equity." *Sentinel Mgmt.*, 728 F.3d at 669. Additionally, the Seventh Circuit has noted that there is significant "difficulty [in] proving that a creditor has engaged in inequitable behavior," because "the question of 'whether a party has acted opportunistically,' is quite subjective," and "[t]here are simply no clear rules for determining whether underhanded behavior occurred." *Id.*; *see also id.* ("Equitable subordination relies on courts' peering behind the veil of formally unimpeachable legal arrangements to detect the economic reality beneath."). "Underhanded behavior is typically clearest, however, when corporate insiders [have attempted] to convert their equity interests into secured debt in anticipation of bankruptcy." *Id.*

***9** Heeding the Seventh Circuit's admonition in *Lifschultz*, the bankruptcy court found that the Trustee's focus on Keywell's undercapitalization was an insufficient basis to equitably subordinate the NewKey loans. *See* 49-1 at 37-38 (*SGK Ventures*, 2015 WL 7755525, at *21-22). Nevertheless, the bankruptcy court found that the Keywell insiders acted inequitably in making the NewKey loans for three other reasons. First, the bankruptcy court relied on the fact that Keywell failed to maintain a "substantial equity cushion" to protect the company despite management's decision not to hedge its scrap metal purchases. R. 49-1 at 38 (*SGK Ventures*, 2015 WL 7755525, at *22). Second, the bankruptcy court noted that Keywell management actively rejected an alternative proposal to add equity from its members to the firm before proceeding with the NewKey I loan. *Id.* And third, the bankruptcy court was disturbed by the fact that "every aspect of Keywell's finances was kept completely confidential from its trade creditors." *Id.* Finally, the bankruptcy court summarily concluded that

> [t]he remaining elements for substantive consolidation are clearly met. By restoring a measure of capitalization through secured

> loans rather than replacement of equity, the Keywell shareholders diminished the funds available to pay their unsecured creditors, and subordinating the NewKey I and II loans to the other creditors' claims contradicts no policy of the Bankruptcy Code.

Id. at 39 (*SGK Ventures*, 2015 WL 7755525, at *23).

As noted, the Seventh Circuit has held that inequitable conduct typically involves either (1) fraud, illegality, breach of fiduciary duties, or (2) the claimant's use of the debtor as a mere instrumentality or alter ego. The bankruptcy court failed to expressly apply these categories in its analysis. The Trustee, however, argues that Keywell's management breached their fiduciary duties to Keywell when they

> elevated the parochial interests of Keywell's members over the interests of the Keywell enterprise, effectively shifting risk to unsecured creditors, and replaced Keywell's 'equity cushion' with 'diminishing funds available to support the trade creditors.' Because of Keywell's culture of secrecy ... unsecured creditors could not have known about the Insider Distributions, or of Keywell's compromised financial condition, or about the circumstances relating to the NewKey infusions, and hence could not have taken actions to protect themselves.

R. 50 at 18 (citations omitted). In other words, the Trustee contends that Keywell's management knowingly and improperly chose not to hedge its scrap metal purchases or alternatively to maintain a sufficient equity cushion, in favor of a policy of regularly distributing cash to members, and eventually financing through the higher interest NewKey loans. *See id.* at 17.

The bankruptcy court's and the Trustee's hindsight criticism of Keywell's business strategy is not a basis for a finding of inequitable conduct. Keywell had successfully operated for many years distributing its excess cash to its members and not hedging its scrap metal purchases. This business strategy collapsed only in the face of the worst economic recession in more than 70 years. The Court cannot fault Keywell's management in such circumstances, let alone find that their actions were inequitable.

Furthermore, the timing of the NewKey loans does not support the Trustee's theory or the bankruptcy court's holding. Had Keywell's management instituted the NewKey loans in the months immediately preceding bankruptcy in an attempt to salvage equity from a dying enterprise, equitable subordination might be a proper remedy. *See* *Sentinel Mgmt.*, 728 F.3d at 669 ("Underhanded behavior is typically clearest, however, when corporate insiders [have attempted] to convert their equity interests into secured debt in anticipation of bankruptcy."). But that is not what happened here. "This is not an example of the insiders converting a pre-existing equity claim into debt." *Lifschultz*, 132 F.3d at 347. The NewKey I loan was made in March 2009 and the NewKey II loan was made in October 2011, well before bankruptcy was imminent. As in *Lifschultz*, the "insiders here contributed fresh working capital" even though "[t]hey were under no obligation to do so." 132 F.3d at 347. Certainly, Keywell was struggling financially beginning in 2008. But the NewKey loans were temporarily successful attempts to right the ship, not attempts to cheat creditors out of their claims.

***10** The Trustee makes much of Keywell management's duties to unsecured creditors. There is authority that "[u]nder Illinois law, like the law of many states, a corporate officer or director assumes a fiduciary duty toward the corporation['s] ... creditors ... upon the corporation's insolvency." *In re Berman*, 629 F.3d 761, 766 (7th Cir. 2011). But even if Keywell was insolvent at the time of either of the NewKey loans (and the Trustee's expert testified that it was, *see* R. 52-3 at 53), the evidence does not support the Trustee's contention that the Keywell insiders breached a fiduciary duty to Keywell's creditors by facilitating the NewKey loans. The NewKey loans enabled Keywell to continue to pay its creditors. The NewKey loans were directly used to pay down the Bank of America line of credit, and this allowed Keywell to continue in business, presumably including continuing to pay its unsecured trade creditors. There is no evidence that any unsecured trade creditors went unpaid until Keywell declared a moratorium on certain of those payments in June 2013, several months prior to declaring bankruptcy. In the context of equitable subordination, "[o]nly misconduct that harms creditors will suffice." *In re Kreisler*, 546 F.3d 863, 866 (7th Cir. 2008). Contrary to the Trustee's contention, the record indicates that the NewKey loans actually ensured that Keywell's unsecured trade creditors continued to be paid over a four year period. This can hardly be described as contrary to their interests.

Similarly, the Trustee's argument that Keywell management's decision to replace low interest debt from the Bank of America credit line with the higher interest

NewKey debt at best ignores the economic reality Keywell was facing in 2009 and 2011, and is at worst disingenuous. The Trustee argues that Keywell "substituted" the Bank of America debt with higher interest NewKey debt. But Keywell was in breach of its loan agreement with Bank of America immediately prior to both of the NewKeys loans. These defaults were the primary reason that the Keywell insiders were looking for alternative financing. They needed to shore up Keywell's financing in order to maintain the Bank of America line of credit, which was integral to Keywell's business plan. Describing the higher rate NewKey loans as replacing the lower rate Bank of America debt overlooks the fact that the NewKey loans were necessary to preserve the availability of the Bank of America line of credit, and Keywell's ability to pay its other creditors. The higher interest debt was the price Keywell—and by extension its unsecured trade creditors—paid for an additional four years of business before bankruptcy.

The Trustee also contends that Keywell management acted inequitably and breached their fiduciary duties in setting the NewKey interest rates at 12%, when the Bank of America credit line rate was only 3.23-3.875%. *See* R. 50 at 17; R. 60 at 33-34. But the Trustee has not pointed to any evidence in its briefs on this appeal to support its contention that the 12% rate on the NewKey loans was "exorbitant." By contrast, Defendants put forward some evidence that the 12% rate was reasonable. Defendants expert testified as such. *See* R. 47-9 at 73 (73:19-23). Additionally, Keywell's CFO testified that he contacted a private equity firm, Eureka Capital, and sought advice from Keywell outside counsel, concerning the appropriate interest rate for "instruments similar" to the NewKey loans. R. 47-4 at 82-83 (82:13–83:4). He testified that he was told that an interest rate between 12 and 19 percent would be appropriate. *Id.* Further, Defendant Tauber also testified that, although he did not consult with Keywell's outside counsel responsible for structuring the NewKey loans, and he did not conduct an "extensive" analysis, he "reviewed [his] portfolio of high-yield bonds," which was the relevant category for the NewKey loans, and he determined that the interest rate for the NewKey loans "was a bargain rate." R. 47-1 at 108-10 (108:19–110:7). The Trustee argues that this testimony is unreliable. *See* R. 60 at 33-34. But in the absence of any contrary evidence, there is no basis for the Court to find that the interest rate itself is indicative of inequitable conduct. Moreover, the Trustee also argues that no other financing was available to Keywell. R. 50 at 52 ("Keywell could not obtain alternative financing from any outside sources...."). Since no other financing was available, there is no rate against which to compare the NewKey rates in order to determine that the rate was inequitably "exorbitant," as the Trustee contends.

***11** The Trustee also contends Keywell management acted inequitably because the NewKey loans were "secret," R. 50 at 22, and thus contrary to the Seventh Circuit's admonition that "fairness" in the context of an equitable subordination claim "is primarily about disclosure." *Lifschultz,* 132 F.3d at 346. The Trustee's allegation of inequitable secrecy is based on a myopic view of the record. Of course Keywell did not want to publicize its poor financial condition. But as a non-public company, it was under no obligation to do so. Further, when Keywell engaged in business dealings that required disclosure, it did so: i.e., to Bank of America, and via UCC filings. The Trustee argues that the UCC filings were useless to trade creditors because trade creditors do not customarily investigate UCC filings prior to rendering service, *see* R. 50 at 21; but that is precisely the point. The unsecured trade creditors were apparently not so concerned with Keywell's financial stability that they undertook any investigation. There is no allegation or evidence that Keywell ever denied any requests for information about its financial condition, or that any such requests were ever made. Keywell's alleged "secrecy" is no greater than any other non-public company, and does not rise to the level of "trickery" which underlies the Seventh Circuit's concern with "disclosure." *Lifschultz,* 132 F.3d at 346. True, Keywell management at one time contemplated a plan involving an escrow, which apparently would have been intended to "obscure from [Bank of America] the amount raised." R. 49-1 at 21. But Keywell management was dissuaded from this plan by counsel, and so never took the actions intended to withhold knowledge of equity contributions from Bank of America. Instead of an equity plan involving an element of deception, Keywell pursued the NewKey debt plan for which it obtained Bank of America's consent. Therefore, the facts here do not support a finding of inequitable conduct, and the bankruptcy court's decision on this count is reversed.

C. Interest Repayment (Counts IV-VI)

The Trustee argues that if the Court reverses the bankruptcy court's denial of recharacterization, or affirms the bankruptcy court's grant of equitable subordination, then the Court should require the NewKeys to repay the interest they received on the NewKey loans. The Court, however, affirmed the bankruptcy court's denial of recharacterization, and reversed the bankruptcy court's grant of equitable subordination, so there is no basis to require repayment of interest.

II. Fraudulent Transfers (Counts I & II)

The Trustee alleges that the 2007 special distribution and the 2008 tax distribution are fraudulent transfers under 740 ILCS 160/5(a)(1) (actual fraud) and 740 ILCS 160/5(a)(2) (constructive fraud). As an initial matter, the Trustee does not make any argument that the 2007 special distribution was fraudulent. This is likely because there is no evidence that Keywell was insolvent in 2007.

That leaves the 2008 distribution. Section 160/5 provides the elements for both actual and constructive fraud:

> A transfer made or obligation incurred by a debtor is fraudulent as to a creditor ... if the debtor made the transfer or incurred the obligation: (1) with actual intent to hinder, delay, or defraud any creditor of the debtor; or (2) without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor (A) was engaged or was about to engage in a business or transaction for which the remaining assets of the debtor were *unreasonably small* in relation to the business or transaction; or (B) intended to incur, or believed or reasonably should have believed that he would incur, debts beyond his ability to pay as they became due.

740 ILCS 160/5(a) (emphasis added). The statute also provides that insolvency at the time of the transfer in question or shortly thereafter is a "factor" in determining actual intent. *See* 740 ILCS 160/5(b)(9). The bankruptcy court held that both claims—for actual and constructive fraud—"depend on evidence that the distributions left Keywell financially impaired." R. 49-1 at 33 (*SGK Ventures*, 2015 WL 7755525, at *19).

A. Constructive Fraud

The parties focus their arguments on whether Keywell was *insolvent* at the time of the March 2008 transfer. Although that can be a factor in determining intent with respect to *actual* fraud, whether a debtor was insolvent is not the relevant question with respect to *constructive* fraud. Rather, the statute asks whether at the time of the transfer the debtor "was engaged or was about to engage in a business or transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction." The NewKeys' expert stated in his report that Keywell had shareholder equity of $30.4 million in the first quarter of 2008, which increased to $32.4 million in the second quarter. *See* R. 49-1 at 17-18. The Trustee's expert also stated in his report that Keywell was solvent after the March 2008 transfer, but had a much smaller "equity cushion" of $3.474 million. R. 52-3 at 53. The Trustee's expert also stated that this equity cushion "did not constitute adequate capital at the time of the March 2008 distribution transaction considering the state of the faltering economy, the volatility of the industry and Keywell specifically, and the recent and continuing credit crisis in the global banking sector." *Id.* The bankruptcy court, however, discounted this analysis for the following reasons:

> ***12** This conclusion, however, is not supported by any further analysis, by reference to particular prior experiences of the expert, or by citation to any authority on capital adequacy. So, for example, there is nothing indicating—if 4.7% of liabilities was an inadequate equity cushion—what surplus amount would have been adequate and why. With no indication that Keywell was in any financial distress shortly after the tax distribution, the trustee has failed to establish that either distribution was either constructively or actually fraudulent.

R. 49-1 at 34 (*SGK Ventures*, 2015 WL 7755525, at *19).

The Trustee does not directly address this analysis. Instead the Trustee focuses on the following paragraph from the "Background" section of the bankruptcy court's decision:

> In a memorandum of October 2009, Michael Sheffieck, Keywell's CFO, ... found inadequate capitalization on two grounds: solvency benchmarks established by Dun & Bradstreet and comparisons to public companies in the same business lines as Keywell.

> Public company data for March 2008 is not part of the record, but the D&B benchmarks can be applied to Keywell's March 2008 balance sheet, with the following results.

D&B ratio	Keywell balance sheet data	D&B benchmark standard	Keywell status March 2008
Current Liabilities/Equity	75,054,549/30,448,540	No more than 0.8 to 1	2.46 to 1
Total Liabilities/Equity	137,884,468/30,448,540	No more than 1 to 1	4.53 to 1
Debt/Equity	73,065,126/30,448,540	No more than 1 to 1	2.40 to 1

> This indicates insufficient capitalization. However, at the end of March 2008, Keywell still had loan availability of more than $49 million, and there is no evidence in Keywell's business documents suggesting any need for additional capital at the time.

R. 49-1 at 18 (*SGK Ventures,* 2015 WL 7755525, at *9). The Trustee argues that this section of the bankruptcy court's decision shows that the bankruptcy court "disregarded" its own "finding" that the "relevant data 'indicates insufficient capitalization,' " on the basis that "Keywell had $49 million in availability under the [Bank of America] revolver." R. 50 at 64-65. The Trustee then cites a number of cases to argue that it is improper "to rely on loan availability as a measure of adequate capitalization." *See, e.g.*, *Wachovia Secs., LLC v. Banco Panamericano, Inc.*, 674 F.3d 743, 752 (7th Cir. 2012) ("Adequate capitalization exists when a corporation has sufficient equity *without* considering loaned funds or encumbered assets.") (emphasis added). The Trustee's cases, however, are not on point. For instance, in *Wachovia* the Seventh Circuit discussed the relevance of available credit to adequate capitalization in the context of determining whether the corporate veil should be pierced, not whether the company's capitalization was so inadequate as to demonstrate that certain transfers were fraudulent. *See* *id.* at 751-57.

By contrast, Defendants point out that many courts agree that "the test for 'unreasonably small' capital should include ... all reasonably anticipated sources of operating funds, which may include ... cash from secured or unsecured loans." *Moody v. Security Pac. Buis.*

Credit, Inc., 971 F.2d 1056, 1072 n.24 (3d Cir. 1992); *see also* *In re Adelphia Commc'ns Corp.*, 652 Fed.Appx. 19, 21 (2d Cir. 2016) (same); *In re Opus East, LLC*, 528 B.R. 30, 55 (Bankr. D. Del. 2015) ("In determining whether a company has adequate capital, the Court must consider its assets, access to borrowing (both third party and affiliate), and equity."); *In re Semcrude, L.P.*, 526 B.R. 556, 561 (D. Del. 2014) ("[T]here can be no dispute that, consistent with *Moody*, it is proper to consider availability of credit in determining whether a company has been left with an unreasonably small capital after a distribution."); *In re Bachrach Clothing, Inc.*, 480 B.R. 820, 874-76 (Bankr. N.D. Ill. 2012) (debtor was not left with unreasonably small capital given belief of management and others as to the reasonableness of contemporaneous projections, lenders' reliance on projections in providing substantial credit, and owner's financial ability to contribute capital and its exhibited willingness to do so). The Trustee counters that these cases also are not on point because they require an analysis "of whether the borrowers reasonably expected to generate enough cash to repay those loans and to continue to sustain operations." R. 60 at 35. But Keywell's income for the relevant period shows that its management had a reasonable basis to believe that it would maintain sufficient cash flow. In the four quarters of 2007 and the first two quarters of 2008, Keywell had *net* income of $27 million, $38 million, negative $3 million, $4 million, $8 million, and $4 million. *See* R. 49-1 at 17. Clearly the first half of 2007 was better than the second half or the first half of 2008, but these net income numbers do not necessarily reflect a danger of insolvency or undercapitalization. The fact that Keywell's income and capitalization was eventually insufficient to survive the economic recession is not a basis to find that the 2008 distribution was fraudulent. Such hindsight analysis is inappropriate. *See* *Boyer v. Crown Stock Distribution, Inc.*, 587 F.3d 787, 794 (7th Cir. 2009) ("[O]ne has to be careful with a term like 'unreasonably small.' It is fuzzy, and in danger of being interpreted under the influence of hindsight bias. One is tempted to suppose that because a firm failed it must have been inadequately capitalized. The temptation must be resisted."); *Paloian v. LaSalle Bank, N.A.*, 619 F.3d 688, 693 (7th Cir. 2010) ("Hindsight is wonderfully clear, but in determining the Hospital's solvency in mid-1997 it was necessary to determine the expected value of this liability as of mid-1997, not the actual value as of 1999 or 2000. Hindsight bias is to be fought rather than embraced."). Therefore, the bankruptcy court's denial of the Trustee's claim for constructive fraud is affirmed.

B. Actual Fraud

***13** The Court also rejects the Trustee's argument that Keywell's minimal capitalization, combined with the other circumstances of Keywell's business practices, demonstrates an intent to defraud. The Trustee cursorily references several other allegations to support her intent argument: (1) the distributions were made to insiders; (2) "Keywell effectively retained possession of the property" in that certain shareholders made "a series of relatively small capital infusions" beginning in 2009; (3) the distributions were not disclosed but "were actively concealed"; and (4) "Keywell incurred tens of millions of dollars of debt that funded" the distributions. R. 60 at 44-45. None of these circumstances works to demonstrate intent to harm creditors. Keywell is a close corporation and regularly made insider distributions throughout its relevant history, so this fact is not indicative of intent to harm creditors. The post-2009 capital contributions do not indicate that a distribution made a year earlier was retained by Keywell. And the fact that Keywell used debt to make the distributions is not suspicious because Keywell historically did not keep its assets in cash, but relied on its line of credit to make its accounts receivable liquid. R. 49-1 at 13-14. Therefore, the bankruptcy court's denial of the Trustee's claim for actual fraud is affirmed.

III. Fiduciary Duties (Counts VIII & IX)

Lastly, the Trustee argues that the Keywell insiders breached their fiduciary duties by taking the following actions: (1) the 2007 and 2008 distributions; (2) the NewKey loans; (3) declaring bankruptcy too late in 2013; and (4) rejecting the Prophet deal. The Court has already affirmed the bankruptcy court's decision that the 2007 and 2008 distributions were not improper, and held that there was no inequitable conduct, including any breach of fiduciary duties, in connection with the NewKey loans. That leaves the timing of Keywell's bankruptcy and the decision to reject the overture from Prophet.

A. Delayed Bankruptcy Declaration

The bankruptcy court rejected the Trustee's claim that the Keywell insiders breached a fiduciary duty by not declaring bankruptcy and wasting Keywell's assets. The bankruptcy court held that the Trustee failed at trial to specify "when the filing should have taken place and what additional recovery for the estate could have been realized." R. 49-1 at 39 (*SGK Ventures*, 2015 WL 7755525, at *23). The Trustee contends that she did present such evidence in the form of testimony from Keywell insiders that they contemplated a bankruptcy filing as early as February 2013, and an analysis by Keywell management in March 2013 showing a shortfall to unsecured creditors that was significantly less than what is currently anticipated as a result of Keywell's September 2013 bankruptcy declaration. *See* R. 50 at 61 n.21. This evidence was countered at trial, however, with evidence that Keywell's financial advisor prepared contrary analyses of potential shortfalls to unsecured creditors. *See* R. 56 at 43-44. Even if the evidence identified by the Trustee is sufficient to draw the conclusion that Keywell should have filed at a certain point in time, since the bankruptcy court's "account of the evidence is plausible in light of the record viewed in its entirety," the Court "will not reverse its factual findings even if [the Court] would have weighed the evidence differently" (a point on which the Court does not need to render an opinion). *Lifschultz,* 132 F.3d at 343. Moreover, the bankruptcy court's finding comports with authority that "officers and directors do not breach the duty of loyalty by exercising their business judgment and continuing to operate an insolvent corporation rather than entering bankruptcy and preserving assets to pay creditors." *Mukamal v. Bakes,* 378 Fed.Appx. 890, 900-01 (11th Cir. 2010) (citing *Trenwick Am. Litig. Trust v. Ernst & Young, LLP,* 906 A.2d 168, 174 (Del. Ch. Ct. 2006)); *Fehribach v. Ernst & Young LLP,* 493 F.3d 905, 909 (7th Cir. 2007) (there is no "substantive duty of prompt liquidation that would punish corporate management for trying in the exercise of its business judgment to stave off a declaration of bankruptcy, even if there were no indication of fraud, breach of fiduciary duty, or other conventional wrongdoing"). Therefore, the Court affirms the bankruptcy court's holding that there was no breach of fiduciary duties with respect to the timing of Keywell's bankruptcy filing.

B. The Prophet Deal

***14** The Trustee also argues that Keywell insiders breached their duties of care and loyalty by not properly considering and accepting the Prophet deal. The NewKeys and the Keywell insiders argue that there never was a deal to be had because there were many other unsettled aspects to the offer.

Although officers and directors of a company generally do not owe a fiduciary duty to the company's creditors, such a duty can arise upon the company's insolvency. *See* *Berman,* 629 F.3d at 766. It is also true that when directors stand "on both sides of a transaction" they implicate the duty of loyalty. *See* *In re Abbott Labs. Derivative Shareholders Litig.,* 325 F.3d 795, 807 (7th Cir. 2003). There is scant authority, however, (either put forward by the parties or discovered by the Court) addressing the particular circumstances of this case, i.e., whether the owners of an insolvent close corporation have a duty to sell or diminish their equity interest to protect the corporation's creditors. *See* *In re Fleming Packaging Corp.,* 370 B.R. 774, 778-90 (Bankr. C.D. Ill. 2007).

The bankruptcy court does not appear to have addressed this aspect of Counts VIII and IX in its decision. The bankruptcy court addressed the general facts of the Prophet deal in discussing the background of the case, but it did not address those facts in its discussion of the Trustee's breach of fiduciary duty claim. Additionally, although the Trustee certainly presented evidence to the bankruptcy court regarding the Prophet deal, the Trustee does not appear to have sufficiently developed in the bankruptcy court the argument that these facts support a finding of a breach of fiduciary duty. The claim is not expressly alleged in the complaint. *See* R. 51-13. The argument is not presented in the Trustee's post-trial brief. *See* R. 51-16.[3] From the Court's review of the trial transcripts, it appears that no opening statements or closing arguments were made. *See* R. 49-4; R. 49-12. Based on the Court's knowledge of the proceedings below, the Court finds that the Trustee waived the argument that the Keywell insiders failure to sufficiently pursue the Prophet deal constituted a breach of their fiduciary duties. *See* *Wittman v. Koenig,* 831 F.3d 416, 420 (7th Cir. 2016) ("the trustee ... waived the issue ... by failing to raise it in the bankruptcy court"). The Court will entertain a motion to reconsider this finding of a waiver, if the Trustee can make an argument, consistent with Federal Rule of Civil Procedure 11, that she sufficiently raised and developed the issue before the bankruptcy court.

Even if the Trustee can successfully make such a showing, the absence of a holding from the bankruptcy court on this issue presents a dilemma. The Court contemplates the following scenarios: (1) remand to the bankruptcy court on the limited issue of whether the Keywell insiders breached their fiduciary duties to Keywell's creditors by not properly pursuing the Prophet deal; or (2) withdraw the reference to the bankruptcy court on this limited issue. *See* 28 U.S.C. § 157(d) ("The district court may withdraw, in whole or in part, any case or proceeding referred under this section, on its own motion or on timely motion of any party, for cause shown"); *see also Pro-Pac, Inc. v. WOW Logistics Co.*, 721 F.3d 781, 788 (7th Cir. 2013) ("the district court can withdraw the reference and resolve the issues itself"); *Fed. Deposit Ins., Corp. v. Veluchamy*, 2014 WL 5420177, at *2 (N.D. Ill. Oct. 21, 2014) ("A review of relevant case law, in this circuit and others, indicates that district courts may simply consider any relevant factor when deciding whether to withdraw a matter from bankruptcy court."); *id.* (the statute does not define "cause," but courts have found that "judicial economy and convenience" and "conservation of debtor and creditor resources" are relevant factors). The Court is inclined to choose the second option primarily for two reasons: (1) relative to the overall scope of the case, this issue is limited and well defined; and (2) Judge Wedoff, who presided over the trial in the bankruptcy court and issued the decision now on appeal, has retired, meaning that the bankruptcy judge currently presiding over the case likely does not have any more familiarity with this particular issue than the Court. (And having prepared this opinion and order, the Court may have more facility with the facts of this case than the bankruptcy court.) If the Court should withdraw the reference (provided there is a basis to show the issue was not waived), the Court contemplates that the Trustee would file a motion seeking summary judgment on this issue citing case law supporting her argument that a fiduciary duty exists in these circumstances, and relevant testimony and evidence presented at the trial in the bankruptcy court. The Court would order additional testimony to the extent necessary.

Conclusion

***15** For the foregoing reasons, the bankruptcy court's decision is reversed with respect to Count VII. The bankruptcy court's decision is affirmed with respect to Counts I, II, III, IV, V, VI, VIII, and IX.

All Citations

Not Reported in Fed. Supp., 2017 WL 2683686

Footnotes

1 By the term "Keywell insiders" the Court refers to the Cross-Appellees in this action other than the NewKeys. The Keywell insiders together with the NewKeys are referred to as the "Defendants."

2 Although the Seventh Circuit applied this reasoning to a claim for equitable subordination, other courts have found it equally relevant to claims for recharacterization. *See In re Official Comm. of Unsecured Creditors for Dornier Aviation (N. Am.), Inc.*, 453 F.3d 225, 234 (4th Cir. 2006) ("a claimant's insider status and a debtor's undercapitalization alone will normally be insufficient to support the recharacterization of a claim. In many cases, an insider will be the only party willing to make a loan to a struggling business...."); *Emerald Casino*, 2015 WL 1843271, at *12; *Kids Creek*, 212 B.R. at 932.

3 From the transcript it appears that the court and parties contemplated that the Trustee would file a post-trial reply brief, but the Court has been unable to locate that document in the record.

TAB 4

2012 WL 1424684
Only the Westlaw citation is currently available.
United States Bankruptcy Court, D. Maryland,
at Greenbelt.

In re RGHGAB AT FREDERICK, LLC Debtor.
Michael G. Wolff, Trustee, Plaintiff
v.
Waverly View Investors, LLC Rocky Gorge
Development, LLC, Defendants.

Bankruptcy No. 11–10627PM.
|
Adversary No. 11–0346PM.
|
April 24, 2012.

Attorneys and Law Firms

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Gabrielle M. Duvall, Jennifer Larkin Kneeland, Linowes and Blocher LLP, Bethesda, MD, for Defendants.

MEMORANDUM OF DECISION

PAUL MANNES, Bankruptcy Judge.

***1** This case comes before the court on the claim pursued, through the auspices of the Trustee, of the minority holder of the stock of the Debtor, RGHGAB at Frederick, LLC ("RGHRAB"), for **equitable subordination** or equitable disallowance of the claim of Waverly View Investors, LLC[1] ("Waverly"), pursuant to 11 U.S.C. § 510(c). The cast of characters includes Christopher Dorment ("Dorment"), the Chairman and Sole Member of Rocky Gorge Development, LLC ("Rocky Gorge"), Robert Berman ("Berman"), the President of GAB Enterprises, Inc. ("GAB"), his father, Malcolm Berman, and Waverly, the present holder of a secured claim in the sum of $9,642,437.46 sought to be subordinated. Dorment caused the formation of Waverly in June 2010 to acquire the secured obligation held by Branch Banking and Trust Company ("BBT"). following what Christopher Dorment viewed as a default on the part of GAB. This dispute was combined for hearing with an Amended Motion for Relief from the Automatic Stay filed by Waverly seeking to enforce the indemnity deed of trust acquired from BBT. Plaintiff also seeks disallowance of the 80% membership interest held by Rocky Gorge in the Debtor. While there were considerable differences in the testimony as to various factual matters and the conclusions to be drawn therefrom, there was no dispute that the Debtor's interest in the subject property was worth $5–6 million less than the amount owed to the holder of the note, whoever that might be.

Debtor was created on November 11, 2003, to implement an Operating Agreement (D.Ex.1) dated November 10, 2003. The Agreement concerned the terms for acquiring, developing and selling nine parcels of real property in Frederick County, Maryland. Under this Agreement the parties were to develop what has been referred to as the Shookstown Road property. The parties contributed their contract rights in the subject property with future expenses to be shared 80% by Rocky Gorge and 20% by GAB. The signatories were to execute guaranties as required. But the matter got off on the wrong foot when BBT required, in addition to the Members' guaranties, the personal guaranty of Dorment on the obligation (hereafter the "Note").

Throughout life of the agreement, the relationship between Berman and Dorment was acrimonious and marked by ongoing disputes almost from the start. The history of this relationship is well summarized in Plaintiff's Proposed Findings of Fact.

The Agreement contemplated that the project would be financed by borrowed funds and member loans. In keeping with this obligation, Rocky Gorge executed a promissory note on January 30, 2004, for $2.75 million, later increased to $8.95 million on September 12, 2007. These obligations were guaranteed by Dorment personally and GAB to a limited extent. The balance of funding required was to be made by capital calls upon the parties. The remedy for a failure of a member to commit funds was limited by Section 5A of the Agreement, an elaborate procedure requiring notice and cash contributions by the non-defaulting member, including buying out the defaulting member or diluting its interest. Dorment did not avail himself of any of these remedies after any of the alleged defaults by Berman. The project ran into the hurricane of the recent momentous downturn in the real estate market in Frederick County and elsewhere. The property was so far undersecured, that is, by at least $5–6 million, that there was no economic reason to hang onto it in the absence of a concession from the secured lender. With no income coming into the partnership, the Debtor was running out of funds. The partners were left to their own resources. Calls were made upon Robert Berman to share in contributions. Berman testified that he did not make these calls as it was not prudent to do so with the loan being in default. He refused and suggested instead the possibility of funding by his father. However, the terms and conditions that were to be imposed by Malcolm Berman were never disclosed or ever committed to writing. Dorment testified that what he had heard about Malcolm Berman made him very reluctant to enter into any arrangement with him without well defined terms committed to writing. Dorment was on his own to procure the funds required to run the project. At all times Robert took the position that it was Dorment's duty under Section 2.2.2. of the Operating Agreement to provide the financing. ("Rocky Gorge shall be responsible for obtaining and/or providing equity investments, institutional and/or private financing, working capital, deposits and guaranties [the Financial Resources], necessary to permit the Company to carry out its business.") However, when the situation became critical, Rocky Gorge could not either supply funds on its own account or obtain the necessary funds "on commercially reasonable terms," as required for such acts by Section 2.2.2 of the Operating Agreement. Faced with almost certain foreclosure and enforcement of his personal guaranty, Dorment sought the opportunity to purchase the Note for $2 .4 million, later reduced to $2 million, leaving the door open for Macolm Berman to make a similar offer that never crystallized. At all times Dorment advised Robert Berman of the situation facing the venture. This was required in that Section 5.3 of the Operating Agreement required his agreement to dissolve or terminate the venture, to do anything in contravention of the agreement, to do any act that would make it impossible to carry on the ordinary business of the venture, or to possess or assign rights in company property or assign rights in company property other than for a company purpose.

***2** By a letter dated November 12, 2009 (P.Ex. 8), Dorment advised Berman of his intention to buy the BBT Note at a discount and that he was seeking fresh equity capital and that this would require ceding of control of the project and dilution of their equity stakes. How he could cede control of the project without the consent of Berman is unclear. Dorment acknowledged the inability of Rocky Gorge to fulfill its financing responsibility. The parties met on February 3, 2010, to discuss the critical situation. Dorment proposed a Strategic Plan (P.Ex. 11) noting the impossibility of progressing under the Operating Agreement and with the goal of salvaging what they could from the project but primarily to avoid liability under their guaranties. The latter was of no importance to Berman as, unlike Dorment, he had no personal responsibility for the debt. Various options were mentioned, including a buy-sell agreement leaving one of the warring partners in total control. The document concluded that the only practical course of action would be for a new entity to buy the BBT Note, and "if the Managing Member reaches that conclusion, the Managing Member would proceed ahead with the goal of protecting the interests of the Company even if the minority member objected." The court finds as a fact that the primary motivation of Dorment was to limit his liability on the guaranty and secondarily to protect the venture.

In order to buy time, Dorment entered into negotiations for a forbearance agreement with BBT dated March 30, 2019 (P.Ex. 19). Although all that this would have involved was for his shell corporation to sign a guaranty, Berman, true to his uncooperative nature, refused to sign the agreement. The agreement was consummated without his signature, and during the period of the forbearance the parties had another quarterly meeting in May. The parties discussed their situation, mutual buy-outs and other resolutions of the situation. At this point, Malcolm Berman took a role in the proceedings with an initial view of GAB buying out Dorment and purchasing the Note, provided that Dorment stayed active in the project. Malcolm Berman then met with the zoning lawyer and the engineer and, following these meetings, ultimately stated that he was only interested in providing "friendly financing" to the Debtor. Malcolm Berman then called BBT's attorney to see the price at which he could buy the Note. At about this time, Rocky Gorge obtained the exclusive right to purchase the Note. Another 45–day extension of the Note was obtained by Rocky Gorge in exchange for a $75,000.00 deposit.

On July 1, 2010, Dorment met with the Bermans at Clyde's Restaurant in Columbia. The purpose of the meeting was to discuss the terms by which Malcolm Berman would buy the Note. At no time did Malcolm discuss anything but generalities and never was anything put in writing by him in regard to his advancing money for the project. Following the meeting, Dorment sent Malcolm a Term Sheet that he found unacceptable.

***3** On August 6, 2010, Dorment received a commitment from Capital Bank to enable him and his associates in Waverly to purchase the Note from BBT (P.Ex. 46). Dorment and his wife were to be guarantors as a condition of the commitment, and the obligation to Capital Bank was to be further secured by the Note. Following receipt of the commitment, Dorment obtained a further extension to September 13, 2010. The purchase price was reduced to $2,000,000.00. Dorment then disclosed to Berman that the Note would be purchased by Waverly, inasmuch as Rocky Gorge lacked the capacity to buy it (P.Ex. 45B). After assignment by Rocky Gorge to Waverly of the note purchase agreement with Capital Bank, the transaction closed on September 17, 2010. While Berman states that he was never informed of Waverly's intention to foreclose on the property after acquisition of the Note, the court finds it hard to believe that he did not foresee that possibility as the only sure way of breaking the logjam that the partners were in. Here again, while no one disputes the financial ability of Malcolm Berman to be a white knight in this transaction, there never was any publication of a definitive statement of the terms that he would extract for his funding.

Following the closing, Dorment began acting for Waverly as if it owned the subject property, entering into letters of intent and contracts with national builders. At the same time, he signed a Deed of Easement on behalf of the Debtor. Waverly's foreclosure action, said to have been scheduled for January 11, 2011, was interdicted by the involuntary bankruptcy petition filed at 4:43 p.m. that day.

The court finds a total absence of harm by the actions complained of to the one creditor holding a secured claim or the six holders of claims without priority. Without actual harm to creditors, there is no basis for the cause of action. *In re Kreisler,* 546 F.3d 863, 866–867 (C.A.7 2008). The absence of any harm caused by the note acquisition is demonstrated by the fact that this project was so far indebted to the holder of the secured claim that there was no scenario under which the Trustee's constituent body, the holders of unsecured claims, could receive any distribution whatsoever. Rocky Gorge might have a fiduciary relationship to GAB, but that is not what this adversary proceeding concerns. Similarly, were there equity available for distribution after payment of the secured claim, GAB might well have a valid claim for subordination of the Rocky Gorge claim, and the Trustee might have a cause of action against both Rocky Gorge and GAB to recharacterize their member loans as camouflaged equity under the authority of such cases as *In re Airadigm Communications, Inc.,* 616 F.3d 642 (C.A.7 2010), but there is no basis for disallowance of the secured claim. To do so would create a windfall for GAB, the real party in interest in this adversary proceeding.

Plaintiff seeks recovery pursuant to the principle of **equitable subordination**, a remedy provided by 11 U.S.C. § 510(c):

> ***4 11 U.S.C. § 510. Subordination**
>
> (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.

It is a core proceeding under 28 U.S.C. § 157(b)(2)(K) that must be brought by way of an adversary proceeding pursuant to Fed. Rule of Bankruptcy Proc. 7001(8). As pointed out in *In re ASI Reactivation, Inc.,* 934 F.2d 1315, 1321–1322 (C.A.4 1991):

> Generally, **equitable subordination** involves a number of inquiries: 1) whether the claimant engaged in fraudulent conduct, 2) whether the conduct resulted in injury to creditors and 3) whether subordination would be consistent with other bankruptcy law. *See* *Holt v. Federal Deposit Ins. Co. (In re CTS Truss, Inc.),* 868 F.2d 146, 148 (5th Cir.1989) (assuming arguendo bank's conduct was attributable to FDIC, conduct did not fall within classic pattern warranting extraordinary remedy of **equitable subordination**); *Wilson v. Huffman* (*In re Missionary Baptist Foundation of America, Inc.)* 712 F.2d 206, 212 (5th Cir.1983) (bankruptcy court must make explicit findings on each of the three elements when granting **equitable subordination**); *Benjamin v. Diamond (In re Mobile Steel Co.),* 563 F.2d 692, 699–700 (5th Cir.1977) (as court of equity, bankruptcy court may subordinate claim if three conditions are met). As to purchase

of the secured note, there was simply no evidence that it was either fraudulent or injurious. The record indicates Narayanan used his own funds to buy the note. *There is nothing in the bankruptcy act which per se forbids a principal from obtaining and asserting rights as a lien creditor.* Here there is also evidence that Narayanan bought the note to stave off a foreclosure, for the company's benefit, as well as to solidify his position. If some particular creditor was deceived into dealing with this corporation by this transaction, that was not demonstrated. Thus, the debt underlying the note and the lien were properly recognized by the bankruptcy court. (Emphasis added.)

Again, the court finds that no harm was caused to the creditor body by Dorment forming a group to acquire the Note in and of itself. There could well be a cause of action in what is essentially this two-party dispute between Robert Berman and Christopher Dorment operating through their legal entities. But resolution of the potential dispute is for another day in another jurisdiction.

The court must now deal with the Trustee's claim for disallowance of the claim of Waverley View Investors, LLC, the holder and transferee of the Note. This doctrine was described in *Pepper v. Litton,* 308 U.S. 295, 304–305, 60 S.Ct. 238, 84 L.Ed. 281 (1939). While there is a difference of opinion as to whether this action survived the passage of the Bankruptcy Reform Act of 1978, the court will assume for the purpose of this opinion that the cause of action still is viable. See *Adelphia Recovery Trust v. Bank of America, N.A.,* 390 B.R. 64, 74–76 (BC S.D.N.Y.2008). In any event, the action has been described as being available only "in extreme instances-perhaps very rare-where it is necessary as a remedy...." *Adelphia Recovery Trust v. Bank of America, N.A.,* 390 B.R. 80, 99 (S.D.N.Y.2008). The court explained in describing **equitable subordination**:

***5** "The purpose of **equitable subordination** is to undo wrongdoing by an individual creditor in the interest of the other creditors." *In re Applied Theory Corp.,* 345 B.R. 56, 59 (S.D.N.Y.2006) (*citing* *In re Lockwood,* 14 B.R. 374, 380–81 (Bankr.E.D.N.Y.1981) ("The fundamental aim of **equitable subordination** is to undo or offset any inequality in the claim position of a creditor that will produce injustice or unfairness to other creditors in terms of bankruptcy results.")). It follows reasonably from the judicial and legislative interpretations of the statute that the "other creditors" whose welfare is the primary focus of **equitable subordination** law must be creditors of the same debtor, as a given claim may not be subordinated to an equity interest, but only to another claim.

The **Note** was **acquired** for two purposes, to gain **control** of the subject property for the benefit of the new combine and to relieve Dorment of the weight of a $9 million plus guaranty. The court finds nothing in the nature of inequitable conduct or unfairness on Dorment's part. The creditors, as creditors as explained above, were then at least $5million under water and suffered no change in position as a result of the transfer of the Note to parties friendly to Dorment. Berman, as a partner-creditor, may have a claim against his co-venturer. However, the court finds nothing in the behavior of Dorment or his co-venturers in Waverley to mandate the awesome punishment of equitable disallowance being imposed on them. As explained in the case of *In re Official Committee of Unsecured Creditors for Dornier Aviation (North America) Inc.,* 453 F.3d 225, 232 (C.A.4 2006):

Like disallowance, **equitable subordination** also differs markedly and serves different purposes from recharacterization. While a bankruptcy court's recharacterization decision rests on the substance of the transaction giving rise to the claimant's demand, its **equitable subordination** decision rests on its assessment of the creditor's behavior. As the Tenth Circuit has explained, when a claim is equitably subordinated, "[t]he funds in question are still considered outstanding corporate debt, but the courts seek to remedy some inequity or unfairness perpetrated against the bankrupt entity's other creditors or investors by postponing the subordinated creditor's right to repayment until others' claims have been satisfied." *Sender v. Bronze Group, Ltd. (In re Hedged–Invs. Assocs., Inc.),* 380 F.3d 1292, 1297 (10th Cir.2004); *see also id* . ("The doctrine of **equitable subordination**, by contrast, looks not to the substance of the transaction but to the behavior of the parties involved."). Thus, although recharacterization and **equitable subordination** lead to a similar result, they "address distinct concerns" and require a bankruptcy court to conduct different inquiries. *See* *Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Sys. Corp.),* 432 F.3d 448, 454 (3d Cir.2006). In the case at hand, the bankruptcy court found that **equitable**

subordination was inappropriate because there was no evidence of GMBH engaging in inequitable conduct. This finding does not in any way affect the court's conclusion that recharacterization was appropriate.

***6** The final matter before the court is the motion of Waverly for relief from the automatic stay of 11 U.S.C. § 362(a). The opposition to the motion was based on the proposition that a favorable result on the adversary proceeding would moot the motion, and, in view of the absence of equity in the subject property, the motion for relief from stay is granted. Counsel for Waverly shall present an appropriate order terminating the stay.

All Citations

Slip Copy, 2012 WL 1424684

Footnotes

[1] In this record there are two spellings of the name of this Defendant. Plaintiff uses "Waverly" and Defendant uses "Waverley." The court will use the Plaintiff's spelling.

TAB 5

251 B.R. 24
United States Bankruptcy Court, D. Connecticut.

In re MR. R'S PREPARED FOODS, INC., Debtor.

No. 97–23093.
|
July 11, 2000.

Synopsis
Inside creditors moved for relief from stay to exercise their rights under security agreements, and trustee objected, on theory that creditors' claims should be equitably subordinated. The Bankruptcy Court, Robert L. Krechevsky, J., held that: (1) claim of **equitable subordination** could be asserted as affirmative defense to motion for relief from stay; (2) **insider's** conduct, when approached by bank about honoring his guarantee of debtor's indebtedness, in purchasing bank's promissory note and security agreement at full face value did not enable **insider** to gain any unfair advantage, as required for **equitable subordination** of **insider's** claim; (3) alleged undercapitalization of debtor, without more, did not provide any basis for **equitable subordination**; and (4) **insider** not tacitly admit that his claims should be subordinated.

Motions granted.

West Headnotes (14)

[1] **Bankruptcy**Set-off and counterclaim; affirmative defenses

Claim of equitable subordination may properly be asserted as affirmative defense to motion for relief from stay by secured creditor. Bankr.Code, 11 U.S.C.A. §§ 362(d), 510(c).

[2] **Bankruptcy**Inequitable conduct

Equitable subordination is unusual remedy which should be applied only in limited circumstances. Bankr.Code, 11 U.S.C.A. § 510(c).

1 Cases that cite this headnote

[3] **Bankruptcy**Inequitable conduct

Before they will equitably subordinate claim, courts generally require (1) inequitable conduct by creditor whose claim is to be subordinated; (2) resulting in unfair advantage to the malefactor and/or harm to debtor or its other creditors; and (3) a showing that equitable subordination will not be inconsistent with other aspects of the Bankruptcy Code. Bankr.Code, 11 U.S.C.A. § 510(c).

6 Cases that cite this headnote

[4] **Bankruptcy**Inequitable conduct

Extent and severity of inequitable conduct required for **equitable subordination** of creditor's claim depends on whether creditor was **insider** of debtor. Bankr.Code, 11 U.S.C.A. § 510(c).

1 Cases that cite this headnote

[5] **Bankruptcy**Determination of priority

Where creditor whose claim is to be equitably subordinated is insider or fiduciary of debtor, trustee bears initial burden of presenting material evidence of unfair conduct, but once trustee meets this burden, creditor must then prove fairness of his transactions with debtor or his claim will be subordinated. Bankr.Code, 11 U.S.C.A. § 510(c).

[6] **Bankruptcy**Insiders, stockholders, fiduciaries, and dominant persons

Mere fact of insider relationship is insufficient to warrant equitable subordination of insider's claim; rather, insider status goes only to establishing standard to apply in reviewing insider's conduct. Bankr.Code, 11 U.S.C.A. § 510(c).

[7] **Bankruptcy**Insiders, stockholders, fiduciaries, and dominant persons

For court to equitably subordinate inside creditor's claim, inside creditor must actually use its power or control to its own advantage, or to other creditors' detriment. Bankr.Code, 11 U.S.C.A. § 510(c).

3 Cases that cite this headnote

[8] **Bankruptcy**Insiders, stockholders, fiduciaries, and dominant persons

Insider's conduct, when approached by bank about honoring his guarantee of corporate debtor's indebtedness, in purchasing bank's promissory note and security agreement at full face value did not enable insider to gain any unfair advantage, as required for equitable subordination of insider's claim, since insider would have been subrogated to bank's rights, even without purchase of note, simply by paying debtor's debt. Bankr.Code, 11 U.S.C.A. § 510(c).

1 Cases that cite this headnote

[9] **Bankruptcy**Inequitable conduct

Second requirement for equitable subordination of creditor's claim based on its inequitable conduct, that such conduct must have resulted in unfair advantage to misbehaving creditor and/or harm to debtor or its other creditors, is conjunctive test, which requires a showing of both unfair advantage to misbehaving creditor and harm to debtor or its other creditors. Bankr.Code, 11 U.S.C.A. § 510(c).

6 Cases that cite this headnote

[10] **Subrogation**Subrogation to Rights of Creditor

It is generally held that, when guarantor honors his guarantee by paying debt, he is, at least as against the debtor primarily liable, subrogated to all the rights and remedies of creditor, even without formal assignment of debt or judgment.

[11] **Bankruptcy**Insiders, stockholders, fiduciaries, and dominant persons

Even assuming that insider's loan to debtor-corporation, which debtor used to pay its ongoing expenses and not for making any distributions to its equity holders, was sign that debtor was undercapitalized, such undercapitalization did not provide any basis for equitable subordination of secured claim that insider acquired by virtue of his loan, where loan did not confer any unfair advantage on insider but permitted debtor to obtain $500,000 in operating income in return for notes secured by property worth no more than $136,000. Bankr.Code, 11 U.S.C.A. § 510(c).

2 Cases that cite this headnote

[12] **Bankruptcy**Insiders, stockholders, fiduciaries, and dominant persons

While **insider's** loan to insolvent corporation may be indicative of undercapitalization, undercapitalization alone generally is insufficient to justify **equitable subordination** of **insider's** claim, without evidence of additional inequitable conduct. Bankr.Code, 11 U.S.C.A. § 510(c).

1 Cases that cite this headnote

[13] **Bankruptcy** **Insiders**, stockholders, fiduciaries, and dominant persons

Conduct of inside creditor's son, the debtor's president, in maintaining a checking account in his own name for debtor's use, was not "inequitable conduct," of kind which provided any basis for **equitable subordination** of inside creditor's claim, given evidence that banks refused to open account in debtor's name and that account at issue was necessary to permit debtor to operate; no evidence was presented that account at issue was misused, or that son commingled funds of debtor with any other funds. Bankr.Code, 11 U.S.C.A. § 510(c).

[14] **Bankruptcy** Subordination agreements

Inside creditor's agreement, as added consideration for conveyance of debtor's assets to new entity owned by debtor's insiders as provided in debtor's confirmed Chapter 13 plan, to equitably subordinate his claims to those of unsecured creditors was not tacit admission that his claims should be subordinated, of kind which could be given any effect when financing did not materialize to complete sale, and when debtor's case was converted to one under Chapter 7. Bankr.Code, 11 U.S.C.A. § 510(c).

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JOINT RULING ON MOTIONS FOR RELIEF FROM STAY FILED BY (1) T & B INVESTMENTS, LLC and (2) THOMAS ROTANELLI

ROBERT L. KRECHEVSKY, Bankruptcy Judge.

I.

Mr. R's Prepared Foods, Inc. ("the debtor")[1] filed a Chapter 11 petition on July 11, 1997. On February 28, 2000, T & B Investments, LLC ("T & B") and Thomas Rotanelli ("Rotanelli") (together "the movants") filed separate motions for relief from the automatic stay in order to enforce each movant's prepetition perfected security interest in certain assets of the debtor. On March 2, 2000, the court converted the debtor's bankruptcy case to a liquidation proceeding under Chapter 7 and appointed a trustee. The Chapter 7 trustee, John J. O'Neil, Jr., Esq., supported by the United States of America, Internal Revenue Service and the State of Connecticut, Departments of Revenue Services and Labor, as holders of claims for ***27** administrative expenses (together "the objectors"), objected to the motions. A hearing was held on May 4, 2000 at which time the court heard the testimony of Rotanelli and various exhibits were introduced into evidence. The parties thereafter submitted extensive post-hearing memoranda of law.

II.

BACKGROUND

The debtor is a closely held corporation owned and managed since its incorporation in 1994 by Rotanelli and other members of his immediate family. T & B is a limited liability company formed on March 11, 1996 by Rotanelli and his wife for the purpose of managing their investment portfolio.

On January 31, 1995, the debtor borrowed $490,000 from The Bank of New York ("the Bank") in return for which it gave a promissory note ("the secured note"), personally guaranteed by Rotanelli, and a duly perfected security interest in all of the debtor's present and after-acquired accounts receivable and inventory. When the debtor was unable to repay the secured note, the Bank filed a lawsuit against the debtor and Rotanelli, as guarantor. To settle the lawsuit, T & B, on March 22, 1996, purchased the secured note from the Bank. Following a cash payment from T & B equal to the $490,000 outstanding principal plus interest and fees, the Bank assigned to T & B the secured note and the security interest. The assignment of the security interest was duly filed.

On October 24, 1995 and December 7, 1995, Rotanelli made two loans to the debtor of $200,000 and $300,000 ("the $500,000 loans"). In return, on January 30, 1996, the debtor executed separate promissory notes to Rotanelli for such amounts and granted Rotanelli a duly perfected security interest in all of the debtor's present and after-acquired assets, including equipment.

After the debtor, on July 11, 1997, filed a Chapter 11 bankruptcy petition, it continued to operate the business as debtor in possession. Rotanelli's son, Mario Rotanelli ("Mario"), assumed responsibility for management of the debtor's day to day operations. Rotanelli remained actively involved in the debtor's operations in various capacities, but received no salary or other compensation therefor. The court, on July 8, 1999, confirmed the debtor's plan of reorganization. The plan's consummation was contingent upon the sale, to a newly formed company, LB Manufacturing (LB) owned by the debtor's principals, of the debtor's assets with third party financing to be provided by Jack Conley ("Conley") and River City Capital, LLC.

The debtor has not paid postpetition rent, amounting to $168,000, to Rotanelli, the owner of the real property on which the debtor's operations were located. The confirmed plan provided that Rotanelli's administrative claim for the unpaid postpetition rent would be subordinated to the claims of other creditors. (Plan ¶ 3.01(a), Tr.Ex. A.) The plan further provided that, "As consideration for approval of the Plan, [the claims at issue in this proceeding plus an additional $55,000 postpetition secured loan] shall be extinguished upon confirmation of the Plan and the sale of the Debtor's assets to LB pursuant thereto." (Plan ¶¶ 5.01, 5.03, 5.04, Tr.Ex. A.) The plan provided for payment in full, from the proceeds of the sale of assets to LB, of all other allowed administrative claims, priority and tax claims. Allowed general unsecured claims, excluding $3,400,000 of such claims held by Rotanelli, members of his family, and various entities owned by them, would receive a pro rata share of $125,000 from the proceeds of the asset sale. Equity interests would be extinguished and receive no distribution under the plan.

In anticipation of the sale of assets to LB, LB hired the debtor's employees. Following plan confirmation, the debtor's checking account was terminated by its ***28** bank and Mario opened an account in his name d/b/a/ Lady B Foods for the debtor's use. The required financing never materialized, the plan was not consummated, and on various parties' motions, the court, as noted, on March 2, 2000, converted the debtor's case to one under Chapter 7.

The disclosure statement and confirmed plan indicate that Rotanelli supplied an initial capital contribution of $1,000,000 to the debtor (Tr.Ex. 1 at 7) and prepetition unsecured loans of $3,400,000 (Tr.Ex. 1 at 10), in addition to the secured loans at issue in this proceeding, and a subordinated post-petition loan of $55,000. The debtor's assets are valued at $175,365, consisting of $15,000 of inventory, $24,365 of accounts receivable and $136,000 of machinery and equipment. (Tr.Ex. 1 at 11.) No party disputes any of the relevant amounts.

The movants submit that they have satisfied their burdens of proof, warranting the granting of the motions. The objectors contend the court should deny the motions on the sole ground that Rotanelli and T & B are insiders of the debtor whose claims should be equitably subordinated pursuant to Bankruptcy Code § 510(c).[2]

III.

BURDEN OF PROOF

The movants have the burden of proof on the issue of the debtor's equity in the property and the objectors have the burden of proof on all other issues. 11 U.S.C. § 362(g). It is undisputed that T & B has a perfected security interest in the debtor's accounts receivable and inventory to secure its claim of $490,000; that Rotanelli has a perfected second security interest in some of the debtor's assets and a perfected first security interest in the debtor's equipment securing his claim of $500,000; and that the debtor has made no payments on any of these obligations. It is also undisputed that the debtor's total assets have a value of $175,365 and that the debtor has no equity in these assets. Thus, each of the movants has met its and his burden of proof.

[1] While the objectors do not dispute the debtor's lack of equity or the validity of the movants' security interests, they assert, as an affirmative defense, that the security interests at issue should be equitably subordinated. "The affirmative defense of equitable subordination under Code § 510(c) may properly be asserted as a defense to a motion for relief from stay." *In re Poughkeepsie Hotel Assoc. Joint Venture,* 132 B.R. 287, 293 (Bankr.S.D.N.Y.1991) (relying on the rationale adopted by the Second Circuit Court of Appeals in *In re Sonnax Industries, Inc.,* 907 F.2d 1280 (2d Cir.1990)). "The issue is limited to whether the [objectors have] presented sufficient evidence of the bona fides of their claim for the court to deny the motion for relief from stay." *Resolution Trust Corp. v. Shehu* (*In re Shehu*), 128 B.R. 26, 29 (Bankr.D.Conn.1991).

IV.

EQUITABLE SUBORDINATION

[2] [3] Equitable subordination is an unusual remedy which should be applied only in limited circumstances. *Fabricators, Inc. v. Technical Fabricators, Inc.* (*In re Fabricators, Inc.*) 926 F.2d 1458, 1464 (5th Cir.1991). In determining whether equitable subordination of a claim is justified, courts have generally applied the three-pronged *Mobile Steel* ***29** test, which requires (1) inequitable conduct by the creditor whose claim is to be subordinated (2) resulting in unfair advantage to the malefactor and/or harm to the debtor or its other creditors, and (3) that equitable subordination would not be inconsistent with other aspects of the Bankruptcy Code. *Benjamin v. Diamond* (*In re Mobile Steel*), 563 F.2d 692, 699–700 (5th Cir.1977); *See also* *United States v. Noland,* 517 U.S. 535, 538–39, 116 S.Ct. 1524, 1526, 134 L.Ed.2d 748, 754 (1996) (citing the *Mobile Steel* test as that generally followed) ....

White Current Corp. v. Rural Util. Svc. (In re Vermont Elec. Gen. & Transmission Coop., Inc.), 240 B.R. 476, 482 (Bankr.D.Vt.1999).

[4] [5] The extent and severity of the inequitable conduct required for **equitable subordination** depends on whether the movants were **insiders** of the debtor. "Where the claimant is an **insider** or fiduciary, the trustee bears the burden of presenting material evidence of unfair conduct. Once the trustee meets this burden, the claimant must then prove the fairness of his transactions with the debtor or his claim will be subordinated." *Estes v. N & D Properties, Inc.* (*In re N & D Properties, Inc.*), 799 F.2d 726, 731 (11th Cir.1986).

[6] [7] The movants do not dispute that they were insiders of the debtor at the time they obtained the security interests at issue. However, "[t]he cases are clear that the mere fact of an insider relationship is insufficient to warrant subordination. The insider status goes only to establishing the standard to apply in reviewing the insider's conduct. In order to equitably subordinate a creditor's claim, the creditor-insider must actually use its power to control to its own advantage or to the other creditors' detriment." *Fabricators,* 926 F.2d at 1467 (citations omitted). The court will consider the objectors' allegations of insider misconduct.

A. The T & B Motion for Relief from Stay

[8] The security interest presently held by T & B was initially given to the Bank as security for a loan. When the debtor defaulted on the note, the Bank sought payment from Rotanelli as guarantor. The objectors contend that T

& B's purchase of the note is equivalent to its purchase by Rotanelli; for the purposes of the present motion, Rotanelli has not argued otherwise. The objectors argue that, although T & B purchased the note for the full amount due thereunder, the Bank's conveyance of its security interest to T & B in return for its purchase of the note conferred an unfair advantage on Rotanelli, since, as guarantor of the note, he was already liable for its payment.

[9] "In [the Second] Circuit, the second requirement for equitable subordination involves a conjunctive test, requiring a showing of both unfair advantage to one creditor and harm to the debtor or its other creditors.... [*See*] *Cosoff v. Rodman (In re W.T Grant Co.),* 699 F.2d 599, 611 (2d Cir.1983) ('They must show at least that the banks acted solely for their own benefit, taking into account their [senior position] ... *and* adversely to the interest of others.') (emphasis added)." *White Current Corp.,* 240 B.R. at 485.

[10] "It is generally held that in equity when one standing in such a relation (guarantor) pays he is, at least as against the debtor primarily liable, subrogated to all the rights and remedies of the creditor, and this even without a formal assignment of the debt or judgment. Thus, [the guarantor] is subrogated to all the rights of the bank, including the right to the debt itself, and has the same priority with respect to the perfected security interest as that of the bank." *First Nat'l Bank of Sikeston, Missouri v. Jefferson Sales & Distrib., Inc.,* 341 F.Supp. 659, 672 (S.D.Miss.1971), *aff'd* 460 F.2d 1059 (5th Cir.1972) (applying U.C.C. § 9–504(5), which is enacted in Connecticut as ***30** Conn.Gen.Stat. § 42a–9–504(5)). T & B's purchase of the note and receipt of the Bank's security interest, therefore, left the debtor's other creditors in the same positions they would have been in had the Bank collected the indebtedness directly from Rotanelli under his guaranty. The court concludes that the T & B's conduct in relation to the acquisition of the Bank's security interest neither conferred an unfair advantage upon it, nor inflicted any harm upon other creditors. Accordingly, the objectors have not established colorable grounds for equitable subordination of T & B's secured claim.

B. The Rotanelli Motion for Relief from Stay

[11] [12] The objectors contend that the debtor was undercapitalized and that Rotanelli's secured claim for the $500,000 loans should, therefore, be recharacterized as equity contributions. While an **insider** loan to an insolvent corporation may be indicative of undercapitalization, "undercapitalization alone generally is insufficient to justify **equitable subordination** without evidence of additional inequitable conduct." *Summit Coffee Co. v. Herby's Foods, Inc. (In re Herby's Foods),* 2 F.3d 128, 132 (5th Cir.1993) (**insider** secured loan was equitably subordinated where **insiders** intentionally misrepresented debtor's financial condition to other creditors by not initially reflecting the loan on the debtor's books and later listing it as unsecured; no loan agreement existed; and debtor was undercapitalized from date it was acquired by **insider**); *see also* *Pepper v. Litton,* 308 U.S. 295, 309, 60 S.Ct. 238, 246–47, 84 L.Ed. 281 (1939) (**insider's** advances may be equitably subordinated "where the paid-in capital is purely nominal, the capital necessary for the scope and magnitude of the operations of the company being furnished by the stockholder as a loan."); *Fabricators,* 926 F.2d at 1470 ("clear that undercapitalization was not the sole reason for equitably subordinating [**insider's**] claims in light of [**insider's**] other inequitable conduct....").

The objectors do not dispute that Rotanelli provided initial capitalization of $1,000,000 to the debtor, that the documentation supporting the $500,000 loans clearly indicates they were executed as secured loans; or that the proceeds of the loans were used for paying ongoing expenses of the company, not for the acquisition of capital improvements or payments to insiders. The objectors have presented no evidence that the initial capitalization of the debtor was inadequate. Nor did they show how the transaction at issue unfairly benefitted Rotanelli. To the contrary, Rotanelli supplied the debtor with $500,000 cash in return for two notes secured by not more than $136,000 worth of assets.

The objectors rely on *In re Cold Harbor Assoc., L.P.,* 204 B.R. 904 (Bankr.E.D.Va.1997), to support their argument that Rotanelli's loans should be equitably subordinated. Such reliance is misplaced. First, the court in *Cold Harbor* was not concerned with equitable subordination or recharacterization of the alleged loans, but with determining whether, at the time the advances were made, they were loans or contributions to equity. *Id.* at 915 ("Rather than recharacterizing the exchange from debt to equity, or subordinating the claim for some reason, the question before this Court is whether the transaction created a debt or equity relationship from the outset."). Furthermore, this court finds that consideration of the various factors enumerated in *Cold Harbor* favors the conclusion that the loans at issue in this proceeding were properly characterized as such. In *Cold Harbor,* the court noted that the partners' advances were directly in proportion to the ownership interests, that the note at issue was wholly unsecured, and that the proceeds of the alleged loan were used for the acquisition of capital assets. None of those factors are relevant to the present proceeding. A number of factors cited in *Cold Harbor* as indicative of a debtor-creditor relationship, however, are applicable here—e.g., the loans at issue here properly complied with all the formalities ***31** associated with secured loans, the transactions at issue did not reallocate control of the corporation, there is no evidence that the debtor was inadequately capitalized from its inception.

The court concludes that, without some inequitable conduct on the part of Rotanelli and his attainment of an unfair advantage to the detriment of the debtor's other creditors, equitable subordination of Rotanelli's secured claim would not be justified.

C. Other Allegations of Misconduct

The objectors contend that certain other actions of **insiders** provide grounds for **equitable subordination**. The court concludes that these arguments lack substance.

[13] The objectors argue that the conduct of the debtor's President, Rotanelli's son Mario, in maintaining a checking account in his own name, d/b/a Lady B Foods, for the debtor's use was inequitable. The court credits Rotanelli's testimony that the bank with whom the debtor had maintained its checking account closed the account, that several other banks also refused to open an account in the debtor's name and that the account at issue was necessary to permit the debtor to operate. The objectors have presented no evidence that the account at issue was misused, or that Mario commingled the funds of the debtor with any other funds. The court concludes that Mario acted in good faith with regard to the opening and operation of the checking account.

[14] The objectors also allege that the "movants' agreement in the confirmed plan to subordinate their secured insider claims ... show that they tacitly admit that the claims should be subordinated." (Tr.Mem. at 18.) However, the plain language of the plan provides, "As consideration for approval of the Plan, this claim shall be extinguished upon confirmation of the Plan *and the sale of the Debtor's assets to LB pursuant thereto.*" (Plan ¶¶ 5.03–5.04, Tr.Ex. A. (emphasis added)) Because the third party financing required for the sale to occur failed to materialize, the subordination provisions never took effect. Rotanelli testified that, shortly after plan confirmation, he completed everything he was required to do to obtain the necessary financing and that he was constantly reassured by Conley that the funds would be arriving shortly. The court concludes that Rotanelli acted in good faith to obtain the necessary financing and that, in the absence of the sale of assets to LB, the movants were not obligated by the terms of the plan to subordinate their claims.

V.

CONCLUSION

In accordance with the foregoing discussion, the court concludes that each of the motions of the movants for relief from the automatic stay imposed under Bankruptcy Code § 362(a) shall be, and hereby is, granted. It is

SO ORDERED.

All Citations

251 B.R. 24, 36 Bankr.Ct.Dec. 115

Footnotes

1 As of the date of its Chapter 11 petition, the debtor operated under two different trade names—Mr. R's Prepared Foods, and Lady B Foods.

2 11 U.S.C. § 510 provides in relevant part:

...

(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.

End of Document

TAB 6

KeyCite Yellow Flag - Negative Treatment
Declined to Extend by In re FiberMark, Inc., Bankr.D.Vt., March 10, 2006

286 B.R. 431
United States Bankruptcy Court, D. Utah.

In re MEDICAL SOFTWARE SOLUTIONS d/b/a/ PerfectPractice, MD, Debtor.

No. 02–32330.
|
Nov. 14, 2002.

Synopsis
Chapter 11 debtor moved for authority to sell essentially all of its assets to **insider**. The Bankruptcy Court, William T. Thurman, J., held that: (1) sound business reason existed for sale of Chapter 11 debtor's assets outside ordinary course of its business and outside plan, based chiefly upon lack of funds for continued operation of its business and narrow window for sale of assets before they significantly declined in value; (2) corporate **insider** that had provided both pre– and postpetition financing for operation of Chapter 11 debtor's business had valid security interest in assets being sold, and could **credit** **bid** its secured claim; and (3) **insider** qualified as "good faith purchaser," and court would approve sale as being for fair and reasonable price and supported by sound business reason.

Motion granted.

West Headnotes (17)

[1] **Bankruptcy**Time for sale; emergency and sale outside course of business

For court to approve sale of substantially all debtor's assets outside ordinary course of business, debtor must show the following: (1) that sound business reason exists for sale; (2) that there has been adequate and reasonable notice of sale to interested parties, including full disclosure of sales terms and debtor's relationship with buyer; (3) that sale price is fair and reasonable; and (4) that proposed buyer is proceeding in good faith. Bankr.Code, 11 U.S.C.A. § 363(b).

8 Cases that cite this headnote

[2] **Bankruptcy**Time for sale; emergency and sale outside course of business

Sound business reason existed for sale of Chapter 11 debtor's assets outside ordinary course of its business and outside plan, based chiefly upon lack of funds for continued operation of its business and narrow window for sale of assets before they significantly declined in value. Bankr.Code, 11 U.S.C.A. § 363(b).

4 Cases that cite this headnote

[3] **Bankruptcy**Time for sale; emergency and sale outside course of business

Among factors that bankruptcy judge may consider in deciding whether a good business reason exists to approve disposition of debtor's assets outside ordinary course of its business are the following: (1) proportionate value of assets to estate as whole; (2) amount of elapsed time since petition was filed; (3) likelihood that plan of reorganization will be proposed and confirmed in near future; (4) effects of proposed disposition on future plans of reorganization; (5) proceeds to be obtained from disposition vis-a-vis any appraisals of property; (6) which of alternative dispositions of use, sale or lease is at issue; and (7), perhaps most importantly, whether assets are increasing or decreasing in value. Bankr.Code, 11 U.S.C.A. § 363(b).

[4] **Bankruptcy**Manner and Terms

Only those potential bidders with valid security interest in estate asset being sold may set off their claims against purchase price of asset. Bankr.Code, 11 U.S.C.A. § 363(k).

[5] **Bankruptcy**Manner and Terms

Corporate **insider** that had provided both pre– and postpetition financing for operation of Chapter 11 debtor's business had valid security interest in assets being sold, and could **credit bid** its secured claim as part of offer that it made for purchase of assets, even though it had not filed proof of secured claim, where debtor had scheduled **insider** as having secured claims that were not contingent, unliquidated or disputed, and no party in interest had objected to **insider's** claims. Bankr.Code, 11 U.S.C.A. § 363(k).

1 Cases that cite this headnote

[6] **Bankruptcy**Equitable powers and principles

Bankruptcy court, in exercise of its general equitable power to enter "necessary or appropriate" orders, may in appropriate case recharacterize debt as equity. Bankr.Code, 11 U.S.C.A. § 105(a).

[7] **Bankruptcy****Insiders**, stockholders, fiduciaries, and dominant persons

Among factors which bankruptcy court may consider when deciding whether to recharacterize corporate debtor's alleged debt as equity are the following: (1) names given to documents evidencing alleged indebtedness; (2) presence or absence of fixed maturity date; (3) source of payments; (4) creditor's right to enforce payment of principal and interest; (5) any participation by creditor in management flowing as result; (6) status of contribution in relation to regular corporate creditors; (7) intent of parties; (8) debtor's "thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) source of interest payments; (11) ability of debtor to obtain loans from outside lending institutions; (12) extent to which advance was used to acquire capital assets; and (13) any failure of debtor to repay on due date or to seek a postponement. Bankr.Code, 11 U.S.C.A. § 105(a).

[8] **Bankruptcy****Insiders**, stockholders, fiduciaries, and dominant persons
BankruptcyManner and Terms

Mere status of creditor that had provided financing for operation of Chapter 11 debtor's business as one of debtor's shareholders was insufficient, without more, to allow recharacterization of debtor's obligation on loan as equity, so as to prevent creditor from **credit bidding** this debt at sale of debtor's assets. Bankr.Code, 11 U.S.C.A. §§ 105(a), 363(k).

[9] **Bankruptcy**Inequitable conduct

To equitably subordinate creditor's claim, bankruptcy court must find the following: (1) that claimant has engaged in inequitable conduct; (2) that this conduct has injured creditors or conferred unfair advantage on claimant; and (3) that subordination of claim is not inconsistent with the Bankruptcy Code. Bankr.Code, 11 U.S.C.A. § 510(c).

[10] **Bankruptcy****Insiders**, stockholders, fiduciaries, and dominant persons

Mere fact that creditor that had provided financing for operation of Chapter 11 debtor's business was corporate **insider** was insufficient to permit **equitable subordination** of **insider's** claim, so as to prevent creditor from **credit bidding** this debt upon sale of debtor's assets, where examiner appointed by court found no evidence of bad faith in negotiations between parties, and no evidence that **insider** had acted inequitably. Bankr.Code, 11 U.S.C.A. §§ 363(k), 510(c).

[11] **Bankruptcy**Order of court and proceedings therefor in general
BankruptcyManner and Terms

When a pre-confirmation sale of all, or substantially all, of debtor's property is proposed during the beginning stages of Chapter 11 case, sales transaction should be closely scrutinized, and proponent bears heightened burden of proving elements necessary for authorization. Bankr.Code, 11 U.S.C.A. § 363(b).

3 Cases that cite this headnote

[12] **Bankruptcy**Order of court and proceedings therefor in general
BankruptcyManner and Terms

Where proposed sale of estate assets is to purported **insider**, purchaser has heightened responsibility to show that sale is proposed in good faith and for fair value. Bankr.Code, 11 U.S.C.A. § 363(b).

4 Cases that cite this headnote

[13] **Bankruptcy**Time for sale; emergency and sale outside course of business
BankruptcyOrder of court and proceedings therefor in general

Party who seeks to purchase all or substantially all of debtor's assets other than in ordinary course of business qualifies as "good faith purchaser," as required for court to approve sale, if he buys in good faith and for value. Bankr.Code, 11 U.S.C.A. § 363(b).

1 Cases that cite this headnote

[14] **Bankruptcy**Time for sale; emergency and sale outside course of business
BankruptcyOrder of court and proceedings therefor in general

It is not bad faith per se for **insider** to purchase property from estate, and court may approve sale of substantially all of debtor's property to **insider** other than in ordinary course of its business, even where **insider** has fiduciary duty to estate. Bankr.Code, 11 U.S.C.A. § 363(b).

1 Cases that cite this headnote

[15] **Bankruptcy**Time for sale; emergency and sale outside course of business
BankruptcyOrder of court and proceedings therefor in general

Corporate **insider** to which Chapter 11 debtor proposed to sell substantially all of its assets other than in ordinary course of business qualified as "good faith purchaser," and court would approve sale as being for fair and reasonable price and supported by sound business reason, where debtor had made repeated and sustained attempts to market assets to noninsiders but found no willing purchaser, where debtor had negotiated arms-length sale with **insider** that had been reviewed by examiner appointed by court, and where debtor, in seeking court approval for sale, disclosed all elements of transaction, including **insider** status of proposed purchaser. Bankr.Code, 11

U.S.C.A. § 363(b).

11 Cases that cite this headnote

[16] **Bankruptcy** Adequate protection; sale free of liens

Bankruptcy court, in exercise of its authority, would authorize sale of Chapter 11 debtor's assets free and clear of successor liability claims, where debtor had made extensive attempts to market property without success, and prospective purchaser refused to purchase except free and clear of successor liability claims. Bankr.Code, 11 U.S.C.A. § 363(b).

2 Cases that cite this headnote

[17] **Corporations and Business Organizations** Assumption of or Succession to Transferor's Debts and Liabilities

Under general state law, when one corporation transfers assets to another, purchaser is generally not liable for seller's liabilities.

Attorneys and Law Firms

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MEMORANDUM DECISION

WILLIAM T. THURMAN, Bankruptcy Judge.

The issue before the Court is whether the Debtor's proposed sale of substantially all of its assets outside the ordinary course of business, and before a Chapter 11 Plan of Reorganization and Disclosure Statement have been proposed, should be approved by the Court. Complicating matters further, the proposed buyers are **insiders** as that term is defined within the Bankruptcy Code. Arguments and evidence were presented to the Court in a lengthy hearing held September 26, 2002 (the "September 26 Hearing") and the Court orally issued its findings of fact and conclusions of law into the record from the bench on September 27, 2002 wherein the Court granted the sale motion. An order was entered approving the sale that same day. In addition, the Court indicated it would supplement its decision with a written opinion and this Memorandum Decision follows.

***435 I. INTRODUCTION**

The issue before the Court arises in the context of Medical Software Solution's (the "Debtor") motion to sell essentially all of its assets to the Dominion Fund V parties (Dominion Fund V, Windward Ventures 2000 and Windward Ventures 2000–A; collectively known hereinafter as the "DF Lenders"). The Debtor seeks to sell its assets free and clear of all liens, encumbrances and interests, except for assumed liabilities, under 11 U.S.C. §§ 363(b) and (f)[1]. The Debtor's assets include real property leases, equipment leases, licenses, permits, inventory, proprietary assets, general intangibles, assumed contracts, cash, accounts receivable, and other identified personal property. The asset sales contract (the "Purchase Agreement") negotiated between the DF Lenders and the Debtor specifically excludes the sale of claims relating to Chapter 5 of the Bankruptcy Code and other specified claims. Interestingly, and importantly, as part of the Purchase Agreement, the Debtor required the DF Lenders to assume certain liabilities including: liabilities arising out of the assets' ownership and business operation, the real property leases, the assumed contracts with customers and equipment leases, liabilities under certain permits, and certain other liabilities. The Purchase Agreement also excluded certain enumerated liabilities. Specifically excluded was any liability that the Debtor may have to Amy Lewis, the Debtor's former CEO.

II. FACTS

The facts of this case are in nowise straightforward. While some facts have been abbreviated, most of the given information is essential to the Court's decision.

The Debtor's history has been a story of hopes and dreams of success, without significant financial achievement. The Debtor was formed by Ms. Amy Lewis and her former husband, among others, to develop and implement software tools to assist physicians in managing the medical billing process. This endeavor not only grew in scope and customer base, but also in financial needs beyond the founders' capacity to finance expansion. As a result, the Debtor began to look for alternative sources of capital. Recognizing the market potential of medical billing software and finding the opportunity attractive, the DF Lenders invested venture capital in the Debtor.

The Debtor partially funded its cash flow needs by selling its software products to customers. More significantly, however, beginning in 1999, cash flow needs were funded by several cash infusions from the DF Lenders. To illustrate the effect of the cash infusions on the Debtor's financial position, the DF Lenders produced a graph showing the Debtor's cash levels over the last several years in relation to the corresponding cash infusions from the DF Lenders. The cash levels spiked with infusions solely from the DF Lenders. These infusions occurred in January 2000 with the Series A stock for cash transaction, again in September 2000 with the Series B stock transaction and in July 2001 with the Series B–1 stock transaction. Through these collective stock-for-cash transactions, the DF Lenders negotiated a 60% ownership in the company and placed two representatives, Renee Masi and Michael Kevin Lee, on the Debtor's board of directors. The cash infusions, however, were insufficient to make the Debtor profitable.

In October, 2001, the Debtor sought additional financing from the DF Lenders. Even though the Debtor had the option of ***436** additional financing through stock issuance under the previous stock-for-cash agreement, the Debtor negotiated a $2,500,000 loan (the "Bridge Loan") from the DF Lenders. The Bridge Loan is secured by essentially all the Debtor's assets.[2] Despite the cash infusion from the Bridge Loan, the Debtor continued to experience staggering losses. In fact, the Debtor's year-to-date losses on July 25, 2002 were $2,247,379.

Throughout the unprofitable years, and at the occurrence of each financing agreement with the DF Lenders, the Debtor's CEO was Amy Lewis. She participated in negotiations with the DF Lenders, and she was a member of the Debtor's board of directors. She actively participated in decisions to finance the company through the DF Lenders' equity investments and helped negotiate the Bridge Loan. Amy Lewis is also a shareholder in the company.

A management dispute arose in the beginning of 2002, and the board of directors terminated Ms. Lewis from her CEO position with the company. Members of the Debtor's board of directors, in early 2002, consisted of Mr. Lee and Ms. Masi, as representatives of the DF Lenders; Ms. Lewis; Mr. Rick Altinger, an employee of the debtor; and Timothy Layton, a consultant to the company. Mr. Altinger and Mr. Layton were not affiliated with the DF Lenders. After her termination, Amy Lewis commenced a lawsuit against the debtor and others, including the DF Lenders, alleging *inter alia* improper employment termination, sexual harassment and gender discrimination, retaliation, breach of contract and defamation. That litigation is pending elsewhere. She remained a member of the board, however, and the DF Lenders continued to fund the Debtor. The Debtor's total debt from the Bridge Loan, at the time of the bankruptcy petition, was approximately $3,200,000.

The mounting losses within the company and the changes in leadership were beginning to have additional consequences. At the time of the bankruptcy filing, the board consisted of Mr. Lee, Ms. Massey, Ms. Lewis and Mr. Altinger. Mr. Layton resigned from the board of directors citing stress. Mr. Altinger continued to be a consultant to the Debtor and Ms. Lewis is now a consultant for a company identified as OfficeRX. OfficeRX conducts a business similar to the Debtor. OfficeRX also has an escrow agreement with the Debtor whereby should the debtor default on its support obligations to its customers, i.e. the medical offices, OfficeRX has a non-exclusive right to acquire the source code to the Debtor's software free of charge.[3] As problems within the Debtor mounted, losses continued and the board of directors vigorously pursued a sale of the company.

In addition to pursuing a sale just prior to the bankruptcy petition, the Debtor has sought to market the company throughout the preceding year. In September 2001, the Debtor engaged the services of an investment banker, Thomas Weisel Partners ("TWP") to aid in the marketing effort. TWP was selected after the Debtor considered numerous other bankers. TWP compiled a list, updated regularly ***437** with the input of the board, containing the names of all potential interested purchasers. TWP maintained an ongoing log of its sales activities, and of the contacts made with potential purchasers. TWP or Mr. Altinger made weekly reports to the board of directors through January or February 2002 regarding the marketing efforts. Unfortunately, the marketing efforts did not produce any legitimate interest in the Debtor. Mr. Altinger testified that the Debtor conducted some discussions with possible suitors, but received no firm offer, term sheet, deposit or earnest money, and that no efforts were made to close a sale because no offer had been made or received. The Debtor terminated its relationship with TWP in April or May 2002. Mr. Altinger continued to solicit possible buyers afterwards. Evidence at the September 26 Hearing showed diligent efforts on the part of Mr. Altinger to continue to find a buyer throughout August and September 2002.

With no white knight to rescue the company in the foreseeable future, the Debtor elected to file for relief under Chapter 11 of the Bankruptcy Code on July 26, 2002. On Aug. 5, 2002, this Court entered an order directing the appointment of an Examiner.[4] The Debtor sought the unusual relief of an Examiner's appointment to preempt the anticipated allegations of bias against the current board, and of bias regarding a possible sale to the DF Lenders in exchange for cancellation of their secured claims. Pursuant to that request, the Court required the Examiner's appointment to investigate certain aspects of any offer. As part of its mandate, the Court specifically directed the Examiner to investigate the propriety of any sale to the DF Lenders. The United States Trustee's Office appointed Mr. D. Ray Strong as the Examiner, and he has functioned in that capacity since his appointment. The Examiner has filed two reports. The first report was an analysis of the Debtor's request to obtain debtor in possession ("DIP") financing from the DF Lenders, and the second, a report in response to the proposed sale.

The Court considered the Examiner's first report in conjunction with a hearing to consider the Debtor's request for post-petition financing. Although the funding came from an admitted **insider**,[5] it appeared to be appropriate and to be the only means upon which the Debtor could continue operating. The DIP financing motion was approved, and the DF Lenders advanced an additional $500,000 to the Debtor post-petition. Without a buyer for the company, however, the Debtor's assets would likely be liquidated and the Debtor would cease doing business. The terms of the DIP financing require a sale of the company to close on or before September 30, 2002. Failure to close a sale by that date constitutes a default event under the terms of the DIP loan.

The Debtor filed a motion to approve a sale of substantially all of its assets to the DF Lenders on August 22, 2002. The salient portions of the Purchase Agreement are: (1) cancellation of approximately $3,200,000 representing the Buyers' secured pre-petition indebtedness; ***438** (2) cancellation of approximately $500,000, representing the Debtor's post-petition indebtedness to the Buyers approved by the DIP loan; (3) $100,000 in cash for unsecured creditors; (4) additional cash of approximately $22,000 as needed to cure pre-existing liens; (5) additional cash of approximately $85,000 for Chapter 11 administration expenses; (6) assumption of all contracts and agreements especially with its customers, totaling approximately $1,100,000; (7) release of all claims between the Debtor and the buyers—excluding the claim of Amy Lewis and any rights and remedies with respect to her claim; (8) subject to higher and better bids. The agreement also proposed an auction be held on September 23, 2002 should any qualified bids be obtained. No other qualified bids were made, except that of OfficeRX as discussed *infra.*

The Examiner conducted an investigation of the proposed sale to the DF Lenders, including the terms of the Purchase Agreement, and he filed his second report on September 26. The Examiner was sworn as a witness in this matter in the September 26 Hearing regarding the Motion to Approve the Sale, and his report was received into evidence. In his report, the Examiner indicated that he conducted a fair and comprehensive analysis of the Debtor's history, including: its past and current financial condition; the Purchase Agreement between the Debtor and the DF Lenders; the objections submitted by the shareholders and by Amy Lewis; an analysis of the **insider** allegations and affiliations of the parties and their representatives; an analysis of other financing possibilities, i.e., venture capital markets and traditional lending; an analysis of the funding from the DF Lenders;

TWP's involvement and attempts to sell the company; Amy Lewis's position and her termination in March 2002; and an analysis of possible additional bridge loans from the DF Lenders in 2002 and the proposed sale to the DF Lenders.

The Examiner also reported on the efforts to sell the company to other proposed suitors. In particular, he examined one offer from OfficeRX for $200,000 for a non-exclusive license to the source code. The Debtor rejected OfficeRX's offer because it was not a qualified bid under the terms previously established by the Court in its September 9, 2002 Order Approving (A) Bidding Procedures and Protections, and (B) Form and Manner of Notice of Auction and Sale Hearing ("September 9, 2002 Order"). The Examiner found no other evidence of qualified buyers. He also concluded, as part of his analysis of the possibility of competing bids, that he doubted the outcome would be different if the solicitation period was extended.

The Examiner also examined whether the sale was proposed in good faith. Objections to the sale from both Ms. Lewis and the shareholders allege, among other things, bad faith on the part of the DF Lenders. The Examiner investigated and reported on a number of these bad faith allegations made by the objectors. The Examiner found no evidence to suggest that the DF Lenders acted in bad faith regarding the October 2001 Bridge Loan. The examiner also concluded that there was no evidence to suggest bad faith in the Debtor's efforts to market the company or in negotiating the Asset Purchase Agreement with the DF Lenders.

Finally, the Examiner also investigated issues regarding the sale unraised by either party. The Examiner expressed concern that the sale will result in a waiver of claims that may exist between the Debtor and the DF Lenders, although, no evaluation was made as to whether any exist between them. He also pointed out that in ***439** his estimation, the release language relating to claims in the Purchase Agreement is vague and ambiguous.

Ultimately, however, in evaluating the sale as a whole, the Examiner concluded the sale should go forward. The Examiner concluded that the offer from the DF Lenders as set forth in the Purchase Agreement is the highest and best offer received, and that due to the tenuous nature of the Debtor's financial condition, any delay in sale consummation may adversely affect the Debtor's ability to continue as a going concern. In addition, the Examiner testified that the tarnish of bankruptcy might adversely affect the Debtor's ability to obtain new customers and retain existing customers and employees. The Examiner testified that he is not aware of any other alternative proposals for additional DIP financing to allow continued operations past September 30, 2002—the deadline negotiated by the DF Lenders and the Debtor, as part of the DIP financing arrangement, that a sale must close or the Debtor would default on its obligations. This financing arrangement was previously approved by the Court. Significantly, the Examiner stated that any delay in the asset sale might jeopardize the continuing operations as a going concern, resulting in deterioration of the Debtor's assets and adversely affect its creditors.

During the course of the hearing, Mr. Kendell Cooper was called as a witness by the DF Lenders. Mr. Cooper is a managing partner of Dominion Fund V, one of the DF Lenders. He testified regarding his knowledge of the DF Lenders' investments, the Bridge Loan and other matters. Mr. Cooper particularly testified regarding the proposed offer by the DF Lenders to buy the Debtor's assets. He testified that the DF Lenders would not buy the assets unless they were free and clear of liens and interests. He concluded that if the prospect of a pending lawsuit (particularly from Ms. Lewis) is transferred with the assets, he would recommend against purchasing the assets.

Two parties oppose the sale of the Debtor's assets to the DF Lenders: Ms. Lewis, the former CEO; and a group of shareholders led by Ms. Lewis, who will lose their equity interest in the assets under the Purchase Agreement. The objections of Ms. Lewis and the other shareholders revolve around three contentions: (1) the sale lacks good faith and is not for fair and reasonable value; (2) the purchase price is based on what the shareholders believe to be an improper credit in violation of § 363(k) because the "debt" bid by the creditor should be recharacterized as equity, or the debt should be equitably subordinated, and, or alternatively, the secured claims were improperly filed; therefore, the **credit bid** is illusory; and (3) elimination of successor liability claims is improper, in part, because the sale transaction requires the Debtor to release claims against the DF Lenders even though the Debtor has made no effort to investigate or quantify such claims.

Amy Lewis testified on behalf of the objecting parties. Ms. Lewis, as the former CEO, criticized the proposed value of the company, particularly the source code, but did not undertake an evaluation herself. The Court also heard testimony that a successor liability claim could tarnish the assets. Finally, Ms. Lewis testified that discussions took place wherein the DF Lenders indicated they intended to provide enough funding to operate the Debtor through 2002.

III. DISCUSSION

[1] In order to approve a sale of substantially all the Debtor's assets outside the ordinary course of business, the following elements must be met. The Debtor must show (1) that a sound business reason ***440** exists for the sale; (2) there has been adequate and reasonable notice to interested parties, including full disclosure of the sale terms and the Debtor's relationship with the buyer; (3) that the sale price is fair and reasonable; and (4) that the proposed buyer is proceeding in good faith. *See e.g., In re Delaware & Hudson Ry. Co.,* 124 B.R. 169, 176 (D.Del.1991); *WBQ Partnership v. Virginia Dep't of Med. Assistance Serv. (In re WBQ Partnership),* 189 B.R. 97, 102 (Bankr.E.D.Va.1995).[6] The Court considers each element in determining whether the Debtor has met its burden.

A. Sound Business Reason

(1) Sale of substantially all assets under § 363(b) outside a plan.

[2] Section 363(b) provides that "the trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate." 11 U.S.C. § 363(b).

The plain meaning of the statute would imply that the bankruptcy court has unfettered discretion in approving sales outside of an approved plan of reorganization because the statute does not specifically set forth that limitation. The Court, however, agrees with the majority of bankruptcy courts in accepting the boundaries set by the Second Circuit Court of Appeals that requires "a judge determining a § 363(b) application [to] find from the evidence presented before him at the hearing a good business reason to grant such an application" to sell substantially all of a debtor's assets outside the confines of a confirmed plan. *Lionel,* 722 F.2d at 1063.[7]

[3] In *Lionel,* the court enumerated several factors a judge may wish to consider ***441** in making his or her determination regarding whether a good business reason exists to approve the sale. These factors include:

> (1) the proportionate value of the asset to the estate as a whole; (2) the amount of elapsed time since the filing; (3) the likelihood that a plan of reorganization will be proposed and confirmed in the near future; (4) the effect of the proposed disposition on the future plans of reorganization; (5) the proceeds to be obtained from the disposition vis-a-vis any appraisals of the property; (6) which of the alternatives of use, sale or lease the proposal envisions; and *(7) most importantly perhaps, whether the asset is increasing or decreasing in value.*

Id. at 1071 (enumeration and emphasis added).

There was sufficient evidence presented at the September 26 Hearing to warrant approval of an asset sale. Although the list from *Lionel* is not exhaustive, it provides adequate guidance in most cases considering a sale outside of an approved plan. The last factor, whether the asset is increasing or decreasing in value, is an important consideration in this case.

Testimony presented at trial, and the Examiner's report, pointed to a substantial decrease in value if the assets are not sold immediately. The Examiner stated that potential and existing customers would be reluctant to purchase services and goods from a company in tenuous financial condition for fear that future needs would not be met. In addition, the Examiner testified regarding his belief that the company would be unsustainable as a going concern without additional capital—which is unavailable. If the company ceased as a going concern, OfficeRX, among others, would receive rights to the Debtor's source code, the Debtor's most valuable asset. The effect would be a severe devaluation of the code's value, thus severely devaluing the Debtor's total assets. Because the assets' value is reducing rapidly, the Court finds that there is a "good business reason" for granting the Debtor's application to sell assets outside a confirmed plan.

The other *Lionel* factors do not warrant withholding sale approval. The evidence presented conclusively showed that the Debtor had insufficient capital to reorganize, and would liquidate without the sale to the DF Lenders. Thus, an analysis regarding the likelihood of an effective reorganization is moot. Likewise, an analysis of the appraised value compared to the sale value is moot because the evidence presented as to current valuation was inconsistent and dated. Additionally, any appraised value must take into account the fact that the company was marketed extensively throughout the last year with no serious offers to purchase.

Another factor, the proportionate value of the asset to the total assets of the Debtor, appears to favor the objecting parties. The Debtor's business value is high because it is effectively its only marketable asset. This appears to be a case where the Debtor is not a company with extensive property, plant and equipment; but rather a single-product-centric endeavor focused on developing one software product. Finally, it is obvious that the time between filing the plan, and the proposed sale is short. The exigencies of the case, however, dictate a shorter time period because, as discussed above, the asset has a narrow window of marketability and, additionally, the Debtor has been marketing the company for some time. The other ***442** *Lionel* factors support a finding of a good business reason to justify the sale.

B. Adequate and Reasonable Notice

Finally, Ms. Lewis and other shareholders seek to disqualify the DF Lenders as eligible purchasers because the DF Lenders have failed to give effective notice. The Court agrees that the notice has been short in contemplation of this sale. However, the Court heard extensive testimony regarding the attempts to distribute notice to all possible parties and, under the circumstances, the Court finds notice to be appropriate in all respects as previously determined in its September 9, 2002 Order.

C. Sale Price is Fair and Reasonable

The sale price, as set forth in the Court's September 9, 2002 Order, as well as the Purchase Agreement, consists of cancellation of the DF Lender's secured pre-petition indebtedness, approximately $3,200,000; cancellation of the DF Lender's post-petition secured claim, approximately $500,000; cash of $100,000; additional cash not to exceed $22,000 to pay pre-existing liens; $1,100,000 in contracts assumption; and up to $85,000 to cover Chapter 11 unpaid administrative expenses.[8] The objecting parties argue this consideration is inadequate for a number of reasons.

(1) The Validity of the Credit Bid

First, Ms. Lewis and the shareholders object to the DF Lenders using secured claims arising from the previous Bridge Loan to purchase the Debtor's assets through a "**credit bid**." Section 363(k) of the Bankruptcy Code states:

> At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale and if the holder of such claim purchases such property such holder may off-set such claim against the purchase price of such property.

[4] [5] In their objection to the sale, the shareholders quote *Bank of Nova Scotia v. St. Croix Hotel Corp. (In re St. Croix Hotel Corp.),* 44 B.R. 277, 279 (Bankr.D.V.I.1984), for the proposition that § 363(k) only permits those with a valid security interest to claim a setoff and the Court agrees with this assessment. The shareholders argue that the DF Lenders do not have a valid security interest because they have failed to properly file their secured claim. However, a proof of claim is deemed filed under § 501 for any claim or interest that appears in the schedules filed under §§ 521(1) or 1106(a)(2) except a claim or interest that is scheduled as disputed, contingent or unliquidated. *See* 11 U.S.C. § 1111(a). The Debtor filed schedules pursuant to § 521(1) listing the DF Lenders' claims as secured claims that are not contingent, unliquidated, or disputed. Section 502(a) provides that the claim is deemed allowed unless a party in interest objects. No party has objected to the DF Lenders' claims. The Court finds that the DF Lenders hold a valid security interest in the Debtor and may claim a right to setoff.

The Debtor also argues with the contention that the purchase agreement is a "**credit bid**" within § 363 because there is not a "third party" involved, and because the purchase agreement provides for the ***443** release of unsecured claims as well as the secured claims. The

Debtor argues that the unsecured creditors will be in a better position without a "**credit bid**" characterization because if the purchase agreement is characterized as a "**credit bid**," and the assets are deemed to be worth less than the **credit bid**, the DF Lenders would retain a general unsecured claim for the deficiency. The deficiency claim would dilute the value of the sale for the Debtor's general unsecured creditors. Although the Court has the power to deem otherwise, the Court can find no reason to characterize the Purchase Agreement as anything other than a "**credit bid**" under § 363(k) of the Code other than to protect the Lender, in the event that the debt offered in the **credit bid** is recharacterized as equity. The Court finds that the Purchase Agreement negotiated by the Debtor and the DF Lenders constitutes a "**credit bid**" under § 363(k).

Ms. Lewis also argues that the Bridge Loan should be recharacterized as equity, or, alternatively, equitably subordinated. This would force the DF Lenders to purchase the Debtor's assets with new funds, rather than by offsetting the debt the DF Lenders previously extended to the Debtor.

(2) Recharacterization

[6] Although there is a split in opinion as to whether the Bankruptcy courts have power to recharacterize claims, the Tenth Circuit Court of Appeals (the "Tenth Circuit") has followed the majority of jurisdictions in holding that § 105(a) authorizes recharacterization through its general equitable powers. *See* *Sinclair v. Barr (In re Mid–Town Produce Terminal Inc.),* 599 F.2d 389, 393 (10th Cir.1979).

[7] The Court could find no case in which the Tenth Circuit discussed recharacterization in a published opinion. However, Debtor's counsel directed the Court to an unpublished opinion wherein the Tenth Circuit determined that the factors considered in tax cases were useful in determining whether to recharacterize claims in a bankruptcy setting[9]. These factors include:

> (1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a fixed maturity date; (3) the source of payments; (4) the right to enforce payment of principal and interest; (5) participation in management flowing as a result; (6) the status of the contribution in relation to regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between the creditor and stockholder; (10) source of interest payments; (11) the ability of the corporation to obtain loans from outside lending institutions; (12) the extent to which the advance was used to acquire capital assets; (13) the failure of the debtor to repay on the due date or seek a postponement.

Segal v. Ledyard (In re Ruff Fin. Servs., Inc.), No. 97–4094, 1998 WL 813397, at *2, 1998 U.S.App. LEXIS 30137, at *6 (10th Cir. Nov. 25, 1998).

[8] It is clear to the Court, from testimony and other evidence presented, that the Bridge Loan is a debt obligation, and should not be recharacterized as equity. Only factor (9), above, favors recharacterization. The identity of interest between the creditor and stockholder is an issue in this case because the amounts of money ***444** loaned to the Debtor roughly corresponded to the DF Lenders' respective preferred stock ownership. On balance, however, the Court finds that the weight of the evidence supports the debt agreements as described, and will not recharacterize the loans to the Debtor by the DF Lenders as equity.

(3) Equitable Subordination

[9] [10] Ms. Lewis argues that the Court should equitably subordinate the Bridge Loan from the DF Lenders to the claims of other creditors. Section 510(c) of the Code grants a bankruptcy court the power to equitably subordinate a creditor's claim whose conduct has caused injury to the other parties or has afforded a creditor an unfair advantage over the other creditors. Because **equitable subordination** is remedial, not penal, and should be used sparingly, courts have devised a three part test in determining whether **equitable subordination** is appropriate. *See* *Carter–Waters Oklahoma, Inc. v. Bank One Trust Co., N.A. (In re Eufaula Indus. Auth.),* 266 B.R. 483, 488–89 (10th Cir. BAP 2001). This test requires findings that "(1) The claimant has engaged in inequitable conduct; (2) [t]he conduct has injured creditors or given unfair advantage to the claimant; and (3) [s]ubordination of the claim is not inconsistent with the Bankruptcy Code." *Id.* Ms. Lewis has not shown that any of these elements exist in the present case.

First, Ms. Lewis argues that the Bridge Loan is evidence of inequitable conduct. Just as an asset purchase by an **insider** is not bad faith per se, a loan by a majority shareholder in itself, is not inequitable. *See* *In re Mid–Town Produce Terminal, Inc.,* 599 F.2d at 392 (holding that, "loans by majority shareholders will not be subordinated to claims of other creditors absent inequitable conduct.... To hold that the debt may be subordinated on that basis alone would discourage owners from trying to salvage a business.") To equitably subordinate the debt, there must be more than just a loan from an **insider** to the Debtor. Inequitable conduct or bad faith, therefore, must be shown.[10]

Here, the examiner found no evidence of bad faith in the negotiations, and found no evidence that the creditor acted inequitably. Further, it is the Court's opinion, after hearing exhaustive evidence and cross-examination, that the DF Lenders and Debtor in this case acted in good faith—both during the negotiations for the Bridge Loan and the Purchase Agreement. Without any specific, credible evidence by the shareholders or Ms. Lewis of inequitable conduct, subordinating the DF Lenders' debt would be contrary to the principles of equity. Having heard no such evidence, the DF Lenders' claims may not be equitably subordinated.[11]

***445** The Court finds the sale price, as proposed in the Purchase Agreement, to be fair and reasonable in all respects and that there is little or no evidence supporting a contention that a better price could possibly be found in the limited time available to the Debtor to market the business.

D. Good Faith

[11] [12] As counsel for the shareholders pointed out, when a pre-confirmation § 363(b) sale is of all, or substantially all, of the Debtor's property, and is proposed during the beginning stages of the case, the sale transaction should be "closely scrutinized, and the proponent bears a heightened burden of proving the elements necessary for authorization." *In re Channel One Communications, Inc.,* 117 B.R. 493, 496 (Bankr.E.D.Mo.1990). Both Ms. Lewis and the other shareholders argue that because the asset sale is to a purported **insider**, the purchaser has a heightened responsibility to show that the sale is proposed in good faith and for fair value. *See In re Industrial Valley Refrigeration and Air Conditioning Supplies, Inc.,* 77 B.R. 15, 17 (Bankr.E.D.Pa.1987) (holding that "the element of 'good faith' focuses principally on the element of special treatment of the debtor's **insiders** in the sale transaction and contemporaneous transactions therewith"). The Court agrees.

[13] The Court has spent a considerable amount of time considering the question of good faith in this case. Under § 363(m), the purchaser of a Debtor's assets must be a good faith purchaser to enjoy the finality of a sale. The Tenth Circuit has determined that a "good faith" purchaser is "one that buys in good faith, and for value." *Tompkins v. Frey* (*In re Bel Air Assocs., Ltd.),* 706 F.2d 301, 304 (10th Cir.1983). In *Bel Air,* the court found that, for the purposes of § 363(m), actions that destroy a purchaser's good faith include, "fraud, collusion between the purchaser and other bidders or trustee, or an attempt to take grossly unfair advantage of other bidders." *Id.* at 305 n. 11 (citation omitted). *See also In re Abbotts Dairies of Pennsylvania, Inc.,* 788 F.2d 143, 147 (3d Cir.1986) (stating that the typical misconduct involves fraud or collusion).

[14] [15] Although Ms. Lewis and other shareholders have made allegations of bad faith, neither the Court, nor the Examiner, found any evidence to support those allegations. In part, Ms. Lewis points to the **insider** status of the DF Lenders as purchasers. However, as one court has stated, "[i]t is not bad faith per se for an **insider** to purchase property from an estate, even where the **insider** has a fiduciary duty to the estate." *In re Wilde Horse Enterprises, Inc.,* 136 B.R. 830, 842 (Bankr.C.D.Cal.1991); *see also In re Channel One Communications,* 117 B.R. at 496 (a sale may not "*unfairly* benefit **insiders**") (emphasis added). The Court has found none of the elements enunciated by the Tenth Circuit to destroy the DF Lenders' status as a good faith purchaser. After investigating the shareholders' claims, the Examiner found no evidence of collusion between the Debtor and the DF Lenders. The Court found neither collusion nor an attempt to take advantage of other bidders. Instead, the Debtor and the DF Lenders have made repeated and sustained attempts to market the Debtor to parties outside the sphere of **insiders**. Finding no willing purchasers, the Debtor negotiated at arms length with the DF Lenders for the purchase of the Debtor's assets.

In *Wilde Horse Enterprises,* the Court found that the question of good faith when an **insider** purchase of assets "turns on whether the debtor breached its fiduciary duty of full disclosure." 136 B.R. at 834; ***446** *see also Polvay v. B.O. Acquisitions, Inc. (In re Betty Owens Schools, Inc.),* No. 96 Civ.3576(PKL), 1997 WL 188127, at *4 (S.D.N.Y.1997) ("[A] debtor-in-possession who proposes a sale of all of its assets to an **insider** must fully disclose the relationship between the buyer and the seller."). In the present case, the Debtor has disclosed all elements of the transaction, including the **insider** status of the proposed purchaser. In addition, the Debtor moved for the appointment of an examiner to make an independent evaluation. The Court finds that the Debtor acted in good faith, upholding their fiduciary duty of full disclosure to potential bidders, creditors and to the shareholders.

E. Successor Liability

[16] Finally, Ms. Lewis argues that if the sale is approved, that the sale cannot be "free and clear" of all liabilities because her pending civil suit against the Debtor continues to attach to the assets after the sale. Ms. Lewis claims that following the asset sale, the new company formed by the DF Lenders will be liable for any damages awarded in the pending civil suit under the theory of successor liability.[12]

[17] Under general state law, when one corporation transfers assets to another, the purchaser is generally not liable for the seller's liabilities. This general rule is complicated in a bankruptcy proceeding where a court is asked to approve a sale under § 363. Balancing the counter-veiling interests of a purchaser, buyer, and claimant in an asset sale is no easy task. Too liberal an application of the "free and clear" provision in § 363 would allow a seller to effectively avoid all liabilities through a transactional ruse, leaving claimants without remedy. At the same time, bona fide purchasers must be protected, and sales in a bankruptcy proceeding must have finality. Otherwise, creditors could simply follow the assets to a solvent company and seek repayment. Without adequate protection, purchasers would bid nominal amounts for assets to compensate for the risk of uncertainty thereby impairing the debtor's creditors with a lower sales amount.

Under § 363(f) of the code, the court has the power to order the assets of a seller to be transferred free and clear of all claims, including successor liability claims. Indeed, even before the Bankruptcy Code was enacted in 1978, courts relied on their general equitable powers to authorize the sale of assets free and clear. *See* *Volvo White Truck Corp. v. Chambersburg Beverage, Inc. (In re White Motor Credit Corp.),* 75 B.R. 944, 948 (Bankr.N.D.Ohio 1987). The authority to sell free and clear is broad because it reflects a compelling policy intended by Congress in § 363. In *WBQ Partnership v. Virginia Dep't of Med. Assistance Serv. (In re WBQ Partnership),* 189 B.R. 97, 108 (Bankr.E.D.Va.1995), the Court found

> [T]he purpose behind the free and clear language is to maximize the value of the asset, and thus enhance the payout made to creditors. Without free and clear language, prospective buyers would be unwilling to pay a fair price for the property subject to sale; instead, the price would have to be discounted, ***447** perhaps quite substantially, to account for the liabilities that the buyer would face simply as a result of acquiring the asset.

Ms. Lewis relies heavily on the case of *Chicago Truck Drivers, Helpers and Warehouse Workers Union (Independent) Pension Fund v. Tasemkin, Inc.,* 59 F.3d 48 (7th Cir.1995). That case held that an intervening bankruptcy proceeding does not have a "*per se* preclusive effect" on a successor liability claim. *Id.* at 51. That case is distinguishable from the present case. In *Chicago Truck Drivers,* the union's pension fund attempted to recover a claim in the debtor's Chapter 7 case. It was unsuccessful and two years later the pension fund sued the new company, that had effectively foreclosed upon the debtor's collateral, on the basis of successor liability. The court determined that successor liability was not precluded but that the "availability of relief from the predecessor is a factor to be considered along with other facts in a particular case." *Id. Chicago Truck Drivers,* however, did not involve a sale under § 363, nor did the bankruptcy court have the opportunity to determine whether the assets should be sold "free and clear" of claims, including successor liability claims. In fact that case specifically states that it "does not directly implicate the Bankruptcy Code, since the underlying bankruptcy proceeding is long over." *Id.* at 50 n. 2.

In the present case, however, this Court must invoke § 363 and determine whether a sale can be made free and clear of successor liability claims. Under the broad policy that bankruptcy sales should be subject only to specific claims and that purchasers should have some comfort in the "free and clear" language of § 363(f), the Court finds that the Debtor's assets may be sold free and clear of all successor liability claims.

IV. CONCLUSION

The Court approves the sale free and clear, including successor liability claims, as proposed by the Debtor. The Court finds a good business reason justifies the sale. In approving the sale, the court finds that there has been good faith on the part of the DF Lenders and the Debtor. The Court further finds that the Purchase Agreement negotiated between the Debtor and the DF Lenders constitutes a valid **credit bid** within § 363(k) and the sale price is deemed fair and reasonable.

All Citations

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Footnotes

1 All further references to the United States Code are to Title 11 unless otherwise noted.

2 The loan is termed a "Bridge Loan" because the loan conditions provided that the security interest granted to the DF Lenders in consideration for the loan would convert to equity upon the occurrence of either another round of financing or upon the sale of the company.

3 The exact nature of the OfficeRX product was not presented as evidence, however, it is sufficient for the court to note that OfficeRX has a distinct pecuniary interest in the Debtor's success and failure, which clouds Ms. Lewis's motives in this entire matter.

4 The Debtor initially filed the Motion to Appoint an Examiner which was heard by the Court at a hearing held August 1, 2002. The Court expressed reservations about the Debtor's standing to make such a motion under § 1104(c) and, subsequently, the United States Trustee joined in the motion.

5 Section 101(31)(B) states that an **insider** includes a "(i) director of the debtor" and a "(iii) person in control of the debtor." All parties agree that the DF Lenders meet this definition because two members of the Debtor's board of directors are affiliated with the DF Lenders.

6 Many courts have held that Section 363(b) requires these prerequisites in order to approve a sale of substantially all of a debtor's assets outside a confirmed plan. *See In re W.A. Mallory Company, Inc.,* 214 B.R. 834 (Bankr.E.D.Va.1997) ("This Court follows the 'sound business purpose' test when examining § 363(b) sales."); *See also Stephens Indus., Inc. v. McClung,* 789 F.2d 386, 390 (6th Cir.1986); *Committee of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.),* 722 F.2d 1063, 1071 (2d Cir.1983). Two courts within the Tenth Circuit, decided near the same time as *Lionel,* fashioned similar tests in determining when to allow a sale or lease outside the ordinary course of business. *See In re Ancor Exploration Co.,* 30 B.R. 802, 808 (N.D.Okla.1983) (concluding that a "bankruptcy court should have wide latitude in approving even a private sale of all or substantially all of the estate assets not in the ordinary course of business" and specific findings made regarding the emergency nature of the sale, whether other prospective purchasers had been solicited and whether the sale is in the best interests of the estate); *In re Allison,* 39 B.R. 300, 303 (Bankr.D.N.M.1984) (determining that the court must find that "reasonable and adequate notice must be given to all interested parties," the proposed sale or lease must be "economically reasonable" and that objecting parties will not be able to defeat a plan of reorganization).

7 A number of courts considering asset sales within a Chapter 11 case but before plan confirmation agree with *Lionel* in holding a good business reason must justify the sale. *See Licensing by Paolo, Inc. v. Sinatra (In re Gucci),* 126 F.3d 380, 387 (2nd Cir.1997) ("A sale of a substantial part of a Chapter 11 estate other than in the ordinary course of business may be conducted if a good business reason exists to support it. Purchasers of these assets are protected from a reversal of the sale on appeal so long as they acted in good faith.") (citations omitted); *The Institutional Creditors of Continental Air Lines, Inc. v. Continental Air Lines, Inc. (In re Continental Air Lines, Inc.),* 780 F.2d 1223, 1226 (5th Cir.1986) ("[F]or the debtor-in-possession or trustee to satisfy its fiduciary duty to the debtor, creditors and equity holders, there

must be some articulated business justification for using, selling, or leasing the property outside the ordinary course of business."); *Stephens Indus., Inc.,* 789 F.2d at 390 (specifically adopting the *Lionel* test in holding that "a bankruptcy court can authorize a sale of all a Chapter 11 debtor's assets under § 363(b)(1) when a sound business purpose dictates such action").

8 The consideration contemplated by the Debtor and the DF Lenders also includes certain claim waivers by the DF Lenders. This amount is unliquidated, but could be very sizable. However, the Court makes its determination regarding the reasonableness of the terms based on the liquidated amounts as set forth above.

9 Although the Court recognizes that this unpublished case is not binding, the Court specifically adopts the factors enumerated in that case when determining whether to recharacterize a debt claim.

10 The Court is aware that case law imposes a lower burden of proof in showing inequitable conduct when the creditor is an **insider**. *See e.g., In re Eufaula Indus. Auth.,* 266 B.R. at 489 ("If the claimant is an **insider** or a fiduciary, the party seeking **equitable subordination** need only show 'unfair' conduct."); *Bayer Corp. v. MascoTech, Inc. (In re Autostyle Plastics, Inc.),* 269 F.3d 726, 745 (6th Cir.2001) (stating that " 'if the claimant is an **insider**, less egregious conduct may support **equitable subordination**' " but also emphasizing **insiders** may be " 'most interested in restoring and reviving the debtor, and such bona fide efforts should be viewed with approval' ") (citations omitted). As stated above, the objecting parties have not show any "unfair" conduct.

11 The Court notes that under the unusual circumstances and exigencies of this case, and because no proof of claim has been filed, it is appropriate to discuss the possibility of **equitable subordination** even though an adversary proceeding has not been filed in this case as required by Federal Rule of Bankruptcy Procedure 7001(8).

12 The Court is aware of significant legal discussion regarding the issue of successor liability in the context of a sale in bankruptcy. *See e.g.,* JoAnn J. Brighton, *How Free is "Free and Clear"? A Practical Guide to Protection Against Successor Liability When Purchasing Assets Out of a Bankruptcy Estate,* 21 Am. Bankr.Inst. 1 (Sept.2002); George W. Kuney, *Misinterpreting Bankruptcy Code Section 363(F) and Undermining the Chapter 11 Process,* 76 Am. Bankr.L.J. 235, 262 (2002) (arguing successor liability claims should not be eliminated upon a sale of assets outside a plan of reorganization).

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IN THE MATTER OF THE *COMPANIES' CREDITORS ARRANGEMENT ACT*, R.S.C. 1985, c. C-36, AS AMENDED

AND DOMENICO SERAFINO AS A PERSON INTERESTED IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT OF HYDRX FARMS LTD., CANNSCIENCE INNOVATIONS INC. AND SCIENTUS PHARMA INC. (the "Applicant")

Court File No. CV-21-00659187-00CL

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