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OF THE NINTH CIRCUIT

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UNITED STATES BANKRUPTCY APPELLATE PANEL
OF THE NINTH CIRCUIT

In re:)	BAP Nos.	CC-09-1100-HPaMk
)		CC-09-1101-HPaMk
)		CC-09-1102-HPaMk
PALMDALE HILLS PROPERTY, LLC)		CC-09-1103-HPaMk
)		CC-09-1104-HPaMk
Debtor.)		CC-09-1105-HPaMk
)		CC-09-1106-HPaMk
)		CC-09-1107-HPaMk
)		(Related Appeals)

Bk. No. SA 08-17206-ES

LEHMAN COMMERCIAL PAPER, INC.,
Appellant,
v.
PALMDALE HILLS PROPERTY, LLC,
et al.,
Appellees.

O P I N I O N

Argued and Submitted on September 25, 2009
at Pasadena, California

Filed - December 15, 2009

Appeal from the United States Bankruptcy Court
for the Central District of California

Honorable Erithe A. Smith, Bankruptcy Judge, Presiding.

Before: HOLLOWELL, PAPPAS and MARKELL, Bankruptcy Judges.

1 HOLLOWELL, Bankruptcy Judge:

2
3 The issue presented in this appeal is whether a debtor
4 violates the automatic stay of its creditor's bankruptcy case
5 when it proposes to equitably subordinate the creditor's claim
6 and transfer the lien securing the claim under § 510(c).¹
7 Because, in this case, equitable subordination would modify the
8 creditor's property interest, we find it violates the creditor's
9 automatic stay. Accordingly, we REVERSE those provisions of the
10 bankruptcy court's orders on appeal that find otherwise.

11 **I. FACTS**

12 Lehman Commercial Paper Inc. ("Lehman Commercial") is a
13 debtor in a chapter 11 bankruptcy case in the Southern District
14 of New York. Palmdale Hills Property, LLC ("Palmdale") filed a
15 chapter 11 bankruptcy petition on November 6, 2008, in the
16 Central District of California. The case is being jointly
17 administered with seventeen of Palmdale's related entities
18 ("Debtors").² Debtors are part of an integrated network of
19

20 ¹ Unless otherwise indicated, all chapter, section, and
21 rule references are to the Bankruptcy Code, 11 U.S.C. §§ 101-
22 1532, and to the Federal Rules of Bankruptcy Procedure, Rules
23 1001-9037.

24 ² SunCal Beaumont Heights, LLC, SCC/Palmdale, LLC
25 ("SCC/Palmdale"), SunCal Johannson Ranch, LLC, SunCal Summit
26 Valley, LLC ("Summit"), SunCal Emerald Meadows, LLC ("Emerald
27 Meadows"), SunCal Bickford Ranch, LLC ("Bickford"), Acton
28 Estates, LLC ("Acton"), Seven Brothers, LLC, SJD Partners, Ltd.,
SJD Development Corp., Kirby Estates, LLC, SunCal Communities I,
LLC ("SunCal I"), and SunCal Communities II, LLC ("SunCal II")
filed chapter 11 bankruptcies on November 6 and November 7, 2008.
North Orange Del Rio Land, LLC, SCC Communities, LLC, and Tesoro
SF, LLC, filed chapter 11 on November 19, 2008. There are also
(continued...)

1 companies that operate as the Sun Cal Companies, or SunCal, and
2 were formed as part of a joint venture to develop twenty-one
3 residential real estate projects with affiliates of Lehman
4 Brothers, Inc.

5 Lehman Brothers and its affiliates, including Lehman ALI,
6 Inc. (ALI)³ and Lehman Commercial, provided over \$2.3 billion in
7 financing for the projects through a series of loan agreements
8 and equity arrangements on Debtors' projects. Among other
9 things, Debtors allege that the structure of these financing
10 arrangements constituted manipulative lending practices and
11 fraudulent conveyances. Debtors contend that the complete
12 control of Lehman Brothers, as well as ALI and Lehman Commercial,
13 over the use of the funds in the loan facility created Debtors'
14 debt burdens and ultimately forced Debtors to file for bankruptcy
15 protection.

16 On November 10, 2008, soon after filing bankruptcy, Debtors
17 sought blanket relief from the automatic stay in Lehman
18 Commercial's bankruptcy case in the Southern District of New York
19 "to allow the Debtors to generally administer their California
20 Chapter 11 cases in order to avoid the need for having to file
21 repeated relief from stay motions in New York." The bankruptcy
22 court in New York denied the broad relief, but did so without
23 prejudice so that Debtors could refile specific stay relief
24 requests as needed.

25 Debtors' proposed joint chapter 11 plan of reorganization is
26

27 ²(...continued)
28 nine related entities in involuntary bankruptcy proceedings
represented by a court appointed trustee.

³ ALI is not in bankruptcy.

1 based on their attempt to equitably subordinate the claims of ALI
2 and Lehman Commercial ("Lehman Lenders"). On January 6, 2009,
3 Debtors commenced an adversary proceeding against ALI to
4 equitably subordinate its claim. Debtors amended the equitable
5 subordination complaint to include Lehman Commercial as a
6 defendant and proposed to file the amended complaint if the
7 California bankruptcy court determined the complaint would not
8 violate Lehman Commercial's automatic stay.

9 On January 29, 2009, the Lehman Lenders filed motions for
10 relief from stay in Debtors' bankruptcy case asserting they were
11 owed approximately \$649 million in principal, plus interest, on
12 various Lehman Lenders' loans.⁴ The loans consisted, in part, of
13 three credit agreements between Lehman Commercial and Debtors
14 including: an agreement executed in November 2005, by SunCal I,
15 which provided for a loan in the amount of \$75 million (which
16 increased to \$395 million over time and was later reduced to \$277
17 million), secured by a first lien on all the real and personal
18 property owned by Bickford, Acton and Emerald Meadows, as well as
19 a pledge of equity interests held by SunCal I and Summit; a
20 February 2007, agreement with Palmdale for a \$264 million loan
21 secured by Palmdale's real property and equity interests; and a
22 March 2007, agreement executed by SCC/Palmdale for a \$95 million
23 loan, secured by SCC/Palmdale's property and equity interest in
24 Palmdale. ALI holds a promissory note executed by Bickford in
25 May 2005, in the amount of \$30 million secured by a second lien
26 on Bickford's real and personal property.

27
28 ⁴ As noted below, Debtors challenge whether Lehman
Commercial is actually a creditor of the Debtors' estate since
some of the loans were determined by the bankruptcy court to have
been sold (not transferred for security).

1 The Lehman Lenders argued the properties securing the loans
2 lacked equity and were declining in value ("Stay Relief Motion").
3 The Lehman Lenders also argued that Debtors' reorganization could
4 not succeed since it was premised in part on subordinating Lehman
5 Commercial's claim, which Lehman Commercial argued violated its
6 stay.

7 Debtors filed an omnibus opposition to the motion on
8 February 6, 2009 ("Opposition"). Debtors contended they had
9 equity in the properties based on the argument that the Lehman
10 Lenders' claims could be equitably subordinated and the liens
11 transferred to the estate.

12 On February 20, 2009, the bankruptcy court issued a
13 tentative ruling on the Stay Relief Motion, finding that:

14
15 the existence of the [equitable subordination] claims
16 can be asserted as a defense to the motion for relief
17 from stay. . . . Given movant's assertion of secured
18 claims against Debtors in these bankruptcy estates,
19 Debtors are entitled to assert appropriate defenses to
20 such claims and may do so without violating the
21 automatic stay of the movant.

22 The parties addressed the tentative ruling during the
23 hearing that same day. At the close of hearing, the bankruptcy
24 court stated the tentative ruling would stand, finding there was
25 not sufficient cause to grant stay relief and that Debtors could
26 pursue equitable subordination, either through an adversary
27 proceeding or through a plan or reorganization, as a defense to
28 Lehman Commercial's Stay Relief Motion, which the court treated
as an informal proof of claim. The final orders denying stay
relief were entered March 10, 2009 ("Denial Orders"). The Denial

1 Orders held that:

2 (a) The [Stay Relief] Motion sufficiently states an
3 express demand referencing the nature and amount of the
4 claim, and therefore Movant's Motion constitutes an
5 informal proof of claim.

6 (b) This Court has concurrent jurisdiction to determine
7 the scope and applicability of the automatic stay under
8 11 U.S.C. § 362(a) and/or (b), arising from the Chapter
9 11 bankruptcy proceeding of Lehman Commercial Paper
10 Inc. ("Lehman Commercial") as it applies to matters
11 before this Bankruptcy Court.

12 (c) The automatic stay arising from the bankruptcy case
13 of Lehman Commercial does not apply to any objection to
14 the claim of Lehman Commercial, any proceeding to
15 subordinate the claim of Lehman Commercial pursuant to
16 11 U.S.C. § 510(c)(1), and/or the transfer of a lien
17 securing a subordinated claim to the estate pursuant to
18 11 U.S.C. § 510(c)(2), in this Chapter 11 proceeding.

19 (d) The Debtors may object to the claim of Lehman
20 Commercial, seek to subordinate the claim of Lehman
21 Commercial pursuant to 11 U.S.C. § 510(c)(1), and/or
22 seek to transfer a lien securing a subordinated claim
23 to the estate pursuant to 11 U.S.C. § 510(c)(2), via an
24 adversary proceeding or plan, without violating Lehman
25 Commercial's automatic stay.

26 Lehman Commercial timely appealed the Denial Orders. Lehman
27 Commercial does not contend the bankruptcy court abused its
28 discretion in denying the Stay Relief Motion, but assigns error
to the bankruptcy court's determination regarding the scope and
application of Lehman Commercial's automatic stay.

29 **II. JURISDICTION**

30 The bankruptcy court had jurisdiction pursuant to 28 U.S.C.
31 § 157(b)(1) and (2)(G) and (O). We have jurisdiction under 28
32 U.S.C. § 158.⁵

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⁵ Debtors argue Lehman Commercial limited the scope of
appeal to only the finding made by the bankruptcy court that
Debtors, through an adversary proceeding, could subordinate
Lehman Commercial's claim without violating Lehman Commercial's
stay. Debtors contend Lehman Commercial did not appeal the
related finding that Debtors could, through a plan of

(continued...)

1 On September 23, 2009, Debtors filed an emergency motion to
2 continue for sixty days the oral argument, which was scheduled on
3 September 25, 2009. The Panel denied the request the same day.
4 Oral argument was held on September 25, 2009.

5 After oral argument, on October 20, 2009, Debtors filed a
6 motion to dismiss the appeal for lack of jurisdiction as a result
7 of decisions made in the bankruptcy court regarding the ownership
8 of Lehman Commercial's loans ("October Order"). Specifically,
9 the bankruptcy court determined that certain Lehman Commercial
10 loans were sold, not simply transferred to a third party, Fenway
11 Capital ("Fenway Capital Loans"), for security. Thus, in the
12 October Order, the bankruptcy court ruled that Lehman Commercial
13 was not the creditor with respect to the Fenway Capital Loans.
14 The bankruptcy court reserved ruling on whether Lehman Commercial
15 could file proofs of claim as an agent for Fenway Capital.

16 Debtors argue that Lehman Commercial does not own any
17 interest in the Fenway Capital Loans, and therefore, the
18 automatic stay could not bar subordination of such loans. As a
19 result, Debtors argue the appeals are moot and that Lehman
20

21 ⁵(...continued)

22 reorganization, subordinate Lehman Commercial's claim without a
23 stay violation. Therefore, Debtors argue we lack jurisdiction on
24 the basis that we could not provide effective relief to Lehman
25 Commercial. Debtors contend that even if the Panel sets aside
26 the ruling permitting Debtors to prosecute an adversary
27 proceeding to subordinate Lehman Commercial's claim, Debtors
28 would still be able to subordinate Lehman Commercial's claim
through their plan. This argument is meritless. Lehman
Commercial appealed the Denial Orders in their entirety,
"specifically, Lehman Commercial appeals the rulings in the
Order[s] regarding the scope and application of the automatic
stay in Lehman Commercial's chapter 11 case."

1 Commercial lacks standing. Lehman Commercial contends that a
2 portion of at least one of the loans was not part of any sale or
3 transfer to Fenway Capital.

4 An appeal is moot if events have occurred that "prevent an
5 appellate court from granting effective relief." Varela v.
6 Dynamic Brokers, Inc. (In re Dynamic Brokers, Inc.), 293 B.R.
7 489, 493-94 (9th Cir. BAP 2003) citing First Fed. Bank v.
8 Weinstein (In re Weinstein), 227 B.R. 284, 289 (9th Cir. BAP
9 1998).

10 However, we find that effective relief could be granted to
11 Lehman Commercial, since it is not clear that all the loans
12 Lehman Commercial made to the Debtors were the subject of the
13 October Order. Moreover, Lehman Commercial has filed a motion
14 for clarification of the October Order and the bankruptcy court's
15 findings. Thus, no final order regarding the ownership of the
16 loans has yet been entered (and Lehman Commercial has stated that
17 it will appeal the final order after it is entered).

18 For similar reasons, we find that Lehman Commercial has
19 standing to appeal the Denial Orders. The Ninth Circuit has
20 adopted the "person aggrieved" test as the standard for
21 determining whether a party possesses standing in a bankruptcy
22 appeal. See, e.g., Fondiller v. Robertson (In re Fondiller), 707
23 F.2d 441, 442-43 (9th Cir. 1983). The test limits appellate
24 standing to "those persons who are directly and adversely
25 affected pecuniarily by an order of the bankruptcy court." Id.
26 at 442. Even if Lehman Commercial has no interest in the Fenway
27 Capital Loans, it has an interest in at least one of the loans to
28 Debtors, and furthermore, may possibly have an interest in the

1 Fenway Capital Loans under a contractual repurchase obligation.
2 Lehman Commercial also has an interest if and when the October
3 Order becomes final and is successfully appealed. Therefore,
4 Lehman Commercial has standing to appeal the Denial Orders
5 despite the October Order.⁶

6 Accordingly, we conclude we have jurisdiction over these
7 appeals and address the merits.

8 **III. ISSUE**

9 Do Debtors violate Lehman Commercial's automatic stay when
10 they attempt to equitably subordinate Lehman Commercial's claims
11 and transfer its liens to the estate?

12 **IV. STANDARDS OF REVIEW**

13 The scope or applicability of the automatic stay under § 362
14 is a question of law, which is reviewed de novo. Salazar v.
15 McDonald (In re Salazar), 430 F.3d 992, 994 (9th Cir. 2005) ("We
16 review the [bankruptcy court's] interpretation of the bankruptcy
17 code as a question of law and, therefore, review it de novo.").
18 Additionally, the determination of whether a particular action is
19 exempt from the automatic stay is a question of law that we
20 review de novo. Berg v. Good Samaritan Hosp. (In re Berg), 198
21 B.R. 557, 560 (9th Cir. BAP 1996), aff'd 230 F.3d 1165 (9th Cir.
22 2000).

23 **V. DISCUSSION**

24 **A. The Automatic Stay Protects a Debtor's Estate**

25 The filing of a bankruptcy petition creates a bankruptcy
26

27 ⁶ In making this determination, we deny Debtors' Motion to
28 Dismiss Appeal for Lack of Jurisdiction. We do, however, grant
Lehman Commercial's Motion to Supplement Record on Appellee's
Motion to Dismiss Appeal, which was filed December 1, 2009.

1 estate, which is protected by an automatic stay of actions by all
2 entities to collect or recover on claims. 11 U.S.C §§ 541(a) and
3 362(a). The automatic stay arising in the bankruptcy court where
4 a debtor files a petition for relief (the home bankruptcy court)
5 applies to all other bankruptcy courts. Snavely v. Miller (In re
6 Miller), 397 F.3d 726, 731 (9th Cir. 2005).

7 The policy behind § 362 is to protect the estate from being
8 depleted by creditors' lawsuits and seizures of property in order
9 to provide the debtor breathing room to reorganize. White v.
10 City of Santee (In re White), 186 B.R. 700, 704 (9th Cir. BAP
11 1995). The automatic stay extends to "prevent piecemeal
12 dismemberment" of the bankruptcy estate. Id.; In re Worldcom,
13 Inc., 2003 WL 22025051 at *3 (Bankr. S.D.N.Y. Jan. 30, 2003).
14 Thus, the automatic stay prohibits "any act to obtain possession
15 of property of the estate or of property from the estate or to
16 exercise control over property of the estate." 11 U.S.C.
17 § 362(a)(3). The automatic stay preserves assets for both the
18 estate and creditors. Prewitt v. N. Coast Vill., Ltd. (In re N.
19 Coast Vill., Ltd.), 135 B.R. 641, 643 (9th Cir. BAP 1992).

20 Although the scope of the automatic stay is broad, it does
21 not stay all proceedings. Courts have recognized the automatic
22 stay does not apply to actions against the debtor in the debtor's
23 home bankruptcy court. In re Miller, 397 F.3d at 730; In re N.
24 Coast Vill., Ltd., 135 B.R. at 643. Additionally, the automatic
25 stay has been found inapplicable to lawsuits initiated by the
26 debtor. Eisinger v. Way (In re Way), 229 B.R. 11, 13 (9th Cir.
27 BAP 1998) (primary policy considerations do not exist where
28 debtor has initiated a lawsuit against a creditor); Martin-

1 Trigona v. Champion Fed. Sav. & Loan Ass'n, 892 F.2d 575, 577
2 (7th Cir. 1989) (statutory language refers to actions "against
3 the debtor"). Alternatively, a defendant in an action brought by
4 a plaintiff/debtor may defend itself in that action without
5 violating the automatic stay. Gordon v. Whitmore (In re
6 Merrick), 175 B.R. 333, 336 (9th Cir. BAP 1994); In re Way, 229
7 B.R. at 13.

8 Debtors contend Lehman Commercial initiated the action
9 against Debtors by filing its Stay Relief Motion, which was
10 treated by the bankruptcy court as a proof of claim.⁷ Debtors
11 argue that because Lehman Commercial initiated the litigation by
12 filing the Stay Relief Motion or a proof of claim against
13 Debtors, Lehman Commercial's automatic stay does not prevent
14 Debtors from prosecuting their equitable subordination claim. In
15 re Merrick, 175 B.R. at 336 (a party may defend against an action
16 brought by a debtor without violating the automatic stay); Hi-
17 Tech Commc'n Corp. v. Poughkeepsie Bus. Park, LLC (In re
18 Wheatfield Bus. Park, LLC), 308 B.R. 463, 466 (9th Cir. BAP 2004)
19 (debtor may object to a claim filed in its bankruptcy case
20 without violating the automatic stay).

21 The bankruptcy court agreed that Debtors' equitable
22 subordination claims against Lehman Commercial did not violate
23 Lehman Commercial's automatic stay because they were raised as a
24 defense to the Stay Relief Motion. Because equitable
25 subordination would alter the lien rights of the creditor, we
26 agree that equitable subordination involves the question of a

27
28 ⁷ Lehman Commercial has since filed formal proofs of claim
in Debtors' bankruptcy cases. Therefore, we do not reach the
issue of whether the bankruptcy court erred in treating the Stay
Relief Motion as an informal proof of claim.

1 debtor's equity and may be properly asserted as a defense to a
2 motion seeking relief from the automatic stay. See In re
3 Poughkeepsie Hotel Assocs. Joint Venture, 132 B.R. 287, 292
4 (Bankr. S.D.N.Y. 1991); Bialac v. Harsh Inv. Corp. (In re
5 Bialac), 694 F.2d 625, 627 (9th Cir. 1982) (when debtor's
6 affirmative defenses and counterclaims directly involve the
7 question of the debtor's equity, it is appropriate to hear them
8 in the stay proceeding).

9 At the hearing on the Stay Relief Motion, the bankruptcy
10 court stated:

11 . . . the filing of the motion for relief from stay is,
12 and the case law is pretty clear on this, effectively
13 an informal proof of claim. Whether you filed a formal
14 proof of claim or not, you have asserted a claim
15 against the Debtor. It's quite clear that you intend
16 to assert that claim.

17 By denying the motion without prejudice that claim
18 remains within this estate. So in my view, if the
19 Debtor wants to proceed to resolve this issue [through
20 equitable subordination] because this issue was
21 presented as a defense to the motion for relief from
22 stay and I think it's an effective defense to the
23 motion for relief from stay but . . . they can't
24 litigate that defense here because it is not
25 appropriate to do it in a summary sort of situation.

26 Hr'g Tr. at 63:8-20 (February 20, 2009).

27 The bankruptcy court correctly recognized that a separate
28 procedure was required to litigate the merits of Debtors'
equitable subordination claim. See Rule 7001(8) (a request to
subordinate an allowed claim or interest requires an adversary
proceeding except when a debtor's plan provides for the relief).

As one court explained:

When the defendant debtor through complex and bona fide
affirmative defenses or counterclaims seeks affirmative
counter relief it is not proper to attempt to determine

1 that issue in the adequate protection hearing and
2 thereby determine finally the amount of the debt which
3 in turn will determine the extent of the creditor's
4 interest which he is entitled to have protected.
5 Rather, the counterclaims or affirmative defenses may
6 be severed out and the modification of stay tried on
7 the assumption that the creditor will prevail on the
8 counterclaim.

9 In re Poughkeepsie Hotel Assocs. Joint Venture, 132 B.R. at 290.

10 However, the bankruptcy court conflated the defense of
11 equitable subordination to a motion for relief from stay with
12 equitable subordination as a defensive action against (or
13 objection to) a claim. There is a "tremendous difference
14 between adjudication of the merits and mere consideration of
15 counterclaims and defenses' raised in a motion for stay relief."
16 Id. at 293 (quoting In re Tally Well Serv., Inc., 45 B.R. 149,
17 151 (Bankr. E.D. Mich. 1984)). Courts must "disaggregate"
18 litigation so that "particular claims, counterclaims, cross
19 claims and third-party claims are treated independently when
20 determining which of their respective proceedings are subject to
21 the bankruptcy stay." In re Miller, 397 F.3d at 731 (quoting
22 Parker v. Bain, 68 F.3d 1131, 1137 (9th Cir. 1995)). The
23 adjudication of Debtors' equitable subordination action seeks
24 affirmative relief, and therefore, violates Lehman Commercial's
25 automatic stay. See In re Enron Corp., 2003 Bankr. LEXIS 2261,
26 at *23 (Bankr. S.D.N.Y. Jan. 13, 2003).

27 **B. Under These Facts, Equitable Subordination is Not a**
28 **Defensive Action**

Debtors contend they are "entitled to take any action
necessary to defeat" a claim asserted in their bankruptcy case.

1 Thus, Debtors frame their equitable subordination action as a
2 defensive action against Lehman Commercial's claim.

3 The distinction between defensive and offensive actions
4 affecting a debtor's estate is appropriate in determining the
5 applicability of the automatic stay because courts have held that
6 a debtor may defend against suits brought against it without
7 violating a bankruptcy stay. Justus v. Fin. News Network, Inc.,
8 (In re Fin. News Network, Inc.), 158 B.R. 570, 573 (S.D.N.Y.
9 1993) (distinguishing cases where a party "makes an active
10 attempt to recover property" of a debtor through judicial or
11 adversary proceedings); In re Merrick, 175 B.R. at 336. In
12 particular, courts allow debtors to object to creditors' claims
13 on the basis that it is a defense against the assertion of the
14 claim, and therefore, does not violate the creditor's automatic
15 stay. In re Wheatfield Bus. Park, LLC, 308 B.R. at 466.

16 Accordingly, Debtors argue that if the complete elimination
17 of a claim or lien can be achieved through a claim objection
18 without a stay violation, then the "lesser defensive remedy of
19 subordination" cannot be considered an offensive action that
20 violates the automatic stay. We disagree with Debtors'
21 characterization of subordination as a mere defense to a claim or
22 a "lesser remedy" than claim disallowance.

23 A claim is a right to payment. 11 U.S.C. § 101(5)(A). A
24 proof of claim is prima facie evidence of the validity and amount
25 of a claim. Rule 3001(f). A party objecting to a claim has the
26 burden of overcoming the prima facie case by challenging the
27 validity of the claim. In a claim objection, the court
28 investigates the existence, validity, and enforceability of

1 claims and determines whether the claim is allowed by applicable
2 law. Murgillo v. Cal. State Bd. Of Equalization (In re
3 Murgillo), 176 B.R. 524, 532-33 (9th Cir. BAP 1995); USA Capital
4 Realty Advisors, LLC v. USA Capital Diversified Trust Deed Fund,
5 LLC (In re USA Commercial Mortg. Co.), 377 B.R. 608, 617 (9th
6 Cir. BAP 2007) ("disallowance of a claim is a legal determination
7 that the claim under consideration is not allowable by law.").

8 If the claim is disallowed or modified in amount because the
9 asserted claim was found to be unenforceable against the debtor
10 as a matter of law, then the creditor effectively never had the
11 right to payment of the claim it asserted. Importantly, if a
12 debtor succeeds in a claim objection, the debtor does not recover
13 property from the creditor. As a result, a debtor is able to
14 challenge (or "defend" against) a claim without impacting a
15 creditor's property rights.

16 Even though equitable subordination, "if established, may be
17 functionally equivalent to disallowance (i.e., no distribution on
18 the claims)," it is a legally distinct proceeding which seeks to
19 reprioritize the order of allowed claims based on the equities of
20 the case, rather than to disallow the claim in the first
21 instance. In re USA Commercial Mortgage Co., 377 B.R. at 617;
22 see also In re Enron Corp., 2003 Bankr. LEXIS 2261 at *26; In
23 re County of Orange, 219 B.R. 543, 557 (Bankr. C.D. Cal. 1997).

24 Equitable subordination is sought when a creditor has
25 engaged in some type of inequitable conduct that resulted in
26 injury to the debtor's other creditors or conferred an unfair
27 advantage on the claimant. United States v. Noland, 517 U.S.
28 535, 538-39 (1996). It is an unusual remedy, applied only in

1 limited circumstances. Id.; Feder v. Lazar (In re Lazar), 83
2 F.3d 306, 309 (9th Cir. 1996).

3 Section 510(c)(1) allows for subordination of otherwise
4 allowed claims "when the principles of equity would be so
5 offended by the allowance of such claims on a parity with those
6 of other creditors." 4 COLLIER ON BANKRUPTCY ¶ 510.01 (Alan N.
7 Resnick & Henry J. Sommer, eds. 15th ed. rev. 2009). If the
8 subordinated claim is secured by a lien, under § 502(c)(2), the
9 lien is transferred to the debtor's estate. The subordinated
10 lien claim becomes unsecured and the property securing such claim
11 becomes part of the debtor's estate.

12 Thus, unlike in claim disallowance, in the situation of
13 equitable subordination, a creditor has the right to payment on
14 its claim, but that property right may be modified by the
15 bankruptcy court based upon equitable principles.⁸ This key
16 difference turns Debtors' assertion of equitable subordination as
17 a proper defense to Lehman Commercial's Stay Relief Motion into
18 an offensive action against Lehman Commercial's property.

19 As the Panel has previously noted:

20 the proper exercise of the bankruptcy court's equitable
21 powers under § 502 is through investigation into the

22 ⁸ We do not agree that Lehman Commercial's assertion of the
23 automatic stay will paralyze Debtors' reorganization or thwart
24 the principles of bankruptcy law because of Lehman Commercial's
25 "running around the country demanding that all other chapter 11
26 debtors yield to its automatic stay." Appellee's Brief at 14-15,
27 27. Lehman Commercial has a right to protect its estate from
28 diminishment of its assets by others, which here includes
Debtors' proposed modification of its rights, including its lien
rights. Furthermore, Debtors are not without a remedy. They can
seek relief from stay in Lehman Commercial's case where their
earlier motion was denied without prejudice.

1 existence, validity and enforceability of claims
2 leading to their allowance or disallowance; and the
3 proper exercise of equitable powers regarding an
allowed claim is through the equitable subordination
provisions of § 510(c).

4 In re Murgillo, 176 B.R. at 533; Benjamin v. Diamond (Matter of
5 Mobile Steel Co.), 563 F.2d 692, 699 (9th Cir. 1977) (equitable
6 considerations can only justify subordination of claims, not
7 their disallowance). Importantly, misconduct on the part of a
8 creditor, when directed against a debtor, gives a debtor a clear
9 defense to invalidate a claim under § 502. See In re Mobile
10 Steel Co., 563 F.2d at 699 n.10. However, in this case, Debtors
11 have not sought to disallow the claim on principles of misconduct
12 or fraud; they have commenced an adversary proceeding to
13 equitably subordinate Lehman Commercial's claims and transfer the
14 liens securing the claims to Debtors' own bankruptcy estate.

15 This scenario differs markedly from a case cited by Debtors,
16 In re Metiom, 301 B.R. 634 (Bankr. S.D.N.Y. 2003). Metiom
17 involved an unsecured claim. The facts of this case differ from
18 Metiom because, here, Lehman Commercial's claims are secured and
19 Debtors are seeking to transfer the liens to the estate. Such
20 affirmative relief was not part of the Metiom case where the
21 equitable subordination, along with § 547 and § 549, were
22 included as alternatives in debtor's claim objection and the
23 bankruptcy trustee expressly waived any affirmative relief or
24 damages resulting from the creditor's postpetition conduct. Id.
25 at 637. There is no analysis in Metiom that focuses on whether
26 equitable subordination under § 510(c)(2) violates the automatic
27 stay.

28 Simply because Lehman Commercial filed a proof of claim

1 (whether formally or informally) does not mean that Debtors may
2 take any action against Lehman Commercial without violating
3 Lehman Commercial's automatic stay. Debtors may not initiate an
4 action or proceeding against Lehman Commercial that seeks
5 affirmative relief, such as a counterclaim without violating the
6 automatic stay.⁹ In re Miller 397 F.3d at 732. In this case,
7 Debtors' subordination action seeks affirmative control over
8 property of Lehman Commercial's bankruptcy estate by proposing to
9 alter the priority of Lehman Commercial's claim and the transfer
10 of Lehman Commercial's lien rights to Debtors' estate. Thus,
11 equitable subordination seeks affirmative relief: the
12 modification of a claimant's valid claim and property interest.
13 4 COLLIER ON BANKRUPTCY, ¶ 510.01 (Alan N. Resnick & Henry J.
14 Sommer, eds., 15th ed. rev. 2009) ("Because subordination under
15 § 510 involves valid claims, the claimant has a property interest
16 that would be modified by subordination. The notice and hearing
17 requirement, therefore, is a basic due process protection.").

18
19 ⁹ The dissent points to recoupment as a counterclaim that
20 should be permitted because it seeks to adjust the amount of debt
21 owed, and makes an implied correlation to equitable subordination
22 as another type of counterclaim that should be permitted, for the
23 same reasons. Recoupment, however, "is the setting up of a
24 demand arising from the same transaction as the plaintiff's claim
25 or cause of action, strictly for the purpose of abatement or
26 reduction of such claim." Newbery Corp. v. Fireman's Fund Ins.
27 Co., 95 F.3d 1392, 1399 (9th Cir. 1996). It is an equitable
28 common law doctrine to net out debts and allow the defendant to
recoup payments made against the claim and is not limited to pre-
petition claims. It is not subject to the automatic stay. Sims
v. United States Dept. Of Health & Human Serv. (In re TLC
Hospitals, Inc.), 224 F.3d 1008, 1011 (9th Cir. 2000). Equitable
subordination, however, involves the subordination and
reprioritization of an allowed claim and is, therefore, not the
equivalent of a recoupment claim.

1 Accordingly, we find the adjudication of Debtors' equitable
2 subordination claim violates Lehman Commercial's automatic stay.

3 One of the purposes of the automatic stay is to protect the
4 bankruptcy court's jurisdiction over the debtor and the property
5 of the estate. The protection of Lehman Commercial's automatic
6 stay did not evaporate when it filed a proof of claim in Debtors'
7 bankruptcy case. See In re Miller, 397 F.3d at 732. If Debtors
8 were allowed to subordinate Lehman Commercial's claim in the
9 California bankruptcy court without first seeking stay relief in
10 Lehman Commercial's home bankruptcy case, Lehman Commercial's
11 creditors would have no notice or opportunity to challenge the
12 action even though their rights would be affected by the
13 subordination action.

14 Therefore, while the California bankruptcy court may have
15 concurrent jurisdiction to determine the scope or applicability
16 of the automatic stay, the New York bankruptcy court must have
17 the final say as to whether the automatic stay applies to the
18 bankruptcy case before it. See Erti v. Paine Webber Jackson &
19 Curtis, Inc. (In re Baldwin-United Corp. Litig.), 765 F.2d 343,
20 347-48 (2nd Cir. 1985) (even though district court had
21 jurisdiction to determine applicability of stay, asserting that
22 jurisdiction would frustrate the debtor's reorganization efforts
23 in the bankruptcy case); Gruntz v. County of L.A. (In re
24 Gruntz), 202 F.3d 1074, 1079, 1081-82 (9th Cir. 2000) (the
25 automatic stay, which is an injunction issuing from the authority
26 of the bankruptcy court, is the primary means to centralize the
27 control over and administration of bankruptcy cases). Debtors
28 are not hamstrung by this decision; Debtors may either seek

1 relief from stay or initiate the equitable subordination action
2 against Lehman Commercial in the New York bankruptcy case.

3 **CONCLUSION**

4 For the forgoing reasons, we REVERSE and void those
5 provisions of the Denial Orders that find Debtors may prosecute
6 an adversary proceeding, or propose a reorganization plan,
7 seeking to equitably subordinate Lehman Commercial's claim and
8 transfer its liens to the estate in the California bankruptcy
9 case without first obtaining relief from the automatic stay in
10 the New York bankruptcy case.

11
12 MARKELL, Bankruptcy Judge, dissenting:

13
14 I respectfully dissent. The majority essentially holds that
15 a debtor may not, in its own bankruptcy, unilaterally defend
16 against a lender's inequitable claim if that lender is also a
17 bankruptcy debtor. I disagree.¹

18 The central inquiry here is what a debtor may do in response
19 to a creditor's filing a proof of claim.² Normally, this inquiry
20

21 ¹ I do not disagree, however, with the majority's treatment
22 of the mootness and standing issues addressed in Part II of the
23 opinion. I therefore join the majority in its decision to reach
24 the merits, and in its disposition of the Debtors' motion to
25 dismiss and of Lehman Commercial's motion to supplement the
26 record.

27 ² As the majority also points out, the issue was presented
28 in the bankruptcy court in the context of the Debtors' response
to Lehman Commercial's relief from stay motion. But during the
case and after the motions leading to this appeal were filed,
Lehman Commercial filed proofs of claim related to the debt that
(continued...)

1 presents no issue. The only limits are those imposed by the
2 relevant nonbankruptcy law. As recognized by the lender's home
3 bankruptcy court, that law includes the law of equitable
4 subordination. See In re Metiom, 301 B.R. 634 (Bankr. S.D.N.Y.
5 2003) (permissible to join equitable subordination allegation
6 with general claims objection).

7 Here, however, the creditor is also a debtor in bankruptcy.
8 As such, the creditor is entitled to the benefits of the
9 automatic stay with respect to actions against it and its estate.
10 That much is undisputed.

11 What is disputed is whether the lender's stay extends to the
12 Debtors' equitable subordination claims raised in response to the
13 lender's assertion of its claim in the Debtors' bankruptcy. In
14 holding that the lender's stay extends to such actions, but not
15 to any efforts to disallow outright the same claims, the
16 majority's opinion essentially holds that equitable subordination
17 claims are not related to the adjustment of debtor-creditor
18 rights.

19 Existing law does not mandate this result. The Code and our
20 precedents recognize implicit equitable exceptions to the
21 automatic stay that permit a debtor to defend against a filed
22 proof of claim in any manner permitted by applicable
23 nonbankruptcy law. All the bankruptcy court did here was to
24 protect that right. Even if I am wrong, however, I believe

26 ²(...continued)
27 formed the basis of the requested stay relief. At oral argument,
28 counsel for Lehman Commercial conceded that, due to a lack of any
prejudice, the legal issue as framed in the text is identical to
the issue litigated in the bankruptcy court.

1 Lehman Commercial waived its right to raise automatic stay issues
2 when it filed its proof of claim. I would therefore affirm the
3 bankruptcy court's ruling.

4 Although I believe this case is controlled by recognized
5 exceptions to the automatic stay, those exceptions are not found
6 in § 362(b). While § 362(b) lists explicit exceptions to the
7 automatic stay, there are additional, implicit, equitable
8 exceptions necessary for a practical and functioning bankruptcy
9 system. One is that a creditor does not need relief from stay to
10 seek relief from stay. Another is that a creditor does not need
11 relief from stay to file and prosecute a proof of claim. Common
12 sense dictates both these exceptions, even if § 362(b) does not
13 mention them.

14 Our precedents identify a third equitable exception: a
15 debtor need not seek relief from stay to object to a proof of
16 claim filed by a creditor who coincidentally happens to be a
17 debtor in bankruptcy. As we stated in Hi-Tech Commc'n. Corp. v.
18 Poughkeepsie Bus. Park, LLC (In re Wheatfield Business Park,
19 LLC), 308 B.R. 463, 466 (9th Cir. BAP 2004), "the automatic stay
20 does not apply under such circumstances." See also Eisinger v.
21 Way (In re Way), 229 B.R. 11, 13 (9th Cir. BAP 1998); Gordon v.
22 Whitmore (In re Merrick), 175 B.R. 333, 338 (9th Cir. BAP 1994).

23 Merrick provides the analytical underpinning for this
24 equitable exception. In Merrick, we noted that:

25 [A]n equitable principle of fairness requires a
26 defendant to be allowed to defend himself from the
27 attack without imposing on him a gratuitous
28 impediment in dealing with an adversary who suffers
no correlative constraint. The automatic stay should
not tie the hands of a defendant while the plaintiff
debtor is given free rein to litigate.

1 Merrick, 175 B.R. at 338.

2 The majority rejects Merrick and our other precedents as
3 inapplicable on two grounds. Initially, they contend that we
4 permitted these equitable exceptions only in the context of
5 disallowance of a claim under § 502 but not subordination under
6 § 510, and therefore any attempt to subordinate Lehman
7 Commercial's claim under § 510 would be "offensive."³ Second,
8 the majority notes that Lehman Commercial's claim is secured.
9 Therefore, they believe that any subordination pursuant to § 510
10 would adversely affect Lehman Commercial's property interest and
11 violate § 362(a)(3) as it applies in Lehman Commercial's
12 bankruptcy estate.

13 Neither of these arguments is convincing. The majority
14 initially distinguishes between claim allowance and claim
15 subordination. Under these facts, this is a distinction without
16 a difference. A bankruptcy court has core jurisdiction over
17 "proceedings affecting the . . . adjustment of the debtor-
18 creditor . . . relationship." 28 U.S.C. § 157(b)(2)(O). Along
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20

³ The majority states that any action which "seeks
21 affirmative relief, such as a counterclaim violates the automatic
22 stay." To the extent that this could be read to imply that all
23 counterclaims seek affirmative relief. I disagree. Recoupment,
24 for example, typically is asserted by counterclaim, and should
25 not be considered offensive. Cf. Bull v. U.S., 295 U.S. 247, 262
26 (1935) ("recoupment is in the nature of a defense arising out of
27 some feature of the transaction upon which the plaintiff's action
28 is grounded"); ASARCO LLC v. Americas Mining Corp., 396 B.R. 278,
432 (S.D. Tex. 2008) ("recoupment is a common-law, equitable
doctrine that permits a defendant to assert a defensive claim
aimed at reducing the amount of damages recoverable by a
plaintiff").

1 with claim disallowance, equitable subordination has historically
2 been one such proceeding within that broad grant of jurisdiction.
3 Long before the enactment of the 1978 Bankruptcy Code, the
4 Supreme Court had recognized that “[i]n appropriate cases, acting
5 upon equitable principles, [the bankruptcy court] may also
6 subordinate the claim of one creditor to those of others in order
7 to prevent the consummation of a course of conduct by the
8 claimant which, as to them, would be fraudulent or otherwise
9 inequitable.” Heiser v. Woodruff, 327 U.S. 726, 732-33 (1946).

10 Heiser and § 510(c) confirm that equitable subordination has
11 a venerable history as a doctrine available to avoid inequitable
12 distributions. With this heritage, equitable subordination is
13 surely as much a part of the adjustment of debtor-creditor rights
14 as is claim disallowance. I thus fail to see any link between
15 § 510’s language regarding application to “allowed claims” and
16 the nonapplicability of Merrick equitable principles. Put
17 another way, there is no good reason to require a bankruptcy
18 estate to seek permission from another court to avoid inequitable
19 results in its own case, so long as what is sought is confined to
20 the defense of the claim asserted. Any other result
21 unnecessarily hobbles estates in their attempt to maximize fair
22 returns to their creditors.⁴

23 The unfairness of the majority’s position can be seen under
24 _____

25 ⁴ There is also nothing in the history of § 510 that should
26 cause equitable subordination claims to be treated differently.
27 Indeed, Congress intended “that the term ‘principles of equitable
28 subordination’ follow existing case law and leave to the courts
development of this principle.” 124 CONG. REC. 32, 398 (1978)
(statement of Rep. Edwards); id. at 33, 998 (statement of Sen.
DeConcini). See also, 4 COLLIER ON BANKRUPTCY ¶ 510.05 (15th rev.
ed. 2009).

1 the facts present here. When Lehman Commercial sought to
2 establish its claim, the Debtors had a duty on behalf of the
3 estate to respond by raising all appropriate responses. The
4 Debtors believed this response included a challenge to the equity
5 of Lehman Commercial's claimed priority. But the majority's
6 position would have required the Debtors to obtain permission
7 from Lehman Commercial's home bankruptcy court before responding
8 on this ground. This extra step is just the type of "gratuitous
9 impediment in dealing with an adversary who suffers no
10 correlative constraint" that Merrick condemned. See also In re
11 Metiom, 301 B.R. 634 (Bankr. S.D.N.Y. 2003) (under prior version
12 of Rule 3007, court finds that joining equitable subordination to
13 claims objection permissible).

14 The majority's reliance on § 362(a)(3) also does not survive
15 scrutiny. In this context, adjustment of lien priorities is no
16 different from an adjustment of claim priorities. A lien is
17 nothing but an incident of the debt it secures; there can be no
18 lien without a debt to support it. See, e.g., Satsky v. United
19 States, 993 F. Supp. 1027, 1029 (S.D. Tex. 1998). As a result,
20 if no stay relief is necessary to adjust priority of payment, no
21 stay relief should be necessary to adjust liens securing those
22 debts. The majority's position essentially allows creditors to
23 immunize inequitable conduct from equitable subordination by the
24 simple expedient of taking a security interest.

25 Finally, the majority's fears that the bankruptcy court's
26 ruling could somehow usurp the alleged right of Lehman
27 Commercial's home court to determine whether subordination would
28 violate § 362(a)(3) are easily allayed. By filing the proof of

1 claim, Lehman Commercial clearly put its entire claim at risk.
2 At a minimum, Lehman Commercial impliedly consented to have all
3 its claims against the Debtors adjudicated in the Debtors'
4 bankruptcy case. Metiom, a decision from Lehman Commercial's
5 home court, holds as much. Moreover, as the Ninth Circuit has
6 made explicit, "[w]hen a creditor submits to bankruptcy court
7 jurisdiction by filing a proof of claim in order to collect all
8 or a portion of a debt, it assumes certain risks . . . bankruptcy
9 converts the creditor's legal claim into an equitable claim to a
10 pro rata share of the res." Hong Kong & Shanghai Banking Corp.
11 Ltd. v. Simon (In re Simon), 153 F.3d 991, 997 (9th Cir. 1998).

12 It is the height of formalism - and the nadir of equity - to
13 allow Lehman Commercial to file its proof of claim under an
14 implied waiver from the Debtors' stay, only to deny the Debtors a
15 correlative and reciprocal waiver with respect to any accepted
16 challenge to that proof of claim.

17 For these reasons, I would affirm.
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