7 Intra-group Loans and Statutory Subordination[■]

7.1 Introduction

The previous chapter discussed intra-group guarantees, which are used to attract financing from outside investors and financiers, or to secure better terms of such financing. However, this is only a part of the picture. The review of intra-group financing would be incomplete without analysing ways to re-allocate funds within an enterprise group. This re-allocation typically takes the form of a single loan transaction or of a series of transactions within a centralised cash management or cash pooling system. Both forms are prevalent in intra-group financing, as exemplified by the cases of Lehman Brothers, Nortel Networks and Oi Brazil.

The purpose of this chapter to discuss intra-group loans – a common way to re-allocate money within an enterprise group. UNCITRAL notes that "[g] roup financing might involve intra-group lending between the parent and other group members, involving loans both from and to the parent and the granting of cross-guarantees."[1] In large groups, like the Lehman Brothers group, intra-group lending is often arranged through an "internal bank", managing the allocation of liquidity across the group. If we imagine a group as a human body, intra-group loans can be compared to blood that circulates throughout the body, supporting the variety of its organs. When one group member is in need of liquidity, other group members have a strong incentive to provide such liquidity.[2] Continuing with the human body analogy, this financing is comparable to a targeted transfer of resources from one organ to another to preserve its functions and possibly save the entire body. Yet, a different scenario of withdrawing funding and using "selective" insolvency is equally possible, where one group member is placed into insolvency to avoid contagion from spreading across the whole group enterprise. The "selective" insolvency strategy may result in the removal of

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■ This chapter builds upon the following previously published work by the author:
– I. Kokorin, Intra-Group Financial Support in a Crisis: Between Rescue and Abuse, Norton Journal of Banking Law and Practice, Vol. 29, 2020, pp. 378-420.

1 UNCITRAL Legislative Guide, Part three, Ch. I, para. 10.

2 R. Squire, Limits to Group Structures and Asset Partitioning in Insolvency: Suppressing Value and Selective Perforation by Means of Guarantees in The 800-Pound Gorilla. Limits to Group Structures and Asset Partitioning in Insolvency, NACIIL 2018 report, Eleven International Publishing, 2019, p. 1.

assets (i.e. assets tripping) from a group entity placed in insolvency for the benefit of its affiliates and ultimately, shareholders.[3] These value extraction patterns can be challenged using transaction avoidance rules, touched upon in Chapter 8.

This chapter focuses on a situation where the value is infused rather than taken out of a group company. It proceeds as follows. Section 7.2. mentions some of the reasons why enterprise groups engage in intra-group loans and centralised cash management. Section 7.3. examines the specificity of "insider" creditors, as the divide between internal and external creditors often underlies their different treatment in insolvency. The different treatment primarily manifests in subordination of intra-group (shareholder) loans in insolvency (section 7.4).

The treatment of shareholder loans and, more generally, of intra-group claims is a contentious topic, on which positions vary considerably among jurisdictions and among scholars. In countries like Germany, Austria, Sweden, Portugal, Italy, Spain, Brazil, Slovenia, Poland and Russia,[4] claims from shareholder loans might be subject to statutory subordination rules that re-prioritise or downgrade insider claims in the creditor ranking. In other countries, such as the UK and the Netherlands, no general doctrine of subordination is developed. In the USA, claims of insiders could be subordinated under the doctrine of equitable subordination or recharacterized as equity contributions.

There are different opinions on whether claims of shareholders should rank *pari passu* with those of external creditors or whether they should be placed in a lower rank or treated as equity contributions. The complexity arises from the dual role of a party that holds an equity stake in the debtor or is otherwise connected to it by way of control or corporate ties, while also acting as a lender ("double hat" problem). The question is whether the disparities in the nature, incentives, and risks of internal and external creditors justify different (unequal) treatment of creditors in insolvency. No signs

3 See Final Report of Examiner Richard J. Davis, 15 March 2016, *In re Caesars Entertainment Operating Company Inc.*, Case No. 15-01145 (ABG) (Bankr. N.D. Ill.). The examiner concluded that in the period preceding the debtor's bankruptcy, as a result of a number of transactions, assets were removed from the debtor to its own detriment and to the detriment of its creditors. The damage was estimated to range from USD 3.6 to USD 5.1 billion. The examiner pointed out that "in those transactions no one was focused on CEOC's [debtor's] interest alone as opposed to how transactions impacted Caesars as a whole." See C. Gerner-Beuerle, M. Schillig, Comparative Company Law, OUP, 2019, p. 826, noting that the withdrawal of the company's assets may take the form of loans advanced by the debtor companies to the parent or other group companies.

4 For analysis of the subordination doctrine in insolvency law, see A. Shaydullin, Subordination of shareholder claims in insolvency law, PhD dissertation, 2022 (in Russian) <https://izak.ru/upload/iblock/151/SHaydullin-A.I._Kandidatskaya_dissertatsiya_final_pdf.pdf> (accessed 15 July 2023).

of consensus seem to appear on this issue, neither in academic literature nor in law. This chapter summarises arguments in favour and against the subordination of insider (intra-group) loans and highlights the most serious critique of such subordination – the problem of underinvestment (section 7.5.). Section 7.6. concludes.

7.2 Intra-group Loans and Centralised Cash Management

There are various reasons why enterprise groups utilise intra-group loans and centralised cash management. An intra-group loan offers a relatively easy and quick way to put the funds available within the group to the best use. It provides flexibility, convenience, and confidentiality compared to equity finance, which often requires complying with various formalities.

Within a corporate group, one group member may be able to secure better credit terms due to its credit history, or the level of assets and liabilities. This is why the borrower or issuer of corporate bonds is frequently established as a special purpose financing company, acting for the benefit of other group companies or the entire group. For instance, an SPV arrangement was used by the Parmalat group, a dairy and food enterprise, whose failure produced one of the most important cases on the interpretation of the EIR 2000.[5] Parmalat established the Irish subsidiary Eurofood IFSC Ltd (Eurofood), with the main objective of providing financing facilities to other entities in the group. Its primary purpose was to serve the interests of the group by engaging in the issuance of bonds, which were guaranteed by the Italian holding company Parmalat SpA.[6] Similar financial arrangements were embraced by Lehman Brothers and Oi Brazil. In the Oi group, the operations of the Dutch-incorporated SPVs were limited to issuing notes and on-lending the received funds to other group entities.[7] The relevant notes documentation describes the Dutch companies' conduit role and their full dependence on the performance of the group:

> [Coop, a Dutch SPV] has no operations other than the issuing and making payments on the Notes […] and using the proceeds therefrom [to effectuate] lending the net proceeds of the Notes […] to Oi and subsidiaries of Oi. Accordingly, the ability of [Coop] to pay principal, interest and other amounts due on the Notes and other indebtedness will depend upon the financial condition and results of operations of Oi and its subsidiaries that are creditors of [Coop].[8]

5 Case C-341/04, *Eurofood IFSC Ltd*, 2 May 2006.
6 These financial arrangements have been described in the Opinion of Advocate General Jacobs, delivered on 27 September 2005 in *Eurofood IFSC Ltd*, Case C-341/04, ECLI:EU:C:2005:579.
7 See *In re Oi Brasil Holdings Coöperatief U.A.*, 578 B.R. 169 (Bankr. S.D.N.Y. 2017).
8 Ibid.

One should also keep in mind tax considerations, which often play a large role in determining the way intra-group transactions are structured.[9] For all these reasons, it may be cheaper for a corporate group to use an SPV to attract financing, irrespective of whether this entity will use the funds on its own or transfer them through a chain of other group members.

Centralised cash management or cash pooling facilitates economic and operational efficiency and contributes to increases in profitability. Cash pooling can be divided into "notional pooling" ("virtual cash pooling") and "physical pooling" ("cash sweeping" or "cash balancing"). In the former, no physical transfer of funds takes place as it involves the purely arithmetic consolidation of balances from different accounts. In the latter, balances of various accounts are physically consolidated into one balance in a designated account, a so-called master account.

Cash pooling is popular among corporate groups as it allows a parent company or a financing SPV to control intra-group cash balances of group companies and transfer liquidity from a group entity with a surplus to another group entity with a shortage, without having to attract funds from outside the group. The latter option may be more costly, considering the financial position and availability of unencumbered assets of the entity seeking financing. However, centralisation of funds creates its own problems, particularly when a company holding subsidiaries' cash in a master account becomes insolvent, as it happened with LBHI (for an illustration of Lehman Brothers' cash management system, see figure 1).

Finch and Milman point out that the "arrangements that best meet the needs of healthy, trading companies […] are not those that necessarily produce the smoothest-operating insolvency regimes."[10] This is certainly true for centralised cash management. This group-level liquidity-allocation tool is special (e.g. participating group entities may agree on joint and several liability for deficits of the top account, potentially affecting the position of creditors), presents notable challenges for group restructurings (e.g. access to funds in a master account might be cut off if the company holding a mater account goes bankrupt), and may require tailored solutions to preserve the continued operation of a cash pool (e.g. first-day orders in US bankruptcy cases on cash management). Yet, from a legal standpoint, money transfers between participants of a physical cash pool can be treated

9 On the use of tax havens by multinational enterprises, see P. Muchlinski, Multinational Enterprises and the Law, 3rd edn, OUP, 2021. Tax law aspects of intra-group financing fall outside the scope of this book.

10 V. Finch and D. Milman, Corporate Insolvency Law: Perspectives and Principles, 3rd edn, CUP, 2017, p. 55.

as up-, cross- or downstream loans.[11] This is the reason why the issues addressed below, including subordination, are equally relevant for transfers in a cash management system.[12]

7.3 Internal v. External Creditor Divide

7.3.1 Information asymmetry

Despite the proclaimed equal treatment or equality of creditors, the reality is more complicated. To paraphrase the famous passage of George Orwell, all creditors are equal, but some creditors are more equal than others.[13] In many countries, insolvency law provides special treatment of transactions involving related parties, such as directors, shareholders, and their affiliates, sometimes referred to as “insiders”. Related parties typically enjoy reduced protection against transaction avoidance.[14] This materialises in the extension of suspect periods,[15] acceptance of a certain mental element (e.g. knowledge or intention to give preference or to defraud),[16] or a rebuttable

11 J. Jansen (ed), International Cash Pooling: Cross-border Cash Management Systems and Intra-group Financing, Sellier. European law publishers, 2011, p. 6, emphasising that the “purpose of a cash management system is to grant financial assistance between companies within a corporation on a constant basis.” P. Mäntysaari, The Law of Corporate Finance: General Principles and EU Law. Volume III: Funding, Exit, Takeovers, Springer, 2010, p. 72, noting that cash concentration creates loans and debts between participating companies. See also W.A.K. Rank, Van saldocompensatie naar saldoconcentratie? MvV, nummer 11, 2018, p. 333, stating that from a legal standpoint, surplus transfers from group companies to the holding or financing company can be regarded as cash loans.

12 For a country-by-country overview of national law approaches to cash pooling and the implications of insolvency for parties involved in it, see M. Willems (ed), Cash Pooling and Insolvency: A Practical Global Handbook, Globe Business Publishing, 2012.

13 G. Orwell, Animal Farm, 1984. The original quote reads as follows: “All animals are equal. But some animals are more equal than others”. This quote was of course made in a very different setting and with a different message.

14 In many cases, related parties include members of the same group of companies. For an overview, see Clash of Principles: Equal Treatment of Creditors vs. Protection of Trust in European Transaction Avoidance Laws, CERIL Report 2017/1, 26 September 2017; G. McCormack et al., Study on a new approach to business failure and insolvency, 2016, pp. 142-143.

15 E.g. in the UK, the suspect period for preference transactions is two years for connected persons, compared to the otherwise applicable six-month period (see Insolvency Act 1986, section 240). In the USA, the preference period is extended from the usual 90 days to one year in the case of an insider (11 U.S. Code § 547).

16 Under InsO, § 131(2), a person with a close relationship to the debtor on the date of a [preferential] transaction (§ 138) shall be presumed to have been aware of the disadvantage to creditors in insolvency proceedings. Under Insolvency Act 1986, section 239(6), a company that gave a preference to a person connected with it “is presumed […] to have been influenced in deciding to give it by such a desire as is mentioned in subsection (5)” (desire to create advantage to a counterparty). The knowledge of prejudice in related-party transactions is codified in Article 43(1) Fw.

presumption of the harm caused to creditors.[17] The distinct treatment of related parties finds a way in other rules of insolvency law. For example, US bankruptcy law requires that at least one class of impaired creditors accepts a reorganisation plan, without considering the votes of insiders.[18]

There are several important characteristics that distinguish internal (related) creditors from external (non-related) creditors. One of them has to do with information asymmetry. Internal parties, like shareholders and directors, may have access to internal, non-public information concerning the debtor, including its financial situation and likely prospects of survival. They "tend to have the earliest knowledge of when the debtor is, in fact, in financial difficulty."[19] Conversely, outside the formal insolvency procedure, external creditors usually lack up-to-date and full information about the debtor and have to rely on either publicly available sources or data shared by the debtor.[20] The problem of information asymmetry is even larger in corporate groups for a reason that the financial status of the entire group may need to be assessed to make risk calculations. Outside creditors could be unaware of the true state of affairs of the distressed debtor, given its position within the group.

7.3.2 Power and control

Shareholders can exercise control over the debtor. In the absence of insolvency proceedings, and in some cases even during such proceedings, they retain decision-making rights, including the right to appoint and remove directors. Due to this advantage in knowledge and control, they might be able to "prepare" for insolvency by transferring or pushing debtor's directors to transfer assets or value from the debtor to another group member in the vicinity of insolvency (asset dilution), ultimately to the detriment of the transferring company and its creditors. They may also decide to increase the riskiness of the debtor's business (asset substitution) or its borrowing (debt

17 See e.g. Spanish Insolvency Act (*Ley Concursal*), Article 228(1).

18 11 U.S. Code § 1129(a)(10).

19 UNCITRAL Legislative Guide, Part two, Ch. II, para. 182. D.A. Skeel and G. Krause-Vilmar, Recharacterization and the Nonhindrance of Creditors, EBOR, Vol. 7, 2006, p. 268, observing that shareholders "see the problems first, and they may conclude that arranging an outside loan would be too time-consuming and uncertain."

20 Information asymmetry may be mitigated (but not fully solved) through the inclusion of information covenants. R. Carrizosa, S. Ryan, Borrower private information covenants and loan contract monitoring, Journal of Accounting and Economics, Vol. 64, 2017, pp. 313-339.

dilution). These are examples of opportunistic behaviour, which should be controlled ex ante and remedied ex post.[21]

Adopting the agency-costs-of-debt language of Jensen and Meckling, a threat of opportunistic actions by shareholders induces lenders to engage in additional monitoring efforts, producing monitoring costs. In return, shareholders incur bonding costs to reassure creditors that no such actions will occur.

7.3.3 Risk appetite and misalignment of incentives

The risk appetite of shareholders is often higher compared to external creditors because in insolvency, shareholders' equity stake is wiped out. Shareholders of an insolvent company are last in line and give way to creditors as new residual claimants. At the same time, the limited liability shield protects shareholders from claims of the debtor's creditors. The combination of these features gives them economic incentives to pressure the debtor's management to pursue high risk-high reward strategies, including projects with negative net present value (NPV), to avoid liquidation, retain their equity, and create upside potential.[22]

The risk-shifting incentives of shareholders and managers can result in the so-called "gamble for resurrection", further contributing to the dilution of value available to outside creditors. This happens in a situation where the life of an economically unviable business – a business whose going concern value is lower than its liquidation value – is artificially prolonged at the risk and expense of outside financiers. We should keep in mind that this behaviour is not necessarily rational or intentional. Shareholders and managers may actually believe that their company is viable – a belief affected by

21 J. Armour, G. Hertig and H. Kanda, Transactions with creditors, in R. Kraakman et al. (eds), The Anatomy of Corporate Law: A Comparative and Functional Approach, 3rd edn, OUP, 2017, pp. 111-112.

22 D. Scarlino, Zone of Insolvency, Directors' Duties and Creditors' Protection in U.S., European Business Law Review, Vol. 29, 2018, p. 7. On misalignment of incentives in insolvency, see H. Eidenmüller, Trading in Times of Crisis: Formal Insolvency Proceedings, Workouts, EBOR, Vol. 7, 2006, pp. 239-258; P. Davies, Directors' Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency, EBOR, Vol. 7, 2006, p. 306, stating that in the vicinity of insolvency directors may focus solely on the upside, however remote the probability of success is. Empirical evidence of insolvency-related risk shifting is inconclusive. A. Eisdorfer, Empirical Evidence of Risk Shifting in Financially Distressed Firms, The Journal of Finance, Vol. 63, 2008, pp. 609-637, supporting the risk-shifting hypothesis. However, see E. Gilje, Do Firms Engage in Risk-Shifting? Empirical Evidence, The Review of Financial Studies, Vol. 29, 2016, pp. 2925-2954, finding that companies in distress reduce investment risk.

various cognitive biases, including the self-serving bias, positive outcome (or optimism) bias, and the illusion of control.[23]

Unlike shareholders, external creditors may prefer risk-averse behaviour or immediate liquidation of the debtor. The reason for this is that they do not share in the upside of high risk-high reward strategies; they are only entitled to the principal (original amount borrowed) plus interest. However, they are among the most affected parties if the risky or life-extending strategy fails and forces the debtor into insolvency.

7.3.4 Minimum capital requirements and capital maintenance

Companies may be financed through debt or equity. The return on the former usually includes the payment of fixed interest. The return on the latter depends on the success of the company and is distributed in the form of dividends or is translated into an increase of the share value. Unlike the return on debt, the return on equity investment is, in principle, unlimited but can be subject to specific company law rules. These rules provide creditors with a guaranteed equity cushion by means of the minimum capital requirements and capital maintenance.

Over the recent decades, many jurisdictions have either eliminated or significantly reduced the need for private companies to have minimum capital levels. This trend has been instigated by regulatory competition and the positions of standard-setting organisations, such as the World Bank.[24] The abolition of minimum capital requirements has simplified the partition of a single enterprise into a myriad of legal entities. In any event, the efficiency of minimum capital requirements is doubtful, as they do not reflect the riskiness of the business and do not account for the potential size of a debtor and its debts. Capital maintenance rules curb the distribution of corporate assets to shareholders (e.g. via the payment of dividends, redemption or

23 On cognitive biases in vicinity-of-insolvency decision-making, see M-W. Hung, W-H. Tsai, Managerial optimism, CEO retention, and corporate performance: evidence from bankruptcy-filing firms, Journal of Economics and Finance, Vol. 44, 2020, pp. 506-526, analysing data on bankruptcy-filing companies in the USA and concluding that managerial optimism is detrimental to operating performance at filing and survival probability. See also F. Drescher, Insolvency Timing and Managerial Decision-Making, Springer Gabler, 2014, p. 84, noting that "context factors of the insolvency timing decisions are very likely to aggravate the manager's cognitive limitations."

24 M. Becht, C. Mayer and H. Wagner, Where do Firms Incorporate? Deregulation and the Cost of Entry, Journal of Corporate Finance, Vol. 14, 2008, pp. 241-256, concluding that incorporations are primarily driven by minimum capital requirements. V. Saltane, P.G. Serna, Why are minimum capital requirements a concern for entrepreneurs? World Bank Doing Business, 2014, pp. 41-45, arguing that such requirements significantly slow entrepreneurship and fail to serve the purpose of protecting creditors.

repurchase of the company's own shares) in a situation where there are no distributable profits.[25] It is highlighted that capital maintenance is not about avoiding insolvency but about giving effect "to the rule that creditors' claims take priority over those of shareholders" and ensuring that distributions to shareholders do not compromise creditors' interests.[26] In other words, capital maintenance rules impose a negative obligation not to make distributions. They do not translate into any positive obligation of shareholders to make new equity contributions or to abstain from intra-group lending.

To conclude, the disparities in the nature, risk appetite and incentives between external and internal creditors are worth keeping in mind. They could be relied on to justify special treatment, consistent with the idea of formal (as opposed to universal) equality, pursuant to which different situations should not be treated in the same way. One may even argue that since shareholders differ from outside creditors, it is fair to treat them differently. However, this simple conclusion does not solve the problem or provide an answer to the question of whether financial support provided by one group member to another should be subordinated in insolvency. For now, it suffices to stress that the distinct traits of internal creditors underlie the subordination debate.

7.4 Subordination of Shareholder Loans: National Perspectives

7.4.1 Contractual v. statutory subordination

The effect of subordination can be achieved by way of a contract – contractual subordination. Inter-creditor agreements establishing the ranking of creditors are common in syndicated loan transactions.[27] It is also common for a parent company to agree to subordinate its loan to a subsidiary in favour of an outside lender, such as a bank. Such subordination can be a pre-condition to secure external financing, as it provides an outside financier with additional protection in case the debtor cannot overcome financial difficulties and goes insolvent. This protection comes from the fact that the outside financier gets paid in priority to and without competition from the

25 See Companies Act 2006, section 830(2), according to which "company's profits available for distribution are its accumulated, realised profits […] less its accumulated, realised losses." See also Article 56 of the Directive (EU) 2017/1132 of the European Parliament and of the Council of 14 June 2017 relating to certain aspects of company law.

26 A. Cahn and D.C. Donald, Comparative Company Law: Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA, 2nd edn, CUP, 2018, p. 257.

27 L. Gullifer and J. Payne, Corporate Finance Law: Principles and Policy, 3rd edn, Hart Publishing, 2020, p. 265.

parent company, whose claim is contractually subordinated.[28] In the context of group financing, subordination can also attach to recourse claims.[29] The main question is whether contractual subordination remains effective in the event of the borrower's insolvency, considering that the ranking of creditors' claims is prescribed by mandatory rules of insolvency law. The default rule of insolvency distribution is that creditors are to be treated equally. This is why there may be doubts about the creditors' ability to opt out from equal treatment by agreeing on subordination.

Contractual subordination is generally allowed and effective in insolvency proceedings in the three jurisdictions discussed in this book. Burrows emphasises that the *pari passu* principle "prevents a creditor from bargaining for an advantage on the distribution of an insolvent's assets, which is not the case with a subordination agreement of this kind [subordination to all other creditors]."[30] He observes that prohibiting these subordination agreements would have a prejudicial effect on companies that depend on the infusion of funds from the parent and sister companies that are prepared to accept subordination.[31]

The validity and effectiveness of subordination agreements are recognised and upheld by courts in the UK,[32] the USA[33] and the Netherlands.[34] In this respect, Gullifer notes that "judicial confirmation of the validity of

28 *Lehman Brothers International (Europe) (In Administration), Re* [2017] UKSC 38, [2018] A.C. 465, [2017] 5 WLUK 397, addressing the issue of contractual subordination as applied to loans extended by LBIE's immediate holding company and noting that "the perception of the reasonable reader would be that the holders of the subordinated debt were to be at the end of the queue – and, in the event of an Insolvency, at the bottom of the waterfall."

29 See LMA Multicurrency Term and Revolving Facilities Agreement, sec. 18.7 (Deferral of Guarantors' Rights).

30 A. Burrows, English Private Law, 3rd edn, OUP, 2013, para. 19-130.

31 Ibid. See also P. Wood, Project Finance, Securitisations, Subordinated Debt, 2nd edn, Sweet & Maxwell, 2007, para. 11-025, noting that "[n]o policy of the insolvency laws is offended if one creditor voluntarily agrees to postpone himself to the others, but only if he seeks to put himself ahead of other unsecured creditors."

32 *Re Maxwell Communications Corp* [1993] 1 W.L.R. 1402, holding that there were no principles of insolvency law or public policy that precluded a contract between a company and creditor whereby, if the company was insolvent, the debt was to be subordinated in the winding up to the payment of debt owed to other unsecured creditors. See also *Re SSSL Realisations* [2004] EWHC 1760 (Ch), dealing with subordination of intercompany debt.

33 11 U.S. Code § 510(a), providing that a contractual subordination agreement is enforceable "to the same extent that such agreement is enforceable under applicable nonbankruptcy law." This rule codifies pre-Bankruptcy Code case law. *In re Credit Industrial Corp.*, 366 F.2d 402 (2d Cir. 1966). The scope and enforceability of subordination agreements are determined by state law. *Wilmington Trust Co. v. Tribune Co.*, 2014 U.S. Dist. LEXIS 82782 (D. Del. June 18, 2014).

34 Dutch Civil Code, Article 3:277(2). Rb. 's-Gravenhage 28 October 2009, *JOR* 2010/317, *RI* 2010/21 (*Van der Eng c.s./SNSPF, Andalucia Projects*). N.B. Pannevis, Achtergestelde vorderingen (Onderneming en recht nr. 114) (diss. Nijmegen), Deventer: Wolters Kluwer 2019.

subordination agreements is very much to be welcomed,"[35] given their predominance in corporate finance. Contractual subordination arises from the principle of freedom of contract and does not negatively impact the interests of creditors. It does not create an unfair advantage; rather, creditors simply agree on how conflicts between their claims should be addressed in the distribution of the debtor's assets. Nevertheless, there may be concerns with a subordination agreement if the lender (parent company) that agreed to subordinate its claim becomes insolvent. In such a scenario, the agreement could potentially harm its creditors. The subordination agreement will be subject to scrutiny under transaction avoidance rules (e.g. as a transaction at an undervalue), and the benefits afforded to the subordinated lender (e.g. higher interest rates, indicating a higher return for increased risk) are likely to be factors influencing the court's analysis. Disputes could also concern the interpretation of subordination clauses, the ranking of subordinated creditors between themselves, and in relation to other creditors.

To the extent that contractual subordination is based on freedom of contract and usually does not impinge on the equal treatment of creditors or their legitimate expectations, it will not be further discussed in this book. We will focus on statutory subordination. Unlike contractual subordination, statutory subordination is not based on a contract. It is prescribed by law and typically applies to claims of insiders, including shareholders and group affiliates. The following sections explore the national law approaches to statutory subordination.

7.4.2 The UK: subordination for claims of shareholders *qua* shareholders

English law treats claims arising from intra-group financial arrangements *pari passu* with other unsecured claims. In the 1933 case *Matthew Ellis & Co. Ltd.*,[36] the debtor that was in financial difficulty obtained a loan from its chairman and controlling shareholder, Mr. Arthur Tipper. The loan was made to ensure the operational continuity of the debtor and was secured by the floating charge over the debtor's assets. It was agreed that a part of this money was to cover the past debt owed to the principal supplier of goods, of which Mr. Arthur Tipper was a partner. This payment in satisfaction of the past indebtedness was a precondition for the future supplies and the only way to keep the debtor's business going.

The liquidator contested the validity of the security, arguing that the money did not come to the debtor free from obligation and that the debtor acted merely as a conduit pipe. The court refused the liquidator's application and

35 R. Goode and L. Gullifer, Goode and Gullifer on Legal Problems of Credit and Security, 6th edn, Sweet & Maxwell, 2017, para. 5-61.
36 *In re Matthew Ellis Ltd* [1933] Ch. 458.

found that the debtor "did secure a valuable advantage in the continuation of the supply of goods […]" and that "the transaction must be considered as a whole and not split up."[37] The fact that the loan and security involved an insider had no effect on the court's reasoning.

Another relevant case in which the claim of a shareholder was at issue is *Soden v. British & Commonwealth Holdings Plc*.[38] In 1988, British & Commonwealth Holdings Plc (B&C) acquired the entire share capital of Atlantic Computers (Atlantic). The acquisition proved to be disastrous. Atlantic went into administration, as did B&C. B&C brought proceedings against Atlantic for damages for negligent misrepresentations made by Atlantic to induce B&C to buy its shares. The question was whether this claim should be subordinated under section 74(2)(f) of the Insolvency Act 1986. According to this section:

> a sum due to any member of the company (in his character of a member) by way of dividends, profits or otherwise is not deemed to be a debt of the company, payable to that member in a case of competition between himself and any other creditor not a member of the company […].

The administrators of Atlantic submitted that "the basic principle applicable was that "members come last", implying that the members of a company (shareholders) should not receive any payment until outside creditors are paid in full. They considered it a "manifest absurdity" if B&C, as a shareholder in its wholly owned subsidiary, was allowed to claim as damages the sums calculated with reference to the price of shares based on the misrepresentation related to their acquisition. The House of Lords did not agree with this position and declined to subordinate the shareholder's claim.

The court made a distinction between two types of shareholder claims: (i) sums due to a member "in his character of a member", which were interpreted as sums falling due under or by virtue of the "statutory contract" between a shareholder and the company and the members inter se – a memorandum and articles of association, and (ii) sums due to a member "otherwise than in his character as a member". Subordination, in this case, applied solely to rights and liabilities created by the constitutional documents of a company or those conferred and imposed on shareholders by the Companies Act. The court did not accept the principle that "members [always] come last", holding that "a member having a cause of action independent of the statutory contract is in no worse a position than any other creditor."[39] Instead, the principle dictates that the rights of shareholders *qua*

37 Ibid.

38 *Soden and Another v. British & Commonwealth Holdings Plc. (In Administration)* [1997] 4 All ER 353.

39 Ibid.

shareholders come last, reflecting the trade-off for limited liability.[40] Since the cause of action in the present case did not stem from corporate membership but rather from a misrepresentation made by the debtor during the purchase of existing shares from a third party, the court did not impose subordination.

Therefore, a narrow interpretation of the "character of a member" was adopted. If a shareholder holds a claim in his capacity of a creditor (e.g. a claim for loan repayment or a subrogation claim), such a claim will not be subordinated. As a result, claims of insiders under intra-group financial transactions commonly rank *pari passu* with unsecured creditors. This means that in insolvency, such claims could be set off against an obligation of contribution.[41]

English law has not developed a general doctrine of equitable subordination.[42] This is not to say that there has been no critique of the current approach to shareholder loans. The famous Report of the Review Committee on Insolvency Law and Practice, also known as the Cork Report, recognised the issue:

> The strength of the case of those who seek a change in the law – and radical at that – can be seen if a simple and perhaps extreme example is taken. A wholly-owned subsidiary company is under-capitalised. It relies virtually wholly on moneys lent by the parent. Its affairs are conducted by and in the interest of the parent and they are mismanaged. […] The subsidiary becomes insolvent and goes into liquidation. The parent company declines all liability for its subsidiary's debt to external creditors, and competes with them by submitting a proof in respect of its loan. The result is that, out of the total funds realised by the liquidator for distribution among the creditors, a substantial proportion goes to the parent company. We recognize that a law which permits such an outcome is undoubtedly a defective law.[43]

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40 For early cases, see *Re Addlestone Linoleum Co* (1887) 37 Ch.D. 191, ruling that the claimant who is induced to acquire his shares by subscription falls within the class of those who are not allowed to compete with general creditors. See also *Houldsworth v. City of Glasgow Bank* (1888) 5 App. Cas. 317, holding that a shareholder could not sue for damages for misrepresentation made by the company on the occasion of the issue (as opposed to the purchase) of its shares unless he first rescinded the contract, and that once the company had gone into liquidation such a rescission was impossible. See P. Wood, Principles of International Insolvency, 2nd edn, Sweet & Maxwell, 2007, para. 11-073.

41 V. Finch, D. Milman, Corporate Insolvency Law: Perspectives and Principles, 3rd edn, CUP, 2017, p. 533.

42 K. van Zwieten, Goode on Principles of Corporate Insolvency Law, 5th edn, Sweet & Maxwell, 2018, para. 8-30, suggesting that this outcome may be explained by the existence of statutory provisions, such as those enabling subordination of claims of creditor-directors found guilty of fraudulent or wrongful trading (sec. 215(4) and 246ZC of the Insolvency Act 1986).

43 Insolvency Law and Practice: Report of the Review Committee, Cmnd 8558, 1982, pp. 435-436.

The Cork Report made several recommendations for reforms, ranging from joint and several liability of group entities, to the subordination of shareholder loans if they can be properly characterised as capital contributions. It proposed distinguishing debts arising from ordinary intra-group trading activities and debts "which in substance represent long term working capital and which arise from finance provided by the parent company."[44] However, no legislation on the subordination of insider claims was adopted in the UK, neither was it in spotlight of recent insolvency law reforms.

7.4.3 The USA: Equitable subordination and debt recharacterization

7.4.3.1 Equitable subordination: undoing wrongdoing

The doctrine of equitable subordination in the USA allows courts to subordinate the claim of one creditor to the claims of other creditors when the former has engaged in inequitable behaviour, resulting in an unjustified advantage or injury to other creditors of the distressed entity. The doctrine is therefore limited to reordering priorities and does not permit the disallowance of claims as such. In other words, it does not deal with the validity or invalidity of claims. Notably, equitable subordination is not restricted in its personal scope and may in principle apply to any creditor involved in some form of misconduct.[45]

The doctrine of equitable subordination finds its origins in the famous 1939 cases of *Taylor v. Standard Gas & Electric*[46] (often referred to as the Deep Rock case) and *Pepper v. Litton*.[47] In *Deep Rock*, the US Supreme Court considered a claim of Standard Gas & Electric Company (Standard), the corporate parent, against its insolvent subsidiary – Deep Rock Oil Corporation (Deep Rock). Standard ran an open account with thousands of transactions between Standard and Deep Rock from 1919 to 1933. Many of these transactions were attacked as fraudulent, and it was asserted that Standard had made Deep Rock its mere agent or instrumentality.

The Supreme Court held that "[f]rom the outset Deep Rock was insufficiently capitalised, was top heavy with debt and was in parlous financial

44 Ibid., para. 1960.

45 See e.g. *Enron Corp. v. Ave. Special Situations Fund II, LP (In re Enron Corp.)*, 333 B.R. 205 (Bankr. S.D.N.Y. 2005); *Developmental Specialists, Inc. v. Hamilton Bank, N.A. (In re Model Imperial, Inc.)*, 250 B.R. 776 (Bankr. S.D.Fl. 2000). Traditionally, equitable subordination was inapplicable to ordinary creditors, as opposed to insiders. For external creditors, inequitable conduct warranting subordination must be "gross and egregious, tantamount to fraud, misrepresentation, overreaching or spoliation, or involving moral turpitude." See *In re Eufaula Indus. Auth.*, 266 B.R. 483, 489 (B.A.P. 10th Cir.2001).

46 *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307 (1939).

47 *Pepper v. Litton*, 308 U.S. 295 (1939).

condition. Standard so managed its affairs as always to have a stranglehold upon it."[48] Due to the findings of abuses by the parent company and inadequate capitalisation of the subsidiary, the Supreme Court ruled that the claim of the parent against its subsidiary should be allowed to participate in the reorganisation plan of the subsidiary only in subordination to the preferred stock of the subsidiary.[49]

Since 1978, the doctrine of equitable subordination has been codified in § 510(c) of the US Bankruptcy Code, which states that:

> […] 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.[50]

The "principles of equitable subordination" are not defined in the US Bankruptcy Code. As follows from the Congressional records, the development of these principles was intentionally left to courts.[51] This makes equitable subordination "a potentially vague standard".[52]

The case law has formulated a number of requirements to guide courts in their application of the doctrine. In the widely quoted pre-reform case of *In re Mobile Steel Corp.*,[53] a three-prong test for equitable subordination was proposed: (i) the claimant must have engaged in some type of inequitable

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48 *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307, 315 (1939).

49 *Pepper v. Litton*, 308 U.S. 295, 307 (1939), confirming the equitable power of courts "to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate."

50 11 U.S. Code § 510(c).

51 124 Cong.Rec.H 11095, H 11113 (Sept. 28, 1978), stating: "It is intended that the term "principles of equitable subordination" follow existing case law and leave to the courts development of this principle. To date, under existing law, a claim is generally subordinated only if holder of such claim is guilty of inequitable conduct." Interestingly, the initial bill introduced in the House of Representatives (H.R. 31, 94th Cong. (1976)) and the Senate ((H.R. 31, 94th Cong. (1976)) prescribed a blanket subordination of all claims of insiders and their affiliates. The Congress rejected this statutory language.

52 A.J. Levitin, Business Bankruptcy: Financial Restructuring and Modern Commercial Markets, Wolters Kluwer, 2016, p. 957, adding that "as a standard, it is difficult to say exactly what will trigger or not trigger equitable subordination." J. Kilborn, National Report for the United States, in D. Faber et al. (eds), Ranking and Priority of Creditors, OUP, 2016, para. 19.40, noting that the equitable nature "makes application of this doctrine inherently difficult to predict."

53 *Benjamin v. Diamond (In re Mobile Steel Co.)*, 563 F.2d 692 (5th Cir. 1977). The proposed formula was implicitly endorsed by the US Supreme Court in *United States v. Noland*, 517 U.S. 535 (1996).

conduct; (ii) this misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; and (iii) equitable subordination of the claim must not be inconsistent with the provisions of the US Bankruptcy Code. While the second (injury or unfair advantage) and the third (consistency with the law) prongs of the test are relatively unambiguous, the first element, namely "inequitable conduct" or as one court has referred to it, conduct "that shocks one's good conscience",[54] is not precise.

Courts acknowledge that equitable subordination is an extraordinary remedy, and not a penalty, that needs to be employed sparingly.[55] When it comes to claims of insiders, the doctrine has been used in situations involving: (i) fraud, illegality, or breach of fiduciary duty; (ii) undercapitalization; and (iii) control or use of the debtor as an alter ego for the benefit of a claimant.[56] Also, courts apply higher levels of scrutiny when dealing with the claims of insiders[57] and are willing to shift the burden to such insiders to prove both the good faith of the transaction and its inherent fairness.[58]

In the case of *In re Herby's Foods Inc.*,[59] the court ordered the subordination of shareholder loans based on the premise that the debtor's capital was insufficient to support its operations and that the debtor was already insolvent at the time of acquisition by the shareholder. However, the court noted that undercapitalisation alone was not sufficient to justify equitable subordination. Thus, additional grounds or factors for subordination were necessary. Among other factors, the court pointed out that: (i) the insiders never injected any equity capital into Herby's, "electing instead to advance

54 *In re 80 Nassau Associates*, 169 B.R. 832, 837 (Bankr. S.D.N.Y. 1994).

55 See e.g. *In re Alternate Fuels, Inc.*, 789 F.3d 1139 (10th Cir. 2015); *In re Vetter Assets Service, LLC*, 609 B.R. 279 (Bankr. W.D. Okla. 2019); *In re Lifschultz Fast Freight*, 132 F.3d 339, 347 (7th Cir.1997), holding that "[w]rongful or unpredictable subordination spawns legal uncertainty of a particular type: the risk that a court may refuse to honor an otherwise binding agreement on amorphous grounds of equity."

56 *In re Fabricators, Inc.*, 926 F.2d 1458, 1467 (5th Cir.1991); *In re Monahan Ford Corp. of Flushing*, 340 B.R. 1, 44 (Bankr. E.D.N.Y. 2006).

57 Collier on Bankruptcy, 16th edn, 2022, Vol. 4, ¶ 510.05, explaining that a high-level scrutiny is explained by the fact that "insiders have somewhat enhanced opportunities to adjust their position in such a way that other creditors are prejudiced, and therefore, a close inquiry as to whether their claims ought to be subordinated is justified."

58 *Benjamin v. Diamond (In re Mobile Steel Co.)*, 563 F.2d 692 (5th Cir. 1977); *In re Virginia Broadband, LLC.*, 521 B.R. 539 (Bankr. W.D. Va. 2014); *In re Mid-Town Produce Terminal, Inc.*, 599 F.2d 389, 392 (10th Cir.1979), noting that "[b]ecause there is incentive and opportunity to take advantage, dominant shareholders and other insiders' loans in a bankruptcy situation are subject to special scrutiny." However, *In re LightSquared Inc.*, 511 B.R. 253, 348 (Bankr. S.D.N.Y. 2014), stating that "courts in this District have held that there is no different or heightened standard by which to judge a non-insider's conduct, though there may be fewer traditional grounds available because neither undercapitalization nor breach of fiduciary duty applies to the conduct of a non-insider."

59 *In re Herby's Foods, Inc.*, 2 F.3d 128 (5th Cir. 1993).

funds through tardily perfected secured loans made at times when no bona fide third-party lender would have done so"; (ii) the parent's loan was not initially reflected on the debtor's books, and when it was finally booked, it was listed as an unsecured loan; (iii) the security interests were perfected only after the debtor stopped making interest payments; (iv) the aggregate size of the debtor's unsecured debt to its trade creditors increased fivefold – an outcome, at least partially attributed to the shareholder's misrepresentations, which encouraged outside creditors to increase their credit exposure to Herby's. The court considered these factors together as indicative of inequitable behaviour, justifying, in the court's view, subordination of the shareholder loans.

Fact-sensitive analysis is a characteristic feature of cases involving equitable subordination. For example, in contrast to the previous case, in *In re SI Restructuring, Inc.*,[60] the court did not subordinate the loan granted by shareholders, even though the loan was secured. It concluded that the proceeds of the loan were used to pay unsecured creditors and to keep the company in operation. According to the court, this meant that unsecured creditors, as a class, were not harmed by the granting of security. Another argument made was that the creditors were harmed due to the value of the debtor deteriorating as a result of "prolonging an insolvent corporation's life through bad debt", as a result of "deepening insolvency". The court declined to follow this theory.[61]

Another case addressing secured loans of shareholders is *In re Phase I Molecular Toxicology Inc.*[62] In this case, the court refused to subordinate the loans, despite them being made at a time when the thinly capitalised debtor was unable to obtain needed financing from any outside source. It reasoned that the purpose of these loans was to cover the debtor's operating expenses until the closing of the anticipated sale of its subsidiary, which was expected to generate significant funds. Additionally, the court considered that the provision of collateral to secure the shareholder loans was not unreasonable and did not rise to the level of inequitable conduct.

In summary, the doctrine of equitable subordination has been developed as a remedy to address inequitable conduct and restore justice or balance among creditors. While not being limited to insiders, the degree of culpable behaviour and the burden of proof required in cases involving internal

60 *In re SI Restructuring Inc.*, 532 F.3d 355 (5th Cir. 2008).

61 Under the theory of "deepening insolvency", directors may be held liable for prolonging the debtor company's life to the detriment of creditors. This theory remains controversial and has been rejected by several courts. For example, the Delaware Supreme Court did not recognise deepening insolvency as an independent cause of action. See *Trenwick Am. Litig. Trust v. Billet (Trenwick)*, 931 A.2d 438 (Del. 2007).

62 *In re Phase I Molecular Toxicology, Inc.*, 287 B.R. 571 (Bankr. D.N.M. 2002).

and external creditors differ.[63] Yet the mere fact of an insider relationship is insufficient to warrant subordination.[64] As pointed out in one case, insiders are often "the persons most interested in restoring and reviving the debtor, and such bona fide efforts should be viewed with approval."[65] The prevailing fact-based analysis demands more than a simple crisis or undercapitalisation of the debtor at the time of financing. Thus, a showing of deception about the debtor's financial condition or some other misconduct is necessary.

7.4.3.2 Debt recharacterization: discovering parties' intentions

Alongside the equitable subordination remedy, US courts acknowledge their power to re-classify debt (11 U.S. Code, §101(12)) as an equity interest (11 U.S. Code, §101(16)) and to treat a loan as a capital contribution. There is no specific provision in the US Bankruptcy Code that allows claim recharacterization. Some courts derive the right to recharacterize a debt claim as equity from general equitable powers.[66] Other courts base their recharacterization mandate on the statutory authority to allow and disallow claims under state law.[67] In practice, the economic effects of debt recharacterization may be similar to those of subordination of a claim pursuant to equitable subordination. In both cases, the claim is placed behind the claims of other creditors, making its satisfaction unlikely.[68] Nevertheless, it is accepted that

63 C.J. Tabb, Law of Bankruptcy, 4th edn, West Academic Publishing, 2016, p. 714, observing that "[i]nequitable conduct sufficient to support a finding of equitable subordination is much easier to establish in the case of a creditor who is an *insider* or an *alter ego* of the debtor" and, conversely, "[c]ourts are very reluctant to subordinate the claim of a noninsider creditor."

64 Collier on Bankruptcy, 16th edn, 2022, Vol. 4, ¶ 510.05.

65 *In re Hyperion Enterprises, Inc.*, 158 B.R. 555 (D.R.I. 1993); cited with approval in *In re AutoStyle Plastics, Inc.*, 269 F.3d 726, 745 (6th Cir. 2001), adding that "[i]nsider transactions are more closely scrutinized, not because the insider relationship makes them inherently wrong, but because insiders "usually have greater opportunities for […] inequitable conduct." See also *In re Rego Crescent Corp.*, 23 B.R. 958, 964 (Bankr. E.D.N.Y. 1982), holding that "the penalty for attempting to save the corporation should not be subordination".

66 11 U.S. Code § 105(a), which states that bankruptcy judges have the authority to "issue any order, process or judgment that is necessary or appropriate to carry out the provisions" of the US Bankruptcy Code. See *In re Dornier Aviation, Inc.*, 453 F.3d 225 (4th Cir.2006).

67 11 U.S. Code § 502(b), which permits courts to disallow debt claims that state law classifies as equity. See *In re Lothian Oil*, 650 F.3d 539, 542 (5th Cir.2011), also confirming that "recharacterization extends beyond insiders and is part of the bankruptcy courts' authority to allow and disallow claims under 11 U.S.C. § 502." The court applied Texas law and ruled in favour of recharacterization. For critique of the split between the courts and support of sole reliance on state law, see J.M. Wilton, W.A. McGee, The Past and Future of Debt Recharacterization, The Business Law, Vol. 74, Winter 2018-2019, pp. 91-125.

68 R. Craig, Groups of companies: the parent subsidiary relationship and creditors remedies, PhD thesis, University of Durham, 1999, p. 322.

the two doctrines are distinct, serve different purposes and involve different considerations.

In *In re AutoStyle Plastics*,[69] it was explained that recharacterization determines the existence of debt by focusing on the underlying substance of the disputed transaction, while equitable subordination answers the question of whether a claim should be subordinated due to the creditor's inequitable conduct. If the claim is recharacterized, the equitable subordination analysis does not come into play.[70]

Despite the predominant view that the US Bankruptcy Code authorises courts to recharacterize claims, the circuits have taken different approaches in identifying the legal framework for such recharacterization.[71] Most courts use flexible and multi-factor tests to determine when a debt claim can be recharacterized as equity.

Wheaton identified three separate lines of federal case law addressing recharacterization.[72]

The first line of cases is represented by the two-pronged test, pursuant to which a shareholder loan may be deemed a capital contribution in two circumstances: (i) the debtor was initially undercapitalised; or (ii) no other disinterested lender would have extended loans at the time they were made.[73] This test is not widely applied, as it may discourage an insider from providing a loan to a distressed company, even if the insider is acting in the best interests of the company and its creditors.

The second line of cases includes a few early decisions in which courts refused to apply the doctrine of recharacterization based on the lack of authority to recharacterize loans. In *In re Pacific Express*, the court stated that "[w]here there is a specific provision governing these determinations [§ 510(c), equitable subordination], it is inconsistent with the Bankruptcy Code to allow such determinations to be made under different standards

69 *In re AutoStyle Plastics, Inc.*, 269 F.3d 726 (6th Cir. 2001).

70 *United States v. Colorado Invesco, Inc.*, 902 F.Supp. 1339 (D.Colo.1995); *Sinclair v. Barr (In re Mid–Town Produce Terminal, Inc.)*, 599 F.2d 389, 393 (10th Cir.1979), noting that "the usual procedure is to first determine whether the transaction was a contribution to capital rather than a loan."

71 Collier on Bankruptcy, 16th edn, 2022, Vol. 4, ¶ 510.02, noting that "[c]ourts have adopted various multi-factored tests borrowed from nonbankruptcy case law to define the recharacterization inquiry."

72 C. Wheaton, Clearing a Minefield of Insolvency Law: Toward Debt Recharacterization as a Supplement to the Bankruptcy Code, Santa Clara Law Review, Vol. 55, 2015, pp. 769-798.

73 *Estes v. N & D Props., Inc.*, 799 F.2d 726, 733 (11th Cir. 1986).

through the use of a court's equitable powers."[74] It seems that this position is no longer supported or followed.[75]

The third and by far the most prevalent position embraces the multi-factor tests, largely inspired by tax law cases concerning tax benefits of insider loans granted to solvent companies. These tests were never designed to apply to recharacterize loans extended to insolvent companies in the context of intra-group financing.[76] They addressed the tax treatment of interest expense as an important revenue issue. The most commonly cited case in this respect is *Roth Steel Tube Co. v. C.I.R.*, which determined the following catalogue of 11 factors to be used in making the capital contribution vs. loan determination:

(1) the names given to the instruments, if any, evidencing the indebtedness; (2) the presence or absence of a fixed maturity date and schedule of payments; (3) the presence or absence of a fixed rate of interest and interest payments; (4) the source of repayments; (5) the adequacy or inadequacy of capitalization; (6) the identity of interest between the creditor and the stockholder; (7) the security, if any, for the advances; (8) the corporation's ability to obtain financing from outside lending institutions; (9) the extent to which the advances were subordinated to the claims of outside creditors; (10) the extent to which the advances were used to acquire capital assets; and (11) the presence or absence of a sinking fund to provide repayments.[77]

Under this multi-factor test, no single factor is seen as controlling or decisive.[78] Instead, all the factors need to be considered. Notably, the insider status, undercapitalisation and dire financial circumstances surrounding the infusion of cash alone have been regarded as insufficient to cause debt recharacterization.[79]

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74 *In re Pacific Express, Inc.*, 69 B.R. 112, 115 (9th Cir. BAP 1986); *In re Pinetree Partners, Ltd.*, 87 B.R. 481 (Bankr. N.D.Ohio 1988) (following *In re Pacific Express*).

75 *In re Fitness Holdings Intern.*, 714 F.3d 1141, 1147 (9th Cir. 2013), noting that "[b]ecause we hold that a court may recharacterize an obligation that does not constitute "debt" under state law, we disagree with *In re Pacific Express, Inc*."

76 *In re Rego Crescent Corp.*, 23 B.R. 958, 962 (Bankr. E.D.N.Y. 1982), commenting on the use of tax law tests that "the legal questions and policy considerations underlying that determination [dividend vs. loan for tax purposes] are so removed from determining whether money advanced should be considered capital contributions or loans for bankruptcy purposes that those cases are in no way relevant to the inquiry before this court."

77 *Roth Steel Tube Co. v. Commissioner of Internal Revenue*, 800 F.2d 625, 630 (6th Cir. 1986). Another often cited case is *Fin Hay Realty Co. v. U.S.*, 398 F.2d 694, 696 (3d Cir. 1968), proposing a list of 16 distinguishing factors. Also, *Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir.1972), adopting a 13-factor test.

78 In cases involving recharacterization, courts typically go over all the factors under the prevailing test. See e.g. *In re Lyondell Chemical Company*, 544 B.R. 75 (Bankr. S.D.N.Y. 2016); *In re Live Primary, LLC*, 626 B.R. 171 (Bankr. S.D.N.Y. 2021).

79 *In re Dornier Aviation, Inc.*, 453 F.3d 225 (4th Cir.2006); *In re SubMicron Systems Corp.*, 432 F.3d 448 (3d Cir. 2006).

The variability of tests and plurality of factors that may dictate the outcome of a case have been criticised as problematic from the standpoint of predictability.[80] Furthermore, courts have acknowledged that recharacterization does not depend on how many of the relevant factors are met; they also assign different weight to these factors. In one case, it was noted that "no mechanical scorecard suffices. And none should, for Kabuki outcomes elude difficult fact patterns."[81] In our view, predictability of Kabuki outcomes can actually be a virtue, especially from the perspective of group (insider) financiers, without any wrongful conduct on their part. The reason is that the totality-of-the-facts-in-each-case test affords courts wide discretion to recharacterize insider debt as equity. This creates legal uncertainty and compels insiders to engage in a box-ticking exercise to comply with formalities typical of debt instruments. After all, carefully documented loans are less likely to be recharacterized, but uncertainty may still remain. For example, in *In re AtlanticRancher*,[82] the court recharacterized an insider loan, despite the fact that the loan was properly documented, used for working capital, and treated as debt on the debtor's books. Yet, when making the decision to recharacterize, the court held that the insider never made any effort to collect the debt or to foreclose on his collateral. It noted that the creditor "recognized that if he attempted to exercise his rights as a secured creditor it would have put the company out of business."[83] According to the court, the creditor's behaviour signalled that the debt was not treated as a loan but rather as an investment.

To conclude, the boundaries of the recharacterization doctrine in the USA are not clear. First, the very legal basis of the doctrine is disputable. While some US courts rely on the equitable powers granted to them under § 105(a) of the US Bankruptcy Code, other courts adhere to the view that the power to recharacterize should be derived from state law. Second, different multi-factor tests are developed to determine whether an insider loan should be treated as an equity contribution. These tests may produce inconsistent and unpredictable results. They could also have a chilling effect on the willingness of insiders to extend financing to a financially distressed

80 D.A. Skeel and G. Krause-Vilmar, Recharacterization and the Nonhindrance of Creditors, EBOR, Vol. 7, 2006, p. 278, arguing that there are two intractable problems with the "welter of factors". The first being that many of such factors "are either unhelpful or used in precisely the wrong way". The second problem is that the list of factors "tended to distort court's analysis of what should and should not be honored as a loan." H.A. Goehausen, You Said You Were Going to Do What to My Loan? The Inequitable Doctrine of Recharacterization, DePaul Business and Commercial Law Journal, Vol. 4, 2005, p. 133, noting that the doctrine has spawned "conflicting standards and inconsistent judicial decisions" and pointing out that since the doctrine does not require a showing of bad faith or misconduct on the part of a lender, "it is easier for a trustee or creditor to be successful in a recharacterization action then in a claim for equitable subordination."

81 *In re SubMicron Systems Corp.*, 432 F.3d 448, 456 (3d Cir. 2006).

82 *In re AtlanticRancher*, Inc., 279 B.R. 411 (Bankr. D. Mass. 2002).

83 Ibid., at 437.

group member or to refuse to foreclose on collateral or collect the loan in hopes of rescuing such a group member.[84] Third, the parallel existence of two doctrines – equitable subordination and recharacterization – with some overlapping elements or factors (e.g. undercapitalisation) and similar results is hard to justify. It may lead to confusion and further complicate the position of internal creditors.

7.4.4 The Netherlands: conflicting authorities

The issue of statutory subordination of shareholder loans is not settled in the Netherlands.[85] The Dutch Bankruptcy Act does not contain express rules on shareholder loans, and the case law remains contradictory.

In *Oude Grote Bevelsborg q.q./Louwerier q.q.*,[86] the District Court of Breda ruled in favour of subordinating an intercompany claim. The case concerned a claim of the parent company (Stichting Ambacht) against its subsidiary (Ambacht B.V.). The latter was highly dependent on the support from its parent, which provided staff, equipment and materials. When Stichting Ambacht became insolvent, Ambacht B.V. ended up in bankruptcy. The trustee of the parent company submitted a claim in the bankruptcy proceedings of Ambacht B.V. The trustee of the subsidiary did not dispute the existence of the claim but argued that it should be subordinated and treated as a capital contribution. If subordination was ordered, the ordinary creditors could receive the full payment on their claims. Without subordination, the payouts would drop to 40-45%.

The court considered the method of financing and the relationships between the group entities. It noted that in special circumstances there may be grounds to treat a claim as subordinated, even if there was no contractual basis for it. In answering the question of whether in the present case there was a reason to treat the parent's claim differently from the claim of other creditors, the court considered both the method of financing and the interrelationship between the group entities. The court concluded that the claim of Stichting Ambacht against Ambacht B.V. should be considered an informal provision of capital, subordinated to the claims of other creditors. It took into account the close business integration of the two companies. Both

84 For a similar view, see S. Mba, New Financing for Distressed Businesses in the Context of Business Restructuring Law, Springer, 2019, p. 52. Mba refers to the situation around recharacterization tests as a "doctrinal bedlam". J.M. Wilton, W.A. McGee, The Past and Future of Debt Recharacterization, The Business Law, Vol. 74, Winter 2018-2019, p. 106, noting that the use of various tests leads to unpredictable results "that discourage out-of-court workouts and reorganization of insolvent businesses."

85 J. Barneveld, F. Corpeleijn, Financiering met risicomijdend vermogen? Over de aandeelhouderslening in faillissement, TvI 2014/39.

86 Rb. Breda 7 July 2010, *JOR* 2010/293 (*Oude Grote Bevelsborg q.q./Louwerier q.q.*).

companies performed similar activities, used the same staff, and even completed work of each other, only deciding afterwards whether to assign such work to Stichting Ambacht or Ambacht B.V. The subsidiary's continued existence depended on its parent company. This close connection between the two companies was also apparent from the fact that the insolvency of the parent caused the insolvency of its subsidiary. Given these circumstances, the court pointed out that it would be "contrary to reasonableness and fairness for a controlling shareholder that has established the company, had absolute control over the company and has maintained it through the current-account financing, to share in the proceeds of the insolvency estate in the same way as unsecured creditors."[87]

This line of reasoning was not followed in *P&O Partner/Wind Holding*.[88] The debtor company was a developer and manufacturer of offshore wind turbines. On 30 June 2009, the debtor was declared bankrupt. Wind Holding B.V. (Wind) held a 90% stake in the debtor company. Wind itself became insolvent. Pursuant to the loan facility agreement dated 1 October 2008, Wind transferred more than EUR 10 million to the debtor over the period from 31 December 2008 to 8 May 2009. This was the claim submitted by Wind in the insolvency proceedings of the debtor. One of the debtor's creditors, P&O Partner B.V. (P&O), argued that the shareholder loan must be subordinated. The court disagreed.

First, it referred to Article 3:277(1) of the Dutch Civil Code, which states that creditors have an equal right to recover their claims from the debtor's assets, except for reasons of priority granted by law. Second, the court acknowledged that a debtor and a creditor may contractually agree on subordination (Article 3:277(2) BW). It did not follow from the loan documentation that such an agreement was reached in the case at hand. P&O submitted that the parties had decided to convert the loan into equity, and in line with the judgment in the above case, the loan should be treated as an informal capital contribution. However, the conversion from debt to equity was not finalised, nor was it proven that the parties always intended

87 Ibid. Also Gerechtshof Amsterdam 5 November 2005, *JOR* 2007/51, m.nt. S.M. Bartman (*Carrier 1*), where the court approved the unequal treatment of the parent company under the restructuring plan (the parent was promised a smaller distribution of 5.6% compared to other unsecured creditors receiving 33%). The court concluded that the plan was the only feasible compromise and that the loan to the wholly owned subsidiary, in the given situation, at least partly had the character of a capital injection. No specific reasoning was given for classifying the loan as "capital replacement", but the first instance court focused on the fact that the loan was provided at a time and under conditions that would not be accepted by any third party. Commenting on *Carrier 1*, Bartman questioned whether, in the absence of a clear legal basis for a distinction between capital-replacing and other loans, the court's motivation would stand in cassation.

88 Gerechtshof Arnhem-Leeuwarden 10 March 2015, *JOR* 2015/160, m.nt. J. Barneveld (*P&O Partner/Wind Holding*).

to convert the loan into equity. Third, the court noted that Wind's loan to the debtor was an intercompany or shareholder loan, which had no special status under Dutch law, in a sense that Dutch law did not prescribe its subordination. It could not be deduced from case law and literature that the prevailing doctrine supported subordination or that subordination was desirable. Fourth, the court accepted that unlawful behaviour of the parent company may result in its liability towards the subsidiaries' creditors under Article 6:162 BW as a tortious act. It is generally accepted that a parent company must take into account the interests of (future) creditors of its subsidiary when financing such a subsidiary. This is relevant where, in the absence of any real prospects of survival, the subsidiary is financed by shareholder loans, which could mislead creditors and create the impression of creditworthiness, while it would have been in the interest of creditors to cease the debtor's activities. Finally, the court mentioned that subordination could possibly be construed on the basis of the principle of reasonableness and fairness.[89] In the given case, however, this principle was not breached.

In summary, the analysis of the limited case law from lower Dutch courts concerning subordination of shareholder loans does not lead to a clear conclusion. The Dutch Bankruptcy Act does not explicitly address this issue, and the Dutch Supreme Court has not yet expressed its position. However, it is clear that there is no automatic subordination of insider claims. If such subordination is available at all, it is reserved for cases involving harmful behaviour by an insider. In this context, subordination might be seen as compensation for improper conduct.[90] An insider may also be deemed to act unlawfully when disregarding the standards of reasonableness and fairness as applied to creditors. This brings the Dutch approach closer to the US doctrine of equitable subordination, as both require some form of inequitable conduct and reject the notion that insider status alone justifies subordination.

Yet one should exercise caution when drawing any parallels. There are several reasons why making a comparison may be difficult or undesirable, including: (i) the inherent ambiguity of the term "inequitable conduct" and the boundaries of "reasonableness and fairness"; (ii) the fact that, unlike the US Bankruptcy Code, the Dutch Bankruptcy Act does not contain any specific rules on subordination; (iii) the lack of internal coherence in the application of the subordination rules and standards. This is explained

89 On reasonableness and fairness as applied to creditors, see F.M.J. Verstijlen, De faillissementscurator, W.E.J. Tjeenk Willink, 1998, p. 73ff; M.J.M. Franken, Verificatie van vorderingen, redelijkheid en billijkheid tussen schuldeisers onderling: een gemiste kans?, in: N.E.D. Faber et al., De bewindvoerder, een octopus, Serie Onderneming en Recht deel 44, Deventer: Kluwer 2008.

90 N.B. Pannevis, Achtergestelde vorderingen (Onderneming en recht nr. 114) (diss. Nijmegen), Deventer: Wolters Kluwer 2019, 2.4.

by the fact-sensitive analysis characterising cases involving intercompany financing and subordination of insider debt. This is in contrast to UK law, which only subordinates shareholder claims closely tied to the shareholder status (e.g. payment of dividends) and does not prescribe subordination of shareholder loans. Comparative analysis shows the divergence of approaches, necessitating taking a closer look at the arguments found in case law and literature in favour and against statutory subordination of insider claims. Some of them are examined below.

7.5 Shareholder Loans: to Subordinate or not to Subordinate?

7.5.1 Facilitation of early insolvency filings

There is no *communis opinio* or widely held view as to whether financing provided by related parties should be subordinated in insolvency, and if so, under which conditions and with what exceptions, if any. The landscape of national responses to these questions is equally divided. This section offers a concise overview and assessment of some arguments in favour and against statutory subordination of insider loans. In this overview, references to German cases and literature will be made because these sources are particularly well-developed and insightful on the given subject, owing to the strictness and pervasiveness of the German subordination rules.

One of the arguments used in support of the rules imposing subordination of shareholder loans is that it facilitates early filings for insolvency, thereby preventing the build-up of non-performing loans and minimising creditor losses. For example, the materials supplementing the Austrian Equity Substitution Act (EKEG) recognised that subordination of loans has the side effect of counteracting the delay in insolvency filings.[91] This is premised on the assumption that before granting a loan, a shareholder will be more cautious in evaluating the chances of a successful restructuring. If the chances are low (and therefore, the return on the subordinated loan is unlikely), the support will not be provided, and the debtor would be more inclined to file for insolvency in a timely manner. Along the same lines, the German Federal Court of Justice (BGH) has held that the recharacterization of shareholder loans is not solely intended to prevent the shareholder from satisfying its claims before or alongside creditors, but it should also rule out the delay in a crisis response and curb any further reduction of remaining

91 Bundesgesetz, mit dem ein Bundesgesetz über Eigenkapital ersetzende Gesellschafterleistungen (Eigenkapitalersatz-Gesetz - EKEG) geschaffen wird sowie mit dem die Konkursordnung, die Ausgleichsordnung, das Unternehmensreorganisationsgesetz und das Übernahmegesetz geändert werden (Gesellschafts- und Insolvenzrechtsänderungsgesetz 2003), <https://www.parlament.gv.at/PAKT/VHG/XXII/I/I_00124/index.shtml> (accessed 15 July 2023).

assets at the expense of creditors.[92] The BGH emphasises the importance of ensuring that a shareholder uses equity support if it enables the debtor to continue trading and thereby creates an impression to outside creditors of a fully capitalised and viable company. If the shareholder recognises that the company is no longer viable, he must either refuse to support such a company and initiate liquidation, or, if he decides to continue providing assistance, he should do so at his own risk.[93]

Nevertheless, the correlation between subordination of shareholder loans and early insolvency filings is not obvious. Meilicke argues that the goal of a timely insolvency filing is more likely to be achieved without subordination. By granting an unsecured loan, a shareholder acquires a stake ("skin in the game") and an incentive to implement successful restructuring. In other words, a shareholder loan aligns the interests of a shareholder with those of external creditors. In contrast, subordination could make the shareholder go all-in, as he has nothing to lose if the insolvency filing is delayed.[94] Verse agrees and points out that if a shareholder bears the risk of non-return of the loan, he has "a strong incentive to avoid excessive risk and to make a careful assessment of the chances of the company's survival before granting the loan."[95] Similarly, Cahn expresses doubts that, in the absence of subordination, shareholders would be inclined to finance inefficient rescue attempts or artificially extend the life of economically unviable businesses.[96] Some authors suggest that the goals of timely insolvency filing and adequate protection of creditors may be better achieved through other legal mechanisms and remedies, including liability for wrongful trading and transaction avoidance.[97]

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92 BGH, Urteil vom 16. Oktober 1989 - Az. II ZR 307/88.

93 Ibid.

94 W. Meilicke, Das Eigenkapitalersatzrecht - eine deutsche Fehlentwicklung, GmbH-Rundschau, 2007, s. 225-236.

95 D.A. Verse, Shareholder Loans in Corporate Insolvency – A New Approach to an Old Problem, German Law Journal, Vol. 9, 2008, p. 1116.

96 A. Cahn, Equitable Subordination of Shareholder Loans? EBOR, Vol. 7, 2006, p. 300, observing that "given the uncertainties inherent in calculating expected values and the fact that shareholders are not likely to put substantial amount of fresh money at stake if they do not have good reason to expect a successful turnaround, the chances in practice of fostering overinvestment are probably negligible."

97 H. Eidenmüller, Comparative Corporate Insolvency Law, in J.N. Gordon, W-G. Ringe (eds), The Oxford Handbook of Corporate Law and Governance, OUP, 2018, p. 1024; J. Barneveld, Financiering en vermogensonttrekking door aandeelhouders, Serie vanwege het Van der Heijden Instituut, vol. 120, Deventer: Kluwer, 2014, p. 584, arguing that "[r]ather than an unconditional subordination of all shareholder loans that were furnished in a crisis or a general prohibition of shareholder security, inefficient rescue operations should be prevented by the threat of the wrongful act and the fraudulent transfer (in bankruptcy law)."

7.5.2 Responsibility for consequences of financial decisions

Responsibility for financial decisions represents an important doctrinal basis relied upon by courts and scholars to support statutory subordination. The BGH explains that subordination arises from the shareholders' responsibility to finance their company.[98] This responsibility does not impose a positive obligation on them to replenish the lack of capital from their own assets. Yet, the argument goes, it entails that a shareholder cannot choose a less risky form of financial support to the detriment of other creditors. In other words, if the company is in financial distress, shareholders should take *special responsibility* for the consequences of financial decisions. A similar idea was expressed in the materials accompanying the EKEG.

It is accepted that shareholders are in principle free to choose the form of financing – debt or equity (*Grundsatz der Finanzierungsfreiheit*).[99] Debt financing (e.g. shareholder loan) could be preferred as a more flexible financing instrument compared to a capital increase, as it can be used at short notice when necessary to improve the dire liquidity situation and to avoid defaults and cross-defaults. Subordination of shareholder loans may constitute an interference with the freedom to select the means of financing. If insiders maintain this freedom and are not obliged to finance their companies with equity, where does the special responsibility come from? It is argued that it arises from unwritten general obligations of conduct of shareholders (*allgemeine Verhaltenspflichten der Gesellschafter*).[100]

It appears that the concept of "responsibility for consequences of financial decisions" is linked to the power of shareholders to direct the company and decide what to do with it once it has entered a crisis period. If the company is in a crisis, its shareholders should decide whether to liquidate it or to provide the necessary funding. However, it is not apparent why such funding should be extended in the form of equity. Besides, following the amendments to the InsO in 2008,[101] the distinction between loans granted during the crisis period and at any other time is removed. This means that under German law, and subject to a few exceptions, all shareholder loans are automatically subordinated, irrespective of whether the company was distressed at the time when the loan was advanced. In the wake of the 2008 reform, the BGH confirmed that "[s]ince the repayment of shareholder loans is contestable regardless of their purpose and regardless of the company's

98 BGH, Urteil vom 26 März 1984 - II ZR 171/83.

99 BGH, Urteil vom 7 November 1994 - II ZR 270/93.

100 K. Schmidt, Vom Eigenkapitalersatz in der Krise des Eigenkapitalersatzrechts? GmbH-Rundschau, 2005, s. 798.

101 Gesetz zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen (MoMiG) vom 23. Oktober 2008. See § 39(1)(5) InsO.

economic situation, the affiliated group companies cannot invoke the lack of responsibility for the consequences of financing."[102]

Re-interpreting the responsibility for the consequences of financial decisions in light of the 2008 reforms, Bork argues that these reforms introduced an irrebuttable presumption of a crisis if shareholders finance their company through loans. According to him, "if the company needs money, it normally receives it on the market. If it obtains the loan from its shareholders instead of the market, it is irrefutably presumed that it is in the "crisis" and in urgent need of equity capital [*Eigenkapital*]".[103] Some commentators do not support this line of reasoning, noting that it is somewhat artificial.[104]

7.5.3 Risk re-allocation and risk shifting

The third argument revolves around the distinct characteristics of shareholders and the levels of risk taken by internal and external creditors (see section 7.3.3.). The argument states that by choosing to extend a loan instead of making an equity contribution, a shareholder gets protection in case the debtor fails, while at the same time benefitting from potentially unlimited growth if it succeeds.[105] This problem is inherent in the corporate form, where shareholders do not internalise losses and costs of failure due to limited liability.[106] The risk re-allocation feature of shareholder loans was vividly described in *In re V. Loewer's Gambrinus Brewery Co.*, dealing with loans provided by a creditor who had the same shareholders as the borrower:

102 BGH, Urteil vom 21 Februar 2013 – IX ZR 32/12. The BGH continues to recognise the responsibility for the consequences of financial decisions as a reason for the special treatment of shareholder external financing under insolvency law.

103 R. Bork, Abschaffung des Eigenkapitalersatzrechts zugunsten des Insolvenzrechts? *ZGR* 2007, s. 257. For a similar position, see H. Altmeppen, Das neue Recht der Gesellschafterdarlehen in der Praxis, *NJW* 2008, s. 3602. Also, H. Hirte, InsO § 39 Nachrangige Insolvenzgläubiger. Uhlenbruck, Insolvenzordnung: InsO. 15. Auflage 2019, noting that there is an irrefutable presumption of the abusive nature of loans granted by shareholders, even if such loans are granted prior to the crisis. For a different view, see M. Kampshoff, Behandlung von Bankdarlehen in der Krise der GmbH, GmbHR 2010, 897, arguing that the reason for subordination lies in the proximity of the shareholder to the company, the associated information advantage and a greater scope for influence.

104 C. Behme, InsO § 39 Nachrangige Insolvenzgläubiger, Münchener Kommentar zur Insolvenzordnung, 4. Auflage 2019, Rn. 42-47, stating that the crisis presumption is pure fiction; T. Fedke, Konzerninnenfinanzierung nach dem MoMiG in insolvenznahen Szenarien, *NZG* 2009, 928.

105 R.J. de Weijs, M. Good, Shareholders' and creditors' entitlements on insolvency: who wins where? Butterworths Journal of International Banking and Financial Law, November 2015, p. 643, observing that shareholder loans "dramatically change the risk profile of the company" and prompt "shareholders to have the company make riskier investments."

106 E. Ferran and L.C. Ho, Principles of Corporate Finance Law, OUP, 2014, p. 11.

> Both the shareholders and the creditors in any enterprise assume some risk of its failure, but their risks are different. The shareholders stand to lose first, but in return they have all the winnings above the creditors' interest, if the venture is successful; on the other hand the creditors have only their interest, but they come first in distribution of the assets. Beneficially considered, the same persons are both creditors and shareholders, when they have organized into two corporations under a single control. If in such a case they are allowed to prove in insolvency on a parity with other creditors, as shareholders of the debtor they can use their control to take all the winnings which may be made on their advances while the company is successful, yet they will expose themselves only to creditors' risks, if it fails. […] To compel [an outside creditor] to divide the assets in insolvency with those who at their option have all along had power to take all the earnings, is to add to the risk which he accepted.[107]

The risk-bearing nature of equity contributions creates an incentive for shareholders to monitor management and engage in corporate governance.[108] Equating the position of shareholders with that of creditors leads to risk re-allocation and weakens the said incentive. The risks are effectively externalised from shareholder to creditors. Subordination rules aim to restore the shareholder-creditor balance and create a disincentive to pursue inefficient and unjustifiably risky strategies, and engage in what is known as "gamble for resurrection". According to the BGH, subordination rules seek to prevent shareholders from passing the associated financing risks to outside creditors. The BGH argues that a shareholder "should not be allowed to speculate at the expense of the company's creditors in the expectation of being able to get his money to safety in due time due to better information possibilities."[109] Nevertheless, the BGH clarifies that the information advantage of a shareholder is not the decisive reason for subordination of a loan granted by it.[110] Therefore, the presence of contractual covenants, granting a creditor (e.g. a bank) certain information and control rights usually does not lead to subordination.[111]

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107 *In re V. Loewer's Gambrinus Brewery Co.*, 167 F.2d 318 (2d Cir. 1948).

108 L. Gullifer, J. Payne, Corporate Finance Law: Principles and Policy, 3rd edn, Hart Publishing, 2020, p. 78, noting that it is the "ordinary shareholders, rather than the creditors, who will benefit from the capital gains that flow from the company's success, but they will also lose first should the enterprise fail". These factors give shareholders "the incentive to monitor management, and it is for this reason that company law gives the shareholders a significant corporate governance role."

109 BGH, Urteil vom 26 März 1984 - II ZR 171/83; BGH, Urteil vom 26 November 1979 - II ZR 104/77, noting the risk shifting function of shareholder loans.

110 BGH, Urteil vom 17 Februar 2011 – IX ZR 131/10. The BGH accepted that the information advantage can result in a loan being withdrawn before insolvency becomes apparent. Such a withdrawal is addressed by § 135 and not § 39 of InsO. In other words, the information and control advantages of shareholders may be addressed by means other than subordination.

111 BGH, Urteil vom 6 April 2009 – II ZR 277/07.

Continuing with the shareholder-creditor divide, it is pointed out that combining the roles of a creditor and a shareholder, especially if the shareholder's claim is secured, distorts the operation of transaction avoidance rules and contravenes the fundamentals of insolvency law.[112] The argument goes that if shareholders can establish security rights over corporate assets and thereby guarantee re-payment of (a part of) their investment, insolvency transaction avoidance rules and rules prohibiting pre-insolvency payment of dividends could lose their relevance. Insiders will simply have no need to engage in behaviour to extract undue benefits. For example, in the bankruptcy proceedings of the Dutch retail chain V&D, the ultimate shareholder, the US private equity firm Sun Capital, had security over almost all V&D's assets.[113] As a result, it could satisfy its claims in priority to other creditors whose claims were unsecured. This demonstrates that the idea that in insolvency, creditors are residual claimants and shareholders lose their ownership stake[114] does not match the practice of preserving shareholder control and ownership through a combination of a shareholder and creditor status.

Be it as it may, in Germany, there are some exceptions to subordination rules that are not easy to reconcile with the risk shifting argument or the idea of switching roles in governance and ownership. The first exception relates to the degree of control over the debtor. Thus, loans provided by shareholders holding no more than 10% of the equity stake and who are not involved in the management of the company are exempted (small participant privilege).[115] Yet, small shareholders equally benefit from the upside and have little or nothing to lose in the downside – their equity is wiped out in insolvency. Their risk appetite could be similar to that of majority shareholders. The second exception relates to distress financiers – investors with-

112 R.J de Weijs, Harmonization of European Insolvency Law: Preventing Insolvency Law from Turning against Creditors by Upholding the Debt-Equity Divide, ECFR, 2, 2018, p. 424, stating that subordination fits into the overall framework of insolvency law, including the rules on transaction avoidance and dividend payments. According to De Weijs, these rules become moot, if shareholders can guarantee the return through secured lending. For an overview of arguments in favour and against subordination, see R. de Weijs, J. de Vries and A. Jonkers, Corporate Finance for Lawyers, Edward Elgar Publishing, 2023, Chapter 6.

113 Public report dated 10 December 2019 pursuant to Article 73A Bankruptcy Act, 9th public report in insolvency of V&D <https://florent.nl/wp-content/uploads/2019/12/VD-en-LP-Verslag-09-EN.pdf> (accessed 15 July 2023). Shareholder claims were also fully secured in insolvency of another Dutch company McGregor. See Combined 1st public report of 1 September 2016 - McGregor Fashion Group Holding B.V. <https://cms.law/nl/media/local/cms-dsb/files/bankruptcies/combined-1st-public-report-of-1-september-2016-mcgregor-fashion-group-holding-b.v.-english?v=4> (accessed 15 July 2023).

114 J. Armour, G. Hertig and H. Kanda, Transactions with creditors, in R. Kraakman et al. (eds), The Anatomy of Corporate Law, OUP, 2017, p. 109.

115 InsO, § 39(5).

out a prior equity stake who acquire a stake in the course of restructuring, usually as a result of the debt-to-equity swap (restructuring privilege).[116] By investing in the financially distressed company, often at discounted rates, such investors may be driven by potentially unlimited growth, should the restructuring succeed.[117] These exceptions show that when it comes to subordination, the shareholder-creditor divide is not bulletproof, even in countries with rigid subordination rules.

7.5.4 Value-enhancing and value-destroying rescue attempts

Intra-group financial support may facilitate efficient restructuring. It is widely recognised that businesses need money, and struggling businesses need it the most. Money is required to support the continued operation of the debtor during its negotiations with creditors and to implement the restructuring plan upon confirmation. Preservation of operational continuity may be equally important when contemplating the sale of the business as a going concern, as any interruption might result in a reduction in its price. Access to funds is critical to ensure business continuity and timely payments to critical suppliers of goods and services, lessors, employees, insurance providers, and other stakeholders.[118]

In groups of companies, a common source of funds could be within the group and include both solvent group entities and group members already subject to insolvency proceedings. For illustrative purposes, the Singapore case is of interest. Based on the mix of empirical data and case studies on Singapore schemes in the period of 1996-2019, Wan et al. have observed that "when companies are approaching insolvency or financial distress, controlling shareholders do not unnecessarily hold out; […] they add value (in the provision of financial support) and are often critical to the success of restructuring efforts."[119] The authors conclude that new financing by controlling shareholders is one of the conditions or essential predictors of the effectiveness of schemes.[120]

116 InsO, § 39(4).
117 W. Meilicke, Das Eigenkapitalersatzrecht - eine deutsche Fehlentwicklung, GmbHR, 2007, s. 225-236.
118 UNCITRAL Legislative Guide, Part two, Ch. II, para. 94.
119 W.Y. Wan, C. Watters and G. McCormack, Schemes of Arrangement in Singapore: Empirical and Comparative Analyses, American Bankruptcy Law Journal, Vol. 94, 2020, p. 486.
120 Ibid., p. 502.

The value of new financing is not simply intuitive. A positive effect of rescue financing on the chances of business survival is highlighted in a number of empirical studies.[121] Some of them conclude that debtors with debtor in possession (DIP) financing are more likely to successfully emerge from Chapter 11 compared to the companies that did not receive such financing.[122] The positive impact of post-petition financing on reorganisation is accepted by the American Bankruptcy Institute (ABI) Commission to Study the Reform of Chapter 11 (ABI Commission). It recognised the need for a robust and competitive post-petition financing market and the value that it provides to distressed firms.[123] The importance of rescue financing is also pointed out in the non-US context.[124] Tsioli emphasises that rescue financing "counteracts potential value-destructive 'lingering' of the case, moves it along more briskly and as such helps preserve the debtor's going concern value."[125]

What are the effects of subordination?

In the analysis of the economic effects of subordination rules, Gelter argues that "[even] though subordination has some beneficial effects, it deters some desirable rescue attempts and is an insufficient deterrent for some

121 The term "rescue financing" is mainly used in the EU and the UK, whereas the term "DIP financing" is prevalent in the USA.

122 S. Dahiya et al., Debtor-in-possession financing and bankruptcy resolution: Empirical evidence, Journal of Financial Economics, Vol. 69, 2003, pp. 259-280, finding that DIP-financed companies had a shorter reorganisation period. The authors did not find evidence of overinvestment (e.g. the undertaking of risky projects and projects with negative NPV). U.S. Dhillon, T. Noe and G.G. Ramírez, Debtor-in-possession financing and the resolution of uncertainty in Chapter 11 reorganisations, Journal of Financial Stability, Vol. 3, 2007, pp. 238-260, concluding that DIP financing resolves information asymmetries regarding the value of the firm and is correlated with successful reorganisations.

123 ABI Commission to Study the Reform of Chapter 11, Final Report and Recommendations, 2014, p. 77.

124 L. Stanghellini et al. (eds), Best Practices in European Restructuring. Contractualised Distress Resolution in the Shadow of the Law, Wolters Kluwer, 2018, p. 60, referring to Italian quantitative and qualitative analysis, underlining the importance of new financing to rescue businesses in distress. It is observed that commonly new finance comes from the debtor's shareholders.

125 L. Tsioli, Rescue financing under a 'viability spotlight', Journal of Corporate Law Studies, Vol. 22, 2022, p. 858. Tsioli also highlights the risks related to the exercise of creditor control through DIP financing.

undesirable ones."[126] A similar argument was made by other scholars.[127] For instance, Van Zwieten notes that "a rule mandating the subordination of related party creditor claims would likely limit the availability of insider capital even in circumstances where it might reasonably be expected to increase firm value […]."[128] She points out that a rule that imposes mandatory subordination of related party debt claims "seems highly unattractive, given the potential for related party loans to be value-enhancing for the firm."[129] De Weijs, who generally supports subordination, still notes that the prevention of desirable rescue attempts is "[o]ne of the strongest and most serious critiques as to subordination rules relates to rescue attempts."[130]

Relying on a statistical hypothesis testing, Gelter distinguishes two types of errors relevant for subordination. Type I error occurs if inefficient (negative expected value) rescue attempts are not prevented, so that the life of a dying business is artificially extended (overinvestment). This leads to the accumulation of debt and results in a dissipation of the firm's value to the detriment of creditors. Subordination partly internalises risk with shareholders and can therefore facilitate a timely exit of inefficient firms from the market.[131] Type II error arises where efficient firms are liquidated instead

126 M. Gelter, The subordination of shareholder loans in bankruptcy, International Review of Law and Economics, Vol. 26, 2006, p. 478.

127 S. Mba, New Financing for Distressed Businesses in the Context of Business Restructuring Law, Springer, 2019, p. 55, noting with respect to the German approach that "it would appear that the law does not countenance the need to support the superstructure on which informal distress financing rests, one of which is the provision of restructuring financing and an increasingly important source of this financing being insider/shareholder financing." See also H. Eidenmüller, Comparative Corporate Insolvency Law, in J.N. Gordon, W-G. Ringe (eds), The Oxford Handbook of Corporate Law and Governance, OUP, 2018, p. 1024, stating that "a subordination rule discourages debt financing by shareholders if the company is in financial distress, and the shareholders may be the only available financing source in such a setting. As a consequence, the prospects for a restructuring of the firm might be greatly reduced." M.R. Tucker, Debt Recharacterization During an Economic Trough: Trashing Historical Tests to Avoid Discouraging Insider Lending, Ohio State Law Journal, Vol. 71, 2010, p. 191, arguing that "[c]ourts must not inadvertently prohibit a company's most readily available source of funding [insider financing] by imposing on insiders an unreasonable fear of loan invalidation because of the existing capricious doctrine of debt recharacterization."

128 K. van Zwieten, Related Party Transactions in Insolvency, in L. Enriques and T.H. Tröger (eds), The Law and Finance of Related Party Transactions, CUP, 2019, p. 275.

129 Ibid., p. 274. According to Van Zwieten, a more attractive route to prevent misuse of related-party transactions is a director-targeting personal liability rule. A similar position is taken by Eidenmüller.

130 R.J. de Weijs, Hybrid finance by means of shareholder loans, in R. de Weijs, J. de Vries, A. Jonkers, Corporate Finance for Lawyers, Edward Elgar Publishing, 2023.

131 M. Gelter, The subordination of shareholder loans in bankruptcy, International Review of Law and Economics, Vol. 26, 2006, p. 486.

of being saved (underinvestment).[132] The extent or degree to which subordination reduces overinvestment and increases underinvestment is not entirely clear,[133] and requires empirical evaluation. Yet assuming that there are instances where subordination discourages the provision of intra-group loans to economically viable group entities and thereby prevents efficient rescue attempts (i.e. Type II error), the overall outcome may be detrimental to social welfare. Armour, Hertig and Kanda explain this by noting that:

> The rationale [of subordination] is to deter overinvestment in distressed firms, but such doctrines must walk a tightrope between deterring this and permitting controlling shareholders to make legitimate efforts to rescue failing firms through the injections of new debt capital. Perhaps reflecting these difficulties, this doctrine is not applied in France or the UK.[134]

This is why, for instance, following the recent reforms seeking to encourage shareholders to provide loans to their distressed companies, subordination rules were weakened in Italy. Under reformed Italian law, subordination does not apply to claims of shareholders and other parties exercising direction and control over the debtor arising from loans and guarantees granted by them for the purposes of a *concordato preventive* or debt restructuring agreement up to 80% of the original claim.[135] In this 80%-part, financing is subject to the special regime of *prededuzione*, which gives priority over unsecured creditors. The remaining 20% is subordinated. By contrast, while the German StaRUG allows a plan to incorporate new financing agreements, including those from shareholders (shareholder loans), if the debtor subsequently enters bankruptcy proceedings, shareholder loans under the plan remain shareholder loans, which means that they are subordinated in insolvency distribution (§ 39(1)(5) InsO). Besides, security granted to subordinated debt is widely avoidable.[136]

The difficulty lies in finding a balance between preventing overinvestment in economically non-viable enterprises through intra-group loans, on the one hand, and protecting and encouraging those transactions which aim at value creation and efficient allocation of resources and liquidity within

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132 Ibid. Gelter seems to view subordination as a way of penalising shareholders. See ibid., p. 479.

133 S. Landuyt, A Capital Question, A Capital Question, Should Shareholder Loans be Automatically Subordinated?, in D. Bruloot (ed), Belgian and European perspectives on creditor protection in closed companies, Intersentia, 2019, p. 142, arguing that it is "unlikely that in case of the subordination of shareholder loans the costs of the underinvestment problem will outweigh the benefits generated by the deterrence of excessive risk-taking."

134 J. Armour, G. Hertig and H. Kanda, Transactions with creditors, in R. Kraakman et al. (eds), The Anatomy of Corporate Law, OUP, 2017, p. 132.

135 Codice della crisi d'impresa e dell'insolvenza (Decreto Legislativo 12 gennaio 2019, n. 14), Articles 102(1) and 292(2).

136 InsO, §135.

the group, on the other hand. Our view is that blanket subordination of all insider loans does not establish such balance, as it does not distinguish between value-enhancing and value-destroying rescue attempts. In other words, it may be disproportionate.

Facilitation of intra-group loans in a situation of financial distress (absent external financing on comparable terms) can contribute to the maximisation of enterprise value and preservation of the debtor's business, from which outside creditors and other stakeholders, like employees, can benefit. The sole fact that financing comes from an insider does not change this. However, to mitigate the risk of inefficient rescue attempts and externalisation of costs, a supervised and controlled legal framework for rescue financing may be considered (see Chapter 12). Should the law provide for subordination, this framework might ensure that if the rescue attempt has a positive expected value, subordination does not follow. This would mitigate the problem of underinvestment while discouraging overinvestment.

7.6 Conclusion

In the beginning of this chapter, we compared intra-group, inward-looking financing to the blood flows within a human body. Just like the circulatory system, wherein blood circulates and transports nutrients, such as amino acids and oxygen, to different organs of the body, the provision of capital and liquidity to constituent group entities could be vital for their continued operation and survival. A centralised cash management or cash pooling system, typical for many large enterprise groups like Lehman Brothers, may be seen as the closest analogue to the circulatory system (to the extent that it is possible to compare a living organism with an artificial construct such as a legal entity or an enterprise group). This chapter focuses on intra-group loans, which constitute a common way to re-allocate liquidity within groups of companies.

One issue that is specific to intra-group loans is their potential subordination in insolvency. It means that shareholder loans are repaid after unsecured creditors. It has been shown that countries adopt very different approaches to the issue of shareholder loan subordination. While countries like Germany, Brazil and Spain have strict subordination rules mandating subordination in almost all cases, in the UK, only sums due to a shareholder "in his character of" a shareholder, narrowly interpreted (e.g. dividends), are subject to subordination. In the USA, the doctrines of equitable subordination and debt recharacterization were developed over time. The former is codified in § 510(c) of the US Bankruptcy Code, seeking to remedy inequitable conduct and restore justice among creditors. The latter is not explicitly based on the statute, has unclear boundaries, and relies on different multi-factor tests to determine whether a loan was meant and should be treated as an equity contribution. In the Netherlands, there is no settled stance on subordination. The Dutch Bankruptcy Act does not contain rules prescribing subordination, leaving the narrow possibility to subordinate insiders' claims in situations involving improper conduct or behaviour violating the standards of reasonableness and fairness.

The wide range of approaches to subordination of insider loans is underpinned by a variety of views on the pros and cons of subordination (section 7.5.). Some authors argue that subordination facilitates timely insolvency filings and exit of economically non-viable firms from the market. It is also suggested that subordination could respond to risk-shifting behaviour of shareholders, prevent the externalisation of losses, promote better corporate governance, and preserve creditors' status as residual claimants in insolvency. These arguments reflect the differences between internal and external creditors, discussed in section 7.3. At the same time, other scholars note that a non-subordinated shareholder loan aligns the interests of a shareholder with those of external creditors, whereas the risks of misuse of related-party transactions are better tackled by transaction avoidance and directors' liability rules. UNCITRAL adds that subordination might threaten the viability of the subordinated group entity (as it is likely to receive nothing in the insolvency of the borrower), harm its creditors and cause detriment to the reorganisation of the group as a whole.[137]

Perhaps the strongest and most important criticism of subordination is that it is overreaching and disproportionate, and that it discourages efficient, value-enhancing rescue attempts. There is nothing morally reprehensible about intra-group loans. However, there is a thin line between, on the one hand, deterring overinvestment in inefficient, economically non-viable enterprises and combating group opportunism, and on the other hand, encouraging insiders (e.g. group entities) to make legitimate and value-creating efforts to save financially distressed but economically viable firms, mitigating the problem of underinvestment and contributing to the preservation and maximisation of estate value. Finding a balance is crucial in the context of rescue financing – financing extended to a struggling company to ensure the continuity of its operations during negotiations of a restructuring plan with creditors or necessary for the implementation of the plan.

137 UNCITRAL Legislative Guide, Part three, Ch. II, para. 88. See similarly, I. Mevorach, Transaction Avoidance in Bankruptcy of Corporate Groups, ECFR, Vol. 8, 2011, p. 251, noting that the "prospect of equitable subordination of intra-group debts increases the risk of non-payment to the subordinated party and therefore induces the creditors of that company to investigate the other affiliates' creditworthiness."