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# **Subordination of shareholders' loans in an international perspective**

Evert Verwey (CMS Derks Star Busmann)

Prof. Alexander Schall (Leuphana University)

Audrey Goodwater (Leuphana University)

Arie Van Hoe (Antwerp University)



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# 1. General Introduction

Basic question:

*Should the investment by shareholders be seen as informal capital and therefore being a subordinated claim against the insolvency estate?*



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- Netherlands: unclear, but possibly warming up to the idea
- England: no rules, no cases.
- France/Italy
- Germany: a general subordination rule
- USA: subordination if acted *inequitable*
- Belgium
- European solution ?



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# **Shareholder Loans in the U.S.: Equitable Subordination & Recharacterization**

*Audrey Goodwater*



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## Loans Made by Shareholders

- In the US, it is legal for any person in a fiduciary relationship with a corporation to make a secured loan to a corporate beneficiary.
- However, when this loan is challenged in court, the transaction will be subjected to "rigorous scrutiny."
- In the case of corporate insolvency, loans made by shareholders face potential equitable subordination or recharacterization of the debt as equity.





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## Pepper v. Litton (1939)

SCT held that a claim by a fiduciary that breached its duty through self-dealing that disadvantaged other creditors should be subordinated.  
Bankruptcy courts examine claims to "see that injustice or unfairness is not done in administration of the bankruptcy estate."

## Taylor v. Standard Gas & Electric Co (1939)

Recognized the equitable authority of the bankruptcy code (the "Nelson Act" of 1898) when the SCT upheld the subordination of a parent company's claim against a subsidiary in bankruptcy due to the parent company's mismanagement and undercapitalization.

## Comstock v. Group of Int'l Investors (1948)

By requiring bad faith on the part of the creditor, the SCT here put some limitations on Pepper.

## In re Mobile Steel (5th Cir. 1977)

Fifth Circuit Court of Appeals parses existing case law to establish a three part test for equitable subordination: (1) inequality, (2) creditor harm, and (3) consistency with the whole of the bankruptcy code.

## Bankruptcy Reform Act of 1978 1987

Congress codifies the concept of equitable subordination in insolvency cases with § 510 (c).

## U.S. v. Noland (1996)

SCT recognizes the three-part test from In re Mobile Steel as the standard to be applied for cases of equitable subordination under § 510 (c).

## EQUITABLE SUBORDINATION

1940

1945

1950

1955

1960

1965

1970

1975

1980

1985

1990

1995

2000

2005

2010

2015

## Comstock v. Group of Int'l Investors (1948)

SCT required bad faith of creditors to subordinate, which was a setback for recharacterization. However, courts have continued to recharacterize in the absence of inequitable conduct.

## OH Kruse Grain v. Comm. (9th Cir. 1960)

In a case of tax law, the 9th Cir. brings together the 11 factors used by various tax courts to answer the question: debt v. equity?  
These factors would later be rejected by the 9th Cir. when applied to recharacterization in insolvency.

## Pepper v. Litton (1939)

Substance over form. In dicta, SCT mentions the concept of recharacterization.

## In re Lane (11th Cir. 1984)

Used same 13 factors as in Celtex.

## In re Pacific Express (9th Cir. 1986)

Ninth Circuit Court of Appeals holds that recharacterization is inappropriate in light of 510 (c).

## Roth Steel Tube Co. v. Comm. (6th Cir. 1986)

Used 11 factor test.

## Celtex Corp. v. Hillsborough Holdings Corp. (Bankr. M.D. Fla. 1994)

The court here lists 13 factors that should be examined when recharacterizing debt.

## In re Official Committee of Unsecured Creditors for Dornier Aviation (4th Cir. 2006)

Limitation on recharacterization: "[I]n many cases, an insider will be the only party willing to make a loan to a struggling business, and recharacterization should not be used to discourage good-faith loans."

## In re Sub Micron Systems Corp. (5th Cir. 2006)

The court's review "devolve[s] to an overarching inquiry: the characterization as debt or equity is a court's attempt to discern whether the parties called an instrument one thing when in fact they intended it as something else."

## RECHARACTERIZATION

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## EQUITABLE SUBORDINATION

Substance will not  
give way to form.

## RECHARACTERIZATION

When equity demands that the payment priority of claims of an otherwise legitimate creditor be changed to fall behind (be "subordinated to") those of other claimants.	<b>In a nutshell</b>	Does a debt actually exist?
Bankruptcy Code (statutory) § 510(c)	<b>Sources of Law</b>	Bankruptcy Code (general powers of equity) § 105 (a) (disallowance of claims) § 502 (b)
Yes*	<b>Inequitable conduct required?</b>	No
Subordination of a claim.	<b>Effect</b>	Elimination of a claim. (Debt becomes equity)
Generally can only be brought by TTEE or DIP. However, courts have some discretion to allow other parties to when TTEE or DIP refuses unjustly.	<b>Mechanisms</b>	1. Claim Objection- § 502(a) 2. Plan objection- § 1129 3. Adversary proceeding- Bankruptcy Rule 7001
Supreme Court has recognized the three part test in <i>In re Mobile Steel</i> to be the test for applying § 510(c).	<b>Test</b>	Depends on the jurisdiction: Majority accept 11-factor test, but that is not the only test out there.

\* SCT has not yet determined whether inequitable conduct is an "absolute prerequisite" for equitable subordination under 510(c); however, the majority of courts require it.





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## Equitable Subordination

### Three-Part Test from *In re Mobile Steel*

1. Inequitable conduct by the creditor;
2. Injury to other creditors or conduct that creates an unfair advantage; and
3. Subordination would be consistent with all other provisions of the Bankruptcy Code.

#### **Insiders v. Outsiders**

- Determined by degree of control
- Subordination for outside claims requires gross misconduct, but not so for insiders.

#### **Limitation on power**

Subordination goes “no further than to level off actual inequitable disparities on the bankruptcy terrain for which a creditor is responsible.” *Bostian v. Schapiro*



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# Recharacterization Three Groups of Factors

(1) loan agreement formalities;

- party intent
- document names
- right to enforce payment
- fixed maturity date?
- schedule of interest payments?

(2) corporate financial condition at the time of the loan; and

- inadequate capitalization
- availability of outside financing at the time
- whether undercapitalization was the cause of the bankruptcy

(3) relationship between equity owners and the lender.

- right to participate in management
- all, some or only one shareholder as lender?



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# Recharacterization

## Importance of Jurisdiction

**Tax court's  
11-factor test**  
(6<sup>th</sup> Cir.)

**The three groups are  
essentially the same as  
11 factor test.**  
(10<sup>th</sup> Cir.)

**Recharacterization  
unavailable.**

(9<sup>th</sup> Cir.)

**Non-Bankruptcy Code factors are  
interesting, but not determinative.**  
(3<sup>rd</sup> Cir.)

**Tax court, plus 2**  
(5<sup>th</sup> Cir.)

**Rechar if: (1) ttee provides initial  
under-capitalization or (2) loans were  
made when no other disinterested party  
would lend money.**  
(11<sup>th</sup> Cir.)

State courts??



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## **Hewlett-Packard Co. v. Commissioner**

**T.C. Memo 2012-135 (May 14, 2012)**

**Facts:** U.S. corporation purchased equity in a Dutch bank-owned foreign corporation. The Dutch shareholder had 4x the U.S.-owned interest. Simultaneously with the purchase, the U.S. shareholder purchased a put option from the Dutch bank. The put was valued at FMV as of exercise; the put was mentioned in the shareholder agreement, an agreement which gave the U.S. shareholder the right to convene a meeting for the sole purpose of redeeming the shares. The corporation's activities had been limited to only purchase contingent interest notes from the Dutch shareholder.

**Question:** Whether the taxpayer's investment in the foreign entity was, in substance, debt rather than equity?

**Held:** In this case, the Tax Court held that for income tax purposes, the investment was more appropriately characterized as a loan, not as equity. Therefore, the loss from the transaction was not a capital loss.