10.11.3.d Equitable (In)subordination – Considerations for Sponsors Lending to Portfolio Companies

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Private equity sponsors are increasingly providing additional capital to their portfolio companies either to address liquidity issues at those companies or as part of a negotiated debt restructuring. From a sponsor's point of view, it is often preferable to invest that additional capital in the form of debt rather than equity. However, in structuring that transaction sponsors should be aware that the priority of this debt in a portfolio company's capital structure could be attacked by other creditors if that portfolio company ends up in bankruptcy under the theories of equitable subordination or recharacterization. It is important that sponsors structure any such investments to reduce the risk of a successful attack on the priority status of their debt.

Equitable Subordination

Section 510(c) of the Bankruptcy Code provides that bankruptcy courts may exercise principles of equitable subordination to subordinate all or part of one claim to another claim. Conceptually, this gives the bankruptcy court power to demote a higher priority claim to a lower priority claim under certain circumstances. In some instances, this can convert an otherwise first priority secured claim into a general unsecured claim ranking pari passu with all other general unsecured claims. Although the statutory authority for equitable subordination is clear, the application is not. However, there are some general principles that can be applied as a guide in properly structuring a credit arrangement.

Generally, the courts consider three factors in determining whether to equitably subordinate a claim. These factors are (i) whether the creditor was engaged in inequitable conduct, (ii) whether the misconduct injured other creditors or gave an unfair advantage to the creditor in question and (iii) whether subordination would be consistent with the provisions of the Bankruptcy Code. Importantly, insiders are typically held to a higher standard than are unaffiliated third party lenders because insiders often have (and exercise) influence over management of the company. This means that a sponsor who is also an equity holder needs to use extra caution when loaning money to a portfolio company. The misconduct of a creditor does not need to be tied to such creditor's claim – it can arise out of other actions by the claimant. In an equitable subordination analysis, the court considers whether a creditor engaged in inequitable conduct and applies subordination as a remedy only to the extent necessary to counteract any damage to other creditors.

The recent bankruptcy case involving Schlotzky's, Inc. provided a good illustration of how courts apply these principles. In that case, the two largest shareholders each made separate loans to the company in an effort to resolve a liquidity crisis. The first loan was secured by substantially all of the company's intellectual property and was structured on armslength terms. The second loan, made seven months later, was secured by the same collateral package; however, the bankruptcy court more closely scrutinized this transaction because it was approved in a hurried, last minute board meeting where management reported that the company could not make payroll payments without the loan.

In pursuing the equitable subordination claim, the unsecured creditors of the company attempted to show that the loans contributed to a deepening insolvency of the company (see the August 2008 issue of Private Equity Alert for further discussion of this legal theory). The bankruptcy court found that both loans should be subordinated, holding that the inequitable conduct consisted of a combination of the last minute board meeting in which no alternatives were discussed (even though all noninterested directors approved the loan), a very favorable security package and a modification of the shareholders' personal guarantees. The bankruptcy court's failure to conclude that the loans resulted in harm to the unsecured creditors led to a reversal of the bankruptcy court on the second loan. The Court of Appeals concluded that because the proceeds of the second loan were used to pay unsecured creditors and equitable subordination is remedial, not penal, equitable subordination was not appropriate. As to the first loan, the Court of Appeals ruled that there was no evidence of misconduct, so that loan also should not have been subordinated.

Recharacterization

Recharacterization of a claim occurs where a bankruptcy court uses its equitable powers under Section 105 of the Bankruptcy Code to convert an otherwise valid debt claim into an equity interest. Recharacterization is a highly unusual remedy, but that does not mean that sponsors can ignore the risk that their loans may be recharacterized as equity. The recharacterization analysis differs from that of equitable subordination in that it considers whether or not an investment is actually equity instead of debt. If the answer is yes, then the effect of the recharacterization is to subordinate the investment to all other valid debtor claims and to provide for repayment of the investment only to the extent that there is recovery to equityholders.

Although some courts have taken the position that bankruptcy courts lack the power to recharacterize debt claims as equity interests, the majority of courts that have considered the question have determined that bankruptcy courts may, in the exercise of their inherent powers as courts of equity and the powers granted by Section 105 of the Bankruptcy Code, recharacterize debt claims as equity interests.

Courts that consider themselves to have the power to recharacterize debt claims as equity interests will exercise that power when, despite the label placed by the parties on the particular transaction, the "true nature" of the transaction is, in the court's view, the creation of an equity interest. In pursuing the quest to find the "true nature" of a transaction, most bankruptcy courts apply a multi-factor test where no single factor is determinative. The factors normally considered by courts include the following:

- **Undercapitalization.** Many courts view thin or inadequate capitalization as strong evidence that investments are in fact capital contributions rather than loans.

- **Inability to obtain similar outside financing.** Difficulty in obtaining outside financing on similar terms or off-market credit terms may lead to a determination that the financing was in fact a capital contribution rather than a loan.

- **Presence or absence of fixed terms and obligations and ability to enforce payments.** The absence of a fixed maturity date, interest rate and obligation to repay principal and interest at fixed times is an indication that the investments may be capital contributions and not loans. Similarly, if the instrument does not entitle the holder to enforce payment of principal and interest when due, the investment is more likely to be characterized as a capital contribution and not as a loan. Loans that require a sinking fund or are structured as a demand note payable upon the holders' request are more likely to be treated as debt and not equity.

- **Source of repayments.** Some courts have said that if the expectation of repayment depends solely on the borrower's earnings, the transaction has the appearance of a capital contribution.

- **Failure of the debtor to repay on the due date or to seek postponement.** If the debtor simply fails either to repay the investment on the nominal due date or to seek postponement, some courts have said that the investment looks more like a permanent capital contribution than a loan.

- **Identity of interest between the creditor and the stockholder.** If stockholders make investments in proportion to their respective ownership interests, the transaction has the appearance of a capital contribution. In a frequently cited recharacterization case, a bankruptcy court said that it considered "this to be the most critical factor in its determination".

- **Security.** The presence of a security interest and related documentation is strong indication of a loan and the absence of security cuts somewhat in favor of a capital contribution.

- **Extent of subordination.** The subordination of an advance to the claims of other creditors indicates that the investment was a capital contribution and not a loan.

- **Participation in management.** If the terms of the transaction give the investor the right to participate in the management of the business, the investment is more likely to be characterized as a capital contribution and not as a loan.

- **Treatment in the business records.** At least one court has said that the manner in which the investment is treated in the business records of the debtor is a factor that is relevant to the characterization issue.

It is important to note that almost all the reported decisions in which bankruptcy courts have concluded that a right that the parties have called a claim is in fact an equity interest have involved "loans" made to a debtor by a controlling stockholder, director, officer or other insider. However, the possibility of recharacterization should not by itself discourage sponsors from lending money to their portfolio companies as this remedy is not often sought by claimants or granted by bankruptcy courts and there are steps a sponsor can take to reduce its risk.

Steps that Reduce Risk of Equitable Subordination and Recharacterization

There are some general guidelines that sponsors can follow to help minimize the risk of equitable subordination or recharacterization. The most important guidance is to treat any sponsor loan to a portfolio company as if it is a third party loan being provided on customary market terms, including interest rate, payment terms, fees and other terms. The obvious challenge is finding customary terms in an illiquid market. Also, the sponsor should take extra care to ensure that the proper internal governance procedures are followed by the portfolio company to avoid any implication of misconduct, impropriety or control by the sponsor.

To minimize subordination risk, sponsors should anticipate liquidity problems as early as possible to allow their portfolio companies to adequately consider alternatives. This means avoiding any last minute decisions where the only alternative to an emergency funding transaction is a liquidation or bankruptcy. Also, a potent defense to any equitable subordination claim is that the unsecured creditors were either not harmed or helped by the additional financing. Finally, an insider should avoid loaning money to any portfolio company that the insider knows is undercapitalized or insolvent.

Sponsors should take care to observe the formalities typically associated with debt transactions among unrelated parties. Consideration should be given to the name of the instrument, which should indicate that the instrument is valid, enforceable and is proper evidence of indebtedness. If possible, the instrument should include fixed interest rates, fixed maturity dates and detailed payment schedule. Additionally, the instrument should include rights for the sponsor to enforce repayment. Moreover, courts will note whether the portfolio company actually made the required payments after execution of the instrument and, if it did not, what steps the sponsor took to enforce repayment.

Ideally, any debt instrument should not reference any related equity ownership or provide that the loan is provided in respect of such equity ownership. If possible, the debt should be secured. If the debt is unsecured, the court will be more likely to consider the investment to be debt if the parties include a sinking fund or other similar mechanism in the instrument.

The sponsor should also make an effort to distinguish the investment from characteristics more commonly associated with equity investments. Repayment provisions that are tied to the company's performance, especially if the advance is unsecured, will indicate to a court that the parties intended the investment to be a capital contribution. To the extent possible, the parties should make an effort to avoid having investments made in perfect proportion to the sponsors' equity ownership. If accurate, the instrument should also make clear that the investment is intended to finance the company's daily operating expenses, as opposed to the purchase of capital assets, which courts consider a purpose more indicative of an equity contribution. Additionally, the instrument should not grant management or other rights to control the operations of the business to the sponsor.

Even where the parties involved are not insiders, these principles may be applied. A recent bankruptcy court case applied the remedy of equitable subordination to a secured $232 million claim by Credit Suisse against the estate of Yellowstone Mountain Club. The court found that although Credit Suisse was not an affiliate of Yellowstone (which is typically the case when equitable subordination is applied), the court found a level of misconduct sufficiently egregious to warrant subordination of Credit Suisse's claim. According to the court, Credit Suisse's desire for lending fees contributed significantly to the demise of Yellowstone. Although this appears to be an unusual ruling, it emphasizes that all creditors should be cognizant of the risks involved and take steps to mitigate those risks.

Conclusion

In the current environment, it is increasingly likely that sponsors may consider lending money to struggling portfolio companies. With some additional care and consideration, a sponsor's risk of its debt claim being equitably subordinated or recharacterized as equity can be reduced significantly. Since each of these remedies is in furtherance of the court's equitable powers, however, the court still has ultimate discretion over whether to employ these remedies for the benefit of other creditors.

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