August 2008

Insiders' Last Resort Secured Loan to Cash-Strapped Company Cannot Be Equitably Subordinated Without Specific Evidence of Actual Harm to Creditors

A financially distressed company's majority shareholders and other insiders may have to decide whether to become lenders of last resort to help the company avoid bankruptcy. Sometimes, such loans do not succeed, and the company ends up in bankruptcy. Once a company enters bankruptcy, these loans, particularly when structured as secured loans, can become subject to intense scrutiny by creditors looking to enhance their recoveries by potentially equitably subordinating the resulting claims pursuant to Bankruptcy Code section 510(c).

Section 510(c) permits a bankruptcy court (subject to appeal, of course) to subordinate one claim to another claim or even to an equity interest if the offending party engaged in inequitable conduct that resulted in actual injury. It thus behooves insiders to understand how equitable subordination works in the context of insider loans before making such loans. A recent federal appeals court decision on the extent to which insider loans may be equitably subordinated has provided an opportunity to examine how those rules of the road work.

The *SI Restructuring* Opinion

In 2007, a Western District of Texas bankruptcy court equitably subordinated secured claims asserted by two individuals who had been directors and officers, as well as principal shareholders, of the debtor for two separate secured loans made to the debtor prior to bankruptcy. The district court later affirmed that decision.

But, on June 20, 2008, a three-judge panel of the Fifth Circuit Court of Appeals reversed the bankruptcy and district courts' decisions. *Wooley v. Faulkner (In re SI Restructuring, Inc.)*, 532 F.3d 355 (5th Cir. June 20, 2008). In so doing, the Fifth Circuit panel held that, before an insider's claim may be equitably subordinated, the insider must have engaged in inequitable conduct, and that the inequitable conduct must have harmed the company and its unsecured creditors. Even then, however, that claim may be equitably subordinated only to the extent necessary to offset actual harm. *Id.* at 360-61.

The Fifth Circuit panel reversed the bankruptcy court for two primary reasons:

- There were no findings of inequitable conduct regarding the first of the two secured loans, which meant that the claims arising from that loan could not be equitably subordinated. *Id.* at 361.

- Notwithstanding whether the secured creditors engaged in inequitable conduct or obtained an unfair advantage in making the second loan (an issue that the panel conspicuously did not decide), "the bankruptcy court made no finding" that unsecured creditors, as a class, were harmed. Indeed, any assertion of harm to the class was belied by the fact that the loan proceeds had been used to pay some (but not all) of the unsecured creditors. The panel was clear in holding that such unequal treatment did not constitute harm to unsecured creditors for purposes of equitable subordination. *Id.* at 362.

The Fifth Circuit panel also rejected the possibility of using a deepening insolvency theory to calculate the harm an insider's loan caused to unsecured creditors for purposes of determining whether to equitably subordinate the resulting claim. *Id.* at 363. As the panel noted, "deepening insolvency as a measure of harm depends on how the company uses the proceeds of the loan in question and 'looks at the issue through hindsight bias.'" *Id.* The panel explained that such hindsight bias should not be applied to directors who choose to continue a company's operations in the hope of improving creditor recoveries. If directors were subject to such hindsight bias, they effectively would "become … guarantor[s] of success," which would hold the directors to a much higher standard of conduct than "the appropriate exercise of their business judgment." *Id.*

Lessons Learned from the *SI Restructuring* Case

The Fifth Circuit opinion illustrates certain considerations that a company (its board of directors) and insider(s) should take into account regarding a last resort loan. For example, the company and its board of directors should, among other actions:

- Ensure that the loan proceeds are used to maximize enterprise value, without harming the company or its creditors. For example, in the *SI Restructuring* case, the proceeds from the second loan were used to pay some — but not all — unsecured creditors, thereby keeping the company operating.

- Bear in mind whether alternative sources of liquidity may be available — and the terms thereof — when determining whether to enter into the insider loan.

- Consider utilizing a process for board consideration and approval of the insider loan as a related-party transaction, such as formal board approval by non-insider board members after a thorough — and documented — review.

The insider/lender also should be mindful of not overreaching. For example, in *SI Restructuring*, one important component of the second loan transaction was the granting of liens to the insiders to secure their existing personal guarantees of corporate debt. *Id.* at 359. The Fifth Circuit panel found that the liens did not harm unsecured creditors. No claim arose from those liens because the loans had been repaid in full, and the guarantees were not drawn upon. *Id.* at 362.

The *SI Restructuring* case illustrates vividly that shareholders or other insiders need not shy away from lending to a financially distressed company. But insiders should make those loans only after carefully deliberating about the proposed transaction in consultation with their professional advisors, particularly as to insiders' fiduciary duties and the proposed transaction's potential risks.

Should you have any questions about the matters addressed in this Alert, please contact the following Kirkland & Ellis authors or the Kirkland & Ellis attorney you normally contact:

David R. Seligman
Kirkland & Ellis LLP
200 E. Randolph Dr.
Chicago, IL 60601
dseligman@kirkland.com
+1 (312) 861-2463

Roger J. Higgins
Kirkland & Ellis LLP
200 E. Randolph Dr.
Chicago, IL 60601
rhiggins@kirkland.com
+1 (312) 861-2160

Ray C. Schrock
Kirkland & Ellis LLP
200 E. Randolph Dr.
Chicago, IL 60601
rschrock@kirkland.com
+1 (312) 861-2413

Scott B. Kitei
Kirkland & Ellis LLP
200 E. Randolph Dr.
Chicago, IL 60601
skitei@kirkland.com
+1 (312) 861-3461