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Bankruptcy Court Determines Proper Corporate Governance Necessary to Avoid Recharacterization and Equitable Subordination

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On August 14, 2026, the U.S. Bankruptcy Court for the District of Delaware (the Bankruptcy Court) issued a written opinion recharacterizing an intercompany loan from a parent to an indirect subsidiary as an equity contribution and, in the alternative, equitably subordinating the intercompany loan to the claims of former executives. *See AIG Financial Products Corp. v. Lee Arthurs* (*In re AIG Financial Products Corp.*).[1] The Bankruptcy Court emphasized the absence of arm's-length negotiations and disinterested decision-makers as significant considerations in its evaluation.

Background

Prior to the great financial crisis of 2008, a large, publicly traded company (Parent) and its wholly owned, indirect subsidiary (Subsidiary) were party to hundreds of billions of derivative contracts and related guarantees. When the financial crisis struck, Parent and Subsidiary both faced insurmountable collateral demands. In September 2008, the federal government extended an $85 billion loan to Parent, which Parent was permitted to use for intercompany loans to its subsidiaries if the loans were made at arm's length and were not secured. Parent immediately funded money, through an intermediary subsidiary, to Subsidiary, to facilitate a wind-down of Subsidiary's operations (the Intercompany Loan). Subsidiary did not, however, document the loan transaction at that time.

Parent's control over Subsidiary and its wind-down was well-documented and dated back to 2008 when Parent unilaterally removed and replaced the only independent director from Subsidiary's board with exclusively Parent executives. Subsidiary did not reappoint independent directors to serve on a special committee of Subsidiary's board (the Special Committee) until January 2022.

During the wind-down, Subsidiary offered certain executives (the Former Executives) various forms of retention compensation (the Compensation Plans) to incentivize the Former Executives to continue their employment at Subsidiary. After 2008, Subsidiary did not record any profits, and Parent decided to write off Subsidiary's obligations under the Compensation Plans. Nonetheless, Subsidiary's officers, many of which were Parent employees, told the Former Executives that Subsidiary would be able to determine whether it had sufficient assets to pay the incentives by 2013. In 2010, after the financial crisis had subsided, Parent considered recapitalizing Subsidiary by, among other things, forgiving $35 billion of the Intercompany Loan. Parent chose not to proceed with the recapitalization, however, when it was discovered that doing so would require Subsidiary to make the payments to the Former Executives. Subsequently, two years after the transaction, Parent and Subsidiary documented the Intercompany Loan as a loan on terms dictated by Parent. Subsidiary, acting through employees of Parent, continued to misrepresent its willingness and ability to fund the Compensation Plans until 2014, when Subsidiary finally told the Former Executives they would not receive payment. When Subsidiary filed for Chapter 11 bankruptcy in 2022, it filed a Chapter 11 plan contemplating an exchange of Parent's claims under the Intercompany Loan for 100% of Subsidiary's equity. The Former Executives would only receive a *pro rata* distribution of $1.0 million if they accepted the plan.

Subsidiary filed a declaratory judgment action against the Former Executives seeking a ruling that the Intercompany Loan was debt and the Former Executive's claims were junior in priority to the Intercompany Loan. Parent intervened as a plaintiff, and the Former Executives filed various counterclaims against Subsidiary and crossclaims against Parent. The Bankruptcy Court bifurcated the issues and tried, among other issues, the recharacterization and equitable subordination claims in the first phase.

Recharacterization

The recharacterization doctrine primarily focuses on whether debt should properly be *reclassified* as equity and requires a bankruptcy court to determine "whether the parties called an instrument one thing when in fact they intended it as something else."[2] In the instant case, the Bankruptcy Court, applying both the Third Circuit's *SubMicron* test[3] and the Sixth Circuit's *Autostyle* test,[4] recharacterized the Intercompany Loan into an equity contribution from Parent to Subsidiary.

The Bankruptcy Court found that, notwithstanding the parties' consistent reference to the transaction as a proper loan, "this nomenclature [did] not reflect the reality of the transaction." The Bankruptcy Court reasoned that the issuance of, and characteristics associated with, the Intercompany Loan were unlike those typically linked to a market-based debt transaction. In particular, the Bankruptcy Court highlighted several factors as favoring recharacterization, including (i) the two-year delay in papering and execution of the loan documents, (ii) the absence of Subsidiary board approval (as required by the Intercompany Loan documents), (iii) the lack of traditional credit terms (e.g., payment schedule, set maturity date, and/or security), (iv) Parent's failure to conduct pre-transaction diligence, (v) the notable absence of any expectation of repayment, and (vi) Parent's demonstrated intent to equitize its claims under the Intercompany Loan.

Equitable Subordination

The equitable subordination doctrine seeks "to undo any inequality in the claim position of a creditor that will produce injustice or unfairness to other creditors in terms of distribution of the estate."[5] The Former Executives argued that Parent's unsecured claim for the Intercompany Loan must be equitably subordinated to the Former Executives' claims. The Bankruptcy Court held that the actions of Parent to avoid funding the Compensation Plans resulted in "a pattern of deception" sufficient to "constitute inequitable conduct," which resulted in injury to creditors and "conferred an unfair advantage on the claimant." The Bankruptcy Court cited multiple layers of prepetition behavior to support its conclusions, including the (i) misrepresentations by Parent employees regarding payments under the Compensation Plans aimed at inducing retention of the Former Executives, (ii) absence of any associated efforts to follow-through on such payment, and (iii) decision to forego the recapitalization transaction to avoid such payment.

Notably, the Court found that the involvement of the Special Committee in approving certain transactions was a differentiating factor. On the other hand, the Court found that almost every decision-making process and transaction consummated by Subsidiary when it either (i) had a board of directors comprised entirely of Parent employees or (ii) acted without the authorization of the Special Committee once formed, was inequitable.

The decision in *In re AIG Financial Products Corp.* emphasizes the need for sponsors and parent companies of distressed companies to follow corporate governance best practices when making intercompany and sponsor loan transactions to survive recharacterization and equitable subordination attacks. The presence of disinterested decision-makers allows for arm's-length negotiation and market-based economic terms that will withstand judicial scrutiny. For assistance, please contact any of the authors or your regular Kirkland contact.

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1. *In re AIG Financial Products Corp.*, No. 22-11309, 2026 WL 2408732, at *65 (Bankr. D. Del. Aug. 14, 2026). ↩

2. *In re SubMicron*, 432 F.3d 448, 456 (3d Cir. 2006). ↩

3. *In re SubMicron*, 432 F.3d at 455–56. ↩

4. *In re AutoStyle Plastics, Inc.*, 269 F.3d 726, 749–50 (6th Cir. 2001). ↩

5. *In re Mid-Am. Waste Sys., Inc.*, 284 B.R. 53, 68 (Bankr. D. Del. 2002). ↩

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