

This article was published in a slightly different form in the August 5, 2008, issue of *Law360*.

5th Circ. Stresses Equitable Subordination Rule

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Law360, New York (August 05, 2008)— In a recent case,¹ the Fifth Circuit emphasized its rule that a creditor's claim may be equitably subordinated to the claims of other creditors only to the extent necessary to offset the harm that the other creditors have suffered, based on specific findings and conclusions.

Background

In April and November 2003, John and Jeffrey Wooley made a pair of loans to Schlotzsky's Inc. for US\$1 million and US\$2.5 million, respectively.

The loans were secured by Schlotzsky's rights to royalty streams from franchisees, intellectual property rights and general intangibles, which were arguably Schlotzsky's most valuable assets.

As part of the November loan transaction, the Wooleys also took a lien against the same collateral to secure pre-existing guarantees of Schlotzsky's debt in the amount of US\$4.5 million.

At the time of the 2003 loans, the Wooleys were officers, directors and the largest shareholders of Schlotzsky's. The

company's financial condition deteriorated throughout 2003 and 2004, and in mid-2004, the Wooleys were removed from their positions as officers and resigned as directors.

In August 2004, Schlotzsky's filed a petition for relief under Chapter 11 of the Bankruptcy Code. The Wooleys filed secured claims relating to the April and November transactions, and the committee of unsecured creditors commenced an adversary proceeding seeking to equitably subordinate the Wooleys' secured claims.

The bankruptcy court entered judgment subordinating the Wooleys' claims and thus converting them from secured claims to unsecured claims. In so doing, the court focused on the November transaction and on the short, three days' notice of that transaction that the Wooleys had given to Schlotzsky's board.

At the board meeting to approve the transaction, the board was told that Schlotzsky's could not make payroll and would default on a payment to a secured creditor if the company did not receive an immediate infusion of additional funds.

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The bankruptcy court characterized the board meeting as the Wooleys' presenting the transaction at the eleventh hour, as the only option available and under circumstances where the company would otherwise "collapse tomorrow."

The bankruptcy court also found that securing the Wooleys' contingent guarantees of company debt effectively released them as guarantors at the expense of the company and its creditors.

The bankruptcy court did not, however, make specific findings as to how the Wooleys' conduct had resulted in harm to Schlotzsky's or its creditors. The district court affirmed, and the Wooleys appealed to the Fifth Circuit.

Fifth Circuit Analysis

The Fifth Circuit began its analysis by repeating its widely quoted three-prong test for equitably subordinating a creditor's claim under section 510(c) of the Bankruptcy Code: (1) the creditor must have engaged in inequitable conduct; (2) the inequitable conduct must have resulted in injury to other creditors or conferred an unfair advantage on the creditor and (3) equitable subordination of the creditor's claim must not be inconsistent with the provisions of the Bankruptcy Code.

The court also noted that its decision in *Benjamin v. Diamond*² added a fourth prong that was critical in *Wooley*, requiring that a claim may be subordinated only to the extent necessary to offset the harm that the debtor or other creditors suffered as a result of the inequitable conduct.

It also noted that an order equitably subordinating a claim must be supported by specific findings and conclusions as to each requirement.

The Fifth Circuit observed that the bankruptcy court made no specific findings that the November transaction, which was the basis of the bankruptcy court's decision, harmed unsecured creditors.

To the contrary, the proceeds of the November transaction, as well as the April transaction, were used to pay unsecured creditors and to keep Schlotzsky's in operation. Because of that, unsecured creditors as a class were not harmed.

Unsecured creditors who were paid may have benefitted to the detriment of other unsecured creditors, but no one advanced that theory and, at any rate, that detriment would not have implied that unsecured creditors were harmed simply because the Wooleys took security for their loans.

The Fifth Circuit also rejected the unsecured creditors' argument that the Wooleys secured an unfair advantage by taking security for their pre-existing personal guarantees.

While that might have been the case if the Wooleys' liability on the guarantees had ever been triggered, the liability was not triggered. Because no claim arose on the guarantees, no harm resulted.

Finally, the Fifth Circuit rejected the unsecured creditors' theory that creditors were harmed by, and damages should be measured by, Schlotzsky's deterioration in value following the November transaction.

The Fifth Circuit characterized this theory as deepening insolvency, the prolonging of an insolvent corporation's life through bad debt and the dissipation of its assets.

The court agreed with the Third Circuit, which has rejected deepening insolvency as a theory of damages, and the Delaware Court of Chancery, which has rejected deepening insolvency both as a cause of action and as a theory of damages.

The theory, the court observed, focuses on how the corporation uses the proceeds of the loan in question and is subject to hindsight bias, in that it effectively turns the directors into guarantors of the corporation's success if they choose to borrow in an effort to improve the corporation's position.

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In closing, the Fifth Circuit observed that the bankruptcy court found no inequitable conduct connected with the April transaction, reiterated that the damages theories pressed in connection with the November transaction were not legally cognizable or lacked record support and concluded that “neither claim should have been subordinated.”

As such, the court may have been signaling that claims arising from separate transactions must be subordinated on their own individual merits, rather than in the wholesale fashion that the bankruptcy court had used.

Comment

The Wooley decision makes clear that a secured creditor’s claim will not be equitably subordinated, even where inequitable conduct can be found, except on findings, with support in the record, that other creditors were harmed as a result of the inequitable conduct.

It also makes clear that where the proceeds of the challenged transaction actually flow to unsecured creditors, reducing the size of that claims pool, unsecured creditors as a class cannot be said to have been harmed.

Finally, it suggests that claims arising from separate transactions must be analyzed and, if appropriate, subordinated separately.

The decision should constitute good news to directors or controlling shareholders of a financially troubled company who are willing to lend money to the company only on terms providing reasonable assurance of repayment.

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- 1 *Wooley v. Faulkner* (In re SI Restructuring Inc.), number 07-05872 (5th Cir. June 20, 2007).
- 2 *Benjamin v. Diamond* (In re Mobile Steel Corp.), 563 F.2d 692, 700 (5th Cir. 1977).