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Fifth Circuit Refuses to Equitably Subordinate Insiders' Secured Claims For Loan to Distressed Company Where Underlying Transactions Did Not Harm Either Company or Its Creditors

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Under what circumstances can a corporate insider be confident that if he or she lends money to the corporation in a time of distress, on terms that are less than favorable to the corporation, and the company subsequently files a bankruptcy, the insider's claim will not be equitably subordinated to the claims of the other creditors? In an important decision regarding the rights of corporate insiders, the United States Court of Appeals for the Fifth Circuit recently ruled that so long as the corporation uses the funds for legitimate corporate purposes such as paying employees, secured creditors, or vendors, such that the loan transaction does not cause harm to the company or its unsecured creditor body, the insider's bankruptcy claim will not be equitably subordinated. Wooley v. Faulkner (*In re* SI Restructuring, Inc.), No. 07-50872, 2008 WL 2469406 (5th Cir. June 20, 2008) (overturning a decision of the United States Bankruptcy Court for the Western District of Texas, affirmed by the District Court). Significantly, in so ruling, the SI court expressly rejected the debtor's argument that the transaction ultimately worsened the corporation's financial condition, and thereby caused it injury. The court held that such an argument amounted to an attempt by the debtor[1] to invoke the "deepening insolvency" doctrine, [2] a theory of damage the viability of which the court refused to accept.

In SI, the two largest shareholders of Schlotzsky's, Inc., John and Jeffrey Wooley, who were also officers and directors of the Company, made two secured loans to the Company to relieve critical cash crunches, when other financing options did not pan out. The first, a loan of $1 million made in April 2003, secured by the Company's "crown jewel assets" of royalty streams, intellectual property rights, and other intangible property, was made on an obvious arms-length basis, involving no conduct by the Wooleys that could reasonably be deemed inequitable. In contrast, the second loan, made in November 2003, in

[1] The adversary proceeding seeking equitable subordination was apparently brought by the unsecured creditors' committee, which apparently assigned the claim to the Debtor's Chapter 11 Plan Administrator.

[2] The Court of Appeals defined this doctrine as the "prolonging [of] an insolvent corporation's life through bad debt, causing the dissipation of corporate assets." SI, 2008 WL 2469406, at *5.

the amount of $2.5 million, and similarly collateralized, was presented to the Board of Directors at a hastily called telephone board meeting, at which the other Board members were told that in the absence of the loan, the Company would be unable to meet its payroll and would go into default on other secured debt.[3] The Board approved the loan forthwith, as did an independent audit committee.[4] Notwithstanding the financing, by August of 2004 the Company filed a Chapter 11 case. When the Wooley's filed secured claims with respect to their two loans, the unsecured creditors' committee (acting on behalf of the debtor's estate) responded by suing them on a variety of breach of fiduciary duty theories, and also seeking to equitably subordinate their claims to the claims of all other unsecured creditors pursuant to Section 510(c) of the United States Bankruptcy Code.[5]

The Bankruptcy Court held that the circumstances of the November loan, including (i) its submission to the Board for approval at an eleventh hour Board meeting, without any consideration of possible alternatives; (ii) the Wooley's insistence that the loan be secured by the Company's prime assets; and (iii) their demand that as part of the package their pre-existing personal guarantees be secured by the same assets, constituted inequitable conduct. However, the Bankruptcy Court made no finding that either of the two loan transactions resulted in harm to the Corporation or its unsecured creditors.[6] Nor could it, because there was no such harm. In fact, the proceeds of the loans were used to pay unsecured creditors and to keep the Company in operation. Nevertheless, the Bankruptcy Court equitably subordinated the Wooleys' claims, and the District Court affirmed. The Court of Appeals rejected the Bankruptcy Court's ruling, holding that this lack of harm was fatal to the debtor's equitable subordination claim: "Equitable subordination is remedial, not penal, and in the absence of actual harm, equitable subordination is inappropriate."[7]

The Court of Appeals rebuffed the debtor's attempt to show damage by offering evidence that the Wooleys' loans resulted in a worsening of the Company's financial condition. Such an argument, the Court ruled, was essentially an effort to invoke the doctrine of "deepening insolvency." Following recent Third Circuit and Delaware Chancery

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3 Id. at *1-2.

4 As part of the loan package, the same collateral used to secure the loan was also extended to a previously unsecured series of personal guarantees issued by the Wooleys with respect to Company debt.

5 Prior to trial, the fiduciary duty claims were dismissed by stipulation of the parties, leaving the parties to litigate only the equitable subordination claim.

6 Id. at *2.

7 Id. at *4.

Court decisions, the Court held that the doctrine is "not a valid theory of damages" under Delaware law.[8] If it were, the Court reasoned, it would interfere with a Board's ability and willingness to exercise its business judgment to take actions designed to save a failing company, because such actions might ultimately "result in the firm being painted in a deeper hue of red."[9] The Court also held that in any event, there were no findings and no evidence that the Company was undercapitalized or insolvent at the time of the November loan.

The Fifth Circuit's ruling, which is consistent with the Third Circuit and Delaware precedents it cited, did not explicitly consider the very recent Delaware Bankruptcy Court decision, Miller v. McCown De Leeuw & Co. Inc. (*In re* The Brown Schools), 386 B.R. 37 (Bankr. D. Del. 2008). In the Brown case, a Chapter 7 Trustee sued a corporate debtor's majority shareholder, its affiliates, and others, for breach of fiduciary duty, "deepening insolvency, corporate waste, and asserted other claims, alleging that they had "wrongfully prolonged the existence of the Debtors so that [they] could profit at the expense of the Debtors and their creditors."[10] While the Brown court dismissed the direct claim for "deepening insolvency," it held that a fiduciary duty claim – based on allegations of allowing a distressed company to take on new debt in a fiscally irresponsible manner and/or misuse of corporate assets – could rely upon an alleged "deepening insolvency" as a measure of damages.[11] Future cases will clarify the extent to which, if any, the doctrine can be applied as a measure of damages for fiduciary duty breach claims brought under Delaware law.

Notwithstanding Brown, the significance of SI should not be minimized. It makes clear that the *sin qua non* of equitable subordination is not only inequitable conduct, but also harm to the debtor or the body of unsecured creditors. It is also at least the second Circuit court to reject "deepening insolvency" as an acceptable measure of damage under Delaware law. Although SI does not insulate corporate insiders from liability for all actions taken when the corporation is in distress, it does provide them with some comfort that, at least in the Fifth Circuit, they can personally provide financing to their company to alleviate a legitimate corporate financial crisis, even on terms that are highly favorable to them, without

8 Id. at *6.

9 Id., *quoting*, Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 174 (Del. Ch. 2006), *aff'd*, 931 A.2d 439 (Del. Ch. 2007). *See also* Seitz v. Detweiler, Hershey & Assocs., P.C. (*In re* CitX Corp. Inc.), 448 F.3d 672, 677 (3d Cir. 2006) (rejecting "deepening insolvency" measure of damages in accounting malpractice action).

10 Brown, 386 B.R. at *45.

11 Id. at *48.

facing the prospect that if their efforts to save the company fail, their claim to recover the amount of the financing will necessarily be equitably subordinated to all other claims.

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