• LENDER LIABILITY IN CORPORATE FINANCE TRANSACTIONS AND EQUITABLE SUBORDINATION IN THE U.S. — TOWARDS A CANADIAN PERSPECTIVE •

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COMPARATIVE ISSUES IN THE LAW OF EQUITABLE SUBORDINATION

Any study of comparative legal issues is predicated on the recognition of the continued drive towards globalized economic markets. As the Americas and Europe collapse sovereign borders and form trading blocks, comparative legal issues will invariably clash with international economic comity. This comparative analysis of the doctrine of equitable subordination in U.S. and Canadian jurisprudence is particularly timely to those involved in cross-border financings, as lenders seek protection from exposure to liability.

EQUITABLE SUBORDINATION IN THE UNITED STATES

It is not uncommon for a lender to a financially troubled company to desire more control over the company's policies and activities as a way of managing that risk. However, as a lender assumes more control over the borrower, the lender risks having its interest against the borrower subordinated to (or brought to parity with) the claims of other creditors. This section of the paper focuses more closely on lender liability issues as they typically arise through the application of the doctrine of equitable subordination in bankruptcies and insolvencies.

Historically, the development of the doctrine of equitable subordination has been fact-driven. That is to say, the cases which have explored the doctrine and applied it are, in most instances, of limited value in determining a test of broad application. Accordingly, it is difficult to elicit consensus on the line between permissible and impermissible conduct in the management of a loan and the assertion of contractual and/or legal rights against a debtor. As a rule, the greater the control that a lender wields over a borrower, the more likely it is that a court will equitably subordinate the lender's rights. At the same time, it is also true that the more sophisticated the borrower, the less likely it is that a court will apply the doctrine, absent evidence that the lender or its agent committed outright fraud or other illegalities.

The doctrine of equitable subordination is codified as s. 510(c) of the United States *Bankruptcy Code*, which provides that:[1]

> Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may –
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> (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or
>
> (2) order that any lien securing such subordinated claim be transferred to the estate.

Bankruptcy courts apply a three-part test to determine whether equitable subordination is appropriate:

- the creditor must have engaged in misconduct (*e.g.*, fraud, illegality, breach of duty or undercapitilization);
- the misconduct must have resulted in injury to other creditors or unjustly improved the position of the creditor; and
- subordination must not otherwise violate the principles of bankruptcy law.[2]

The threshold issue in equitable subordination cases is whether or not the creditor is an insider of the debtor. Insiders (*e.g.*, shareholders) are held to a higher standard of conduct than non-insiders and thus to a lower threshold of misconduct for equitable subordination. This was illustrated in *Liberty Mutual Ins. Co. v. Leroy Holding Co. Inc.*,[3] where the court held that creditor corporation – which directed and managed the financial affairs of debtor; determined which creditors would be paid and in what amounts; determined the location of the debtor's business operations; and established administrative procedures — was an "insider" when determining if it engaged in inequitable conduct for equitable subordination purposes.

Insiders may be subject to two levels of scrutiny, depending on whether they are also a fiduciary of the borrower.[4] An "insider" is not necessarily a fiduciary. As stated in *Wilson v. Huffman (In re Missionary Bap-*