Not All Loans Are Created Equal: Equitable Subordination and Prepetition Insider Lending after *SI Restructuring*

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A glance at recent headlines reveals a disquieting outlook: once-stalwart companies teetering on the edge of bankruptcy, venerable industry giants disappearing from the corporate landscape; credit is scant and cashflow is short. Last-minute bailouts and Hail-Mary acquisitions are available for only a handful of troubled businesses. For some companies, salvageable hope may come only from within: a loan from a corporate insider. Faced with a cash crunch, an officer, director, shareholder or parent entity infuses the company coffers with quick cash to avoid bankruptcy. Sometimes, the loan will be secured with the company's various assets. Other times, it will be unsecured. Of course, many times this simply postpones the inevitable. Ultimately, the company's financial condition deteriorates to a state of disrepair and the bankruptcy petition is filed. The inside lender is left with a secured or unsecured claim.

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Once the company is in bankruptcy—and the books are on display for all creditors to scrutinize—that claim becomes vulnerable to a cause of action of equitable subordination or recharacterization. Bankruptcy courts have the extraordinary power to employ these two distinct remedies to reposition claims (*i.e.*, reorder their status). Bankruptcy Code §510(c) authorizes the court to reprioritize a claim in bankruptcy due to inequitable conduct by the claimant. As a result, the whole or a portion of a wrongdoer's claim (whether secured or unsecured) is relegated to an inferior status relative to other creditors. Recharacterization, on the other hand, is more commonly employed when a loan from an insider functions as a capital contribution. Like equitable subordination, recharacterization reshuffles claim priorities, demoting the status of the insider's loan. Thus, both equitable subordination and recharacterization purport to counterbalance any one-sided inequity in the claim position of a creditor that creates unfairness to other creditors.

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This claim jockeying, however, has a chilling effect. Faced with the specter of equitable subordination or recharacterization, insiders may be less likely to loan a company much-needed funds. Essentially, equitable subordination and recharacterization disincentivize eleventh-hour restoration financing. It goes without saying that the lending hazard brought on by equitable subordination carries a dark influence on the actions of inside lenders that wish to provide funding to their companies but are repelled by the consequences of subordination to other creditors' claims. Indeed, many of the outside claims are paid from the insider advances in the wake of successful recharacterization and equitable estoppel claims.

Fortunately, a crack in the case law has allowed some light to shine through, and there appears to be a resurgence of a policy that favors the rehabilitation of a company outside of bankruptcy.

A Wooly Situation

The Fifth Circuit's recent decision in *Wooley v. Faulkner (In re SI Restructuring) (Wooley I)*, 532 F.3d 355 (5th Cir. 2008), may reassure some insider creditors that their claims are protected—even when the cash doesn't prevent a crash. The dispute in *Wooley I* involved the loans made by John and Jeffrey Wooley to Schlotzsky's Inc. The Wooleys were officers and directors and the largest shareholders of Schlotzsky's. With Schlotzsky's finances in dire straights, the Wooleys made two loans to the corporation over the course of six months: one April 2003 for $1 million and another in November 2003 for $2.5 million.

The April 2003 loan came after other financing avenues disappeared. The loan was secured with Schlotzsky's royalty streams from franchisees, intellectual property rights and other intangible property. Schlotzsky's and Wooleys had separate legal counsel, and the board of directors and an audit committee approved the transaction. Schlotzsky's also disclosed the transaction in its SEC filings. Despite the fresh financing, Schlotzsky's again approached the brink of collapse in October 2003. Schlotzsky's looked to the International Bank of Commerce for additional funds. IBC rejected Schlotzsky's request, but agreed to make a loan to the Wooleys, who would, in turn, direct the loan proceeds to Schlotzsky's. As with the April loan, Schlotzsky's same rights to royalty streams from franchisees, intellectual property rights and general intangibles secured the loan. The November loan package provided that the same collateral would secure the Wooleys' potential liability under pre-existing personal guarantees on Schlotzsky's debt.

IBC approved the loan to the Wooleys on Nov. 10, 2003. Schlotzsky's board of directors received notice the next day of a special meeting hastily scheduled for Nov. 13, 2003, in order to approve the Wooleys'

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