

Alessandro Pomelli

# Inside Debt Financing

Theory, Practice, and  
Regulatory Approaches

**Sezione Giuridica**

**Collana del Dipartimento di  
Sociologia e Diritto dell'Economia  
Università di Bologna**



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*To Penelope*



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## LA COLLANA

*Ubi societas, ibi jus.* Questo antico adagio romano dimostra oggi tutta la sua validità nell'indicarci quanto sia cruciale, per la scienza e per l'agire pratico, collegare fra loro i cambiamenti sociali studiati dalla sociologia e il diritto che cerca di dare loro una regolazione normativa. I contatti e l'influenza reciproca tra diritto e sociologia stanno crescendo di continuo ed i docenti dell'una come dell'altra disciplina sono scientificamente persuasi della loro scelta. L'auspicio è che il dipartimento di sociologia e diritto dell'economia possa esercitare un influsso non trascurabile su alcuni campi della ricerca e della riflessione scientifica di settore, talora soddisfatti del loro status quo (con un atteggiamento spesso isolazionista), talora troppo ancorati alla distinzione tra conoscenza dei principi astratti e conoscenza e fruizione dei fatti e delle pratiche sociali. Già da tempo sono emerse connessioni e mediazioni tra principi e realtà in una proficua reciproca fertilizzazione che è il contrassegno essenziale della posizione culturale del dipartimento; vale a dire una concezione della conoscenza che non è puro e semplice rispecchiamento di una realtà statica fuori ed indipendentemente dall'uomo-cittadino ma attività, non solo teorica, essa stessa aspetto della realtà in trasformazione. È così che la conoscenza dei nessi reali, nella dialettica fra le diverse forze umane e le forme di società, assume una sua dignità autonoma, caratteristica del dipartimento. Contro ogni assolutizzazione del metodo di ogni scienza particolare, contro ogni restrizione degli orizzonti e l'impovertimento contenutistico di certa scienza ufficiale. Ciò non toglie che il diritto e la sociologia possano rivendicare la diversità dei metodi di indagine e degli strumenti conoscitivi propri ma al contempo comporta che nella sussidiarietà reciproca possano 'vivere' all'interno dei contesti socio-economici imprimendo il loro rispettivo impulso.

Entrambi possono estrofflettere le proprie forze per riconoscere e concorrere a superare le necessità delle collettività ed i loro impulsi indifferibili. Si pensi ad esempio alle materie di studio come l'autorità e la famiglia, l'impresa e la società, il lavoro e l'economia, l'imposizione fiscale e la solidarietà sociale, la società attiva e la società ac-

quiescente, l'industria e l'ambiente con i relativi contrasti, il potere della comunità e quello del singolo, il sistema bancario-creditizio e le relative connessioni.

Oggi sembra stiano per cadere o per lo meno oscillano pericolosamente i presupposti di ogni legge eppure la legge risulta una condizione cronica della società contemporanea, dando luogo a situazioni talora paradossali talora sfuggenti all'interno delle quali l'uomo continua a vivere. Sembra essere messo in discussione il legame della legge con il territorio, ma al contempo il legame ritorna quasi in un moto perpetuo sicché il diritto continua a irradiarsi con ordini, condizionamenti, decisioni mentre la società tenderebbe a sottrarsene o a rovesciarli, perché la legge pretende una sorta di eternità dei principi che la sottendono mentre la società non vorrebbe essere sottratta ai flussi del tempo con intenzioni infuturanti progettuali autonome. È questa una delle tipiche occasioni in cui scienze sociologiche e giuridiche consentono di affrontare 'insieme' e contemporaneamente nuovi campi di possibilità costruttive, in una molteplicità ordinata che assicura la non contraddittorietà logica della possibilità della sua costruzione. Il diritto e la sociologia non sono ricavabili uno dall'altra ma possono riscontrarsi coincidenze proficue nell'equilibrio continuo delle procedure di libera scelta, pensando simultaneamente gli apparenti opposti, ordine-arbitrarietà, possibilità-necessità, affermazione-negazione. Costituiscono l'uno l'altrimenti dell'altra e al contempo la prossimità dell'altra al primo, senza mai sentirsi identici, pur integralmente affidati al lavoro di restaurazione degli istituti. Dispersioni e disaggregazioni possono assillarli, essendo entrambi essenza di se stessi, ciò che rende raro equivocarli, ma si influenzano reciprocamente nell'esposizione con cui si fanno conoscere e con cui sono stati.

Entrambi superano l'astratta separazione tra tempo vero e tempo apparente e sono dediti al presente per comprenderlo e sostanziarlo, abbracciando la vita in sé con la chiarezza che ne divide e ne rapporta le diverse dimensioni.

Sono discipline che realizzano 'il possibile', oltre ogni errante radice, nell'idea del dover essere della pienezza del presente e quindi entrambe contengono principi universali disincarnati da ogni terra e da ogni luogo, liberi dalla crescente instabilità del termine stesso di Stato.

Gli studiosi del dipartimento conoscono la necessità delle domande e la difficoltà frequente delle risposte, ma il domandare e il rispondere sono per loro elementi di una stessa dimensione e quotidiana abitudine di assumerli come un unico contesto.

Domanda e risposta sono due termini incommensurabili, e gli studiosi del dipartimento lo sanno, perciò sono attenti a non sprofondare nella dimensione della domanda, quando è riconosciuta priva di scopo e perciò inutile, avendo come fine la verità in quanto *probléma*. Così non percorrono vie di fuga, auspicando che la verità prenda forma, se non oggi, un'altra volta, con la pazienza di ottenerla.

È così che il dipartimento di sociologia e diritto dell'economia può essere inteso come labirinto protettivo degli studiosi rivolti al possibile delle risposte, anche se spesso si celano.

Nella fondamentale proposizione di far coincidere esistenza e costruibilità di cose nuove, con approfondito vaglio critico, nell'equilibrio delle due discipline, aperte una all'altra con lucidità.

Il dipartimento è dunque la forma di accoglienza che facilita e nutre il successo della ricerca, attività istintiva e fertile dei suoi componenti che insieme reagiscono al controllo esercitato sulle questioni dall'abitudine; con le loro narrazioni plurali tra il caos dei diritti, le istituzioni, le tradizioni giuridiche e sociali, i soggetti politici in cerca di legittimazione, i poteri nascosti che così tanto ricordano la crisi attuale, le nuove patrie, le tendenze isolazioniste, l'essere in relazione.

Ed è il luogo dell'ascesa di giovani intraprendenti che con le loro intuizioni creano una grande realtà, né impaludata né burocratica, vero riferimento in una globalità sempre più frammentata, in attesa del futuro, con coraggio morale in tempi squilibrati e storti di società subalterne e dilatate.

Sociologia e diritto dell'economia si sono accostate l'una all'altro nell'ambito di un nuovo dipartimento per la specifica funzione morale e sociale delle discipline e del ruolo dei loro studiosi. L'idea del 'compito' delle due discipline è stata centrale per il loro accostamento; tanto da sembrare strettamente legata e finanche suggerita da un'idea morale della società e del sistema giuridico. A questa idea si è affiancata poi la volontà di una intensa attività pubblica e di una altrettanto viva produzione scientifica.

La prossimità tra sociologi e giuristi ha messo in luce il valore politico delle norme e definita la loro funzione in relazione al sistema sociale ed economico e ha sottolineato il differente grado di adeguatezza pubblico-politica in vista della loro applicazione. Si sono trovati così a lavorare gomito a gomito numerosi intellettuali, in una schiera che ha riunito nella figura dello studioso attitudini di vita e vocazioni in una misura in parte anche lontana dalla tradizione accademica. Le due discipline hanno una propria unità intrinseca, guidate da propri principi originali ma le accomuna uno spirito che è lo sforzo di contrastare con puntuali riferimenti e analisi ogni decadenza, ogni sincretismo sui tempi attuali, articolando un senso nuovo dell'uomo in sé, del mondo, del dualismo tra l'uno e l'altro, del dinamismo societario, della conoscenza della verità sulla condizione umana individuale e collettiva.

L'accostamento delle due discipline può rappresentare l'opportunità di possibili novità nel metodo o nella attualità delle ricerche che sono gli elementi che intendono caratterizzare la Collana, aperta ai lavori anche di sperimentazione, o nella messa a fuoco del *proprium* di ogni disciplina, tutti considerati come compito e come responsabilità di ogni studioso. È questa la risposta a studi mistificatori e sedicenti scientifici di alcuni anni passati che enunciavano il crollo di tutti i principi e di tutte le regole. Questa Collana ha una funzione ordinante, regolatrice e costruttiva nel nostro sistema sociale, economico e giuridico, e vuole essere espressione di un sistema di valori economici, giuridici e sociali subito associati al concetto di persona umana senza restringere l'orizzonte scientifico ad una sola epoca storica. È così che le cose possono 'svelare' la

loro esistenza a chi le interroga seriamente, visitandole più volte, senza tuttavia svelare del tutto da dove vengono.

Risulta chiaro che la Collana contiene due punti di vista, entrambi necessari, nella comprensione della realtà, ma differenti e vuole superare le difficoltà o le perplessità che un loro avvicinamento ha più volte suscitato, soprattutto per la diffidenza di alcuni studiosi, nonostante siano coscienti della ormai imprescindibile natura interdisciplinare della ricerca, che si tratti di interdisciplinarietà interna o esterna; anche perché soltanto così si evita sicuramente che ogni scienza rifletta esclusivamente su se stessa e sul proprio ruolo e non prenda in considerazione riflessi, relazioni, interferenze che non possono non stimolare.

La Collana del dipartimento costituisce perciò il punto d'incontro speculativo tra le culture degli studiosi afferenti alla struttura e ha l'ambizione di avvalorare i loro apporti dediti al ritrovamento del senso vero della realtà; così ad esempio il giurista va oltre i classici confini dell'interpretazione della legge che non ne esauriscono obbligatoriamente il compito scientifico e il sociologo va oltre i confini delle regole sociali vigenti in una certa collettività, analizzandone il senso, le funzioni e le finalità di cambiamento della collettività stessa.

Risulta così che le due discipline, diritto e sociologia, possono affrontare nuovi argomenti tra scienza e politica, sottolineando la centralità del concreto rispetto all'astratto in una conclusione armoniosa.

# INTRODUCTION

A regulatory intervention affecting the distribution of legal entitlements, for it to be warranted, must bear the burden of proving that in its absence market forces would fail to allocate the entitlements in a socially desirable way.<sup>1</sup> A cause of market failure in the efficient allocation of entitlements by private arrangements entered into by market participants is negative externalities, that is, costs imposed on defenceless third parties. Rules and doctrines mandating subordination of the debt raised from a firm's insiders<sup>2</sup> to the debt owed outside creditors in a firm's bankruptcy, which cause insiders' debt claims to be paid only after outside creditors' claims have been paid in full, are conceived to remedy distortions in the market for the internal financing of companies and thereby prevent harm to non-insider creditors.

Debt financing from a firm's insiders is a common source of funding for many firms.<sup>3</sup> Insiders routinely provide liquidity to their firm by making

1. A widely accepted idea which traces back to the seminal work of Ronald Coase. See Ronald J. Coase, *The Problem of Social Cost*, 3 JOURNAL OF LAW & ECONOMICS 1 (1960).

2. Unless otherwise specified in the text, by "insiders" I mean controlling shareholders, directors and executive officers.

3. The debt I refer to hereinafter consists of claims originating from the voluntary extension of credit to the firm. The source of such debt claims may be a lending agreement, the purchase of debt securities (bonds, debentures, notes) or a transaction on credit whereby payment to the insider in exchange for goods or services provided to the firm is deferred. Regardless of the transactional form, the substance is that of money consensually advanced to the firm to fund its activities. Therefore, the notion of debt claim herein referred to includes debt claims arising from neither involuntary transactions such as a tort nor voluntary transactions such as the payment to the owner-manager of compensation consisting of firm-issued debt instruments or pension and deferred compensation arrangements. The exclusion of debt from the subordination remedy advocated in this work when originated in connection with compensation arrangements meant for owner-managers does not imply that turning it into subordinated debt would be *per se* undesirable. The benefits of awarding subordinated debt to executives at banks has already been highlighted by others. See Frederick Tung, *Pay for Banker Performance: Structuring Executive Compensation*

loans. They do so whether the firm is solvent or financially distressed. When the firm is solvent, insiders may extend credit to fund operations and growth opportunities. When the firm is financially troubled, insiders may be willing to provide emergency liquidity in the form of debt in order to avert bankruptcy and finance a turnaround.

Corporate finance and agency theory predict that, once the minimum legal capital requirements applicable to a company, if any,<sup>4</sup> are met, the company's insiders will prefer inside debt to inside equity to satisfy any further financing needs of the firm. By choosing debt rather than equity the firm owners mitigate their risk of loss in the event of bankruptcy while not compromising the overall expected return on their investments. The insiders' predilection for debt over equity derives from the order of priorities in insolvency, according to which the estate assets must first be used to pay off liabilities, with equity interests

*for Risk Regulation*, 105 NORTHWESTERN UNIVERSITY LAW REVIEW 1205 (2011). The same benefits would admittedly arise if subordinated debt were allocated to executives at nonfinancial firms. In holding subordinated debt whatever the source, management would have a weaker incentive to side with shareholder appetite for excessive risk-taking. The subordinated debt held by management would be first in line to lose value as a result of policies transferring wealth from debtholders to equityholders. While enjoying no equity-like upside from risky business, it would be side-by-side with equity in suffering all the downside. But imposing undifferentiated subordination on all debt instruments awarded as compensation would likely lead management to object to this form of compensation in many instances. And forcing nonfinancial companies, let alone closely-held nonfinancial companies, to compensate management wholly or partly with subordinated debt is unrealistic. On top of these considerations, this book limits itself to considering debt financing, and debt financing in its conventional meaning occurs when a firm sells debt instruments to obtain inflows of capital on competitive terms to fund its operations or when a firm purchases goods or services on credit to defer cash outlays.

4. The controversial usefulness of minimum legal capital requirements, which may chill entrepreneurship whichever equity threshold they set without ensuring financial solvency whichever equity threshold they set, has led some jurisdictions to keep them so low as to look like nothing more than window dressing and has convinced other jurisdictions to abandon them altogether. For instance, state corporate laws across the United States no longer provide for minimum legal capital requirements, which were dropped at the turn of the 20<sup>th</sup> century. See, e.g., James W. Hurst, *THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES, 1780-1970*, 53 (1970). European Union corporate law still imposes minimum equity, but it does so only with regard to public corporations and sets the minimum threshold at 25,000 euros regardless of the debt-to-equity ratio, with no European Union Member State corporate laws departing largely from such minimum. Besides, neither the state corporate laws of the United States nor European Union corporate law provide for a duty to adequately capitalize a corporation. See Jonathan M. Landers, *A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy*, 42 UNIVERSITY OF CHICAGO LAW REVIEW 589, 592 (1975) (the United States); Peter O. Mülberr, *A Synthetic View of Different Concepts of Creditor Protection, or: A High-Level Framework for Corporate Creditor Protection*, 7 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW 357, 392-94 (2006) (the European Union).

solely entitled to the leftover. In light of such a priority scheme, should the company enter bankruptcy, equityholders likely see their equity stake entirely wiped out. Conversely, debt claims may still entertain the hope to recover some cents on the dollar, however small such hope may be. Therefore, corporate insiders have a strong incentive to allocate resources to the firm in the form of debt as opposed to equity.

Yet, allowing insider creditors to rank on a par with outside creditors prejudices the recovery rate of the latter if the firm ultimately does enter bankruptcy, with the magnitude of the harmful effects for the outside creditor class correlated with the severity of a company's financial troubles and the size of the inside debt relative to the outside debt. Additionally, if the debt advances made by the insiders were used to pursue excessively risky business strategies or prolong the life of a floundering company in the expectation of an unlikely recovery, the eventual deepening of the financial imbalance would diminish the chances of reimbursing the outside creditors' claims even further. It is therefore widely believed that making the firm insiders' debt claims junior to all the other outside creditors' claims would help deter advances from the insiders opportunistically designed to serve their private interests at the outside creditors' expense.<sup>5</sup>

While subordination of inside debt might deter strategic insider lending, the prospect for insiders of recovering a higher value in bankruptcy by choosing debt financing as opposed to equity financing may become critical for the rescue of a firm in financial dire straits. When the firm is financially distressed, insider financing may prove the only readily available source of funding.<sup>6</sup>

5. See Kathleen Kinney, *Equitable Subordination of Shareholder Debt to Trade Creditors: A Reexamination*, 61 BOSTON UNIVERSITY LAW REVIEW 433 (1981) (claiming that if shareholders fail to adequately capitalize a corporation, their creditor claims should be subordinated to those of the trade creditors upon bankruptcy); Leonard J. Long, *Automatic Subordination as Incentive for Insider Creditors' Prudential Investing*, 13 JOURNAL OF LAW & COMMERCE 97, 118 (1993) (arguing that automatic subordination of insiders' creditor claims "could serve as a potentially useful tool to encourage the proper level of investment in closely-held and financially troubled enterprises"); Simon Landuyt, *A Capital Question, Should Shareholder Loans Be Automatically Subordinated?* (University of Ghent Financial Law Institute Working Paper Series, Working Paper no. 03, 2018), [www.law.ugent.be/fli/wps/pdf/WP2018-03](http://www.law.ugent.be/fli/wps/pdf/WP2018-03) (contending that subordination of inside debt would force shareholder-managers to internalize the costs of their excessive risk-taking); Rolef J. de Weijs, *Harmonization of European Insolvency Law: Preventing Insolvency Law from Turning against Creditors by Upholding the Debt-Equity Divide*, 2 EUROPEAN COMPANY AND FINANCIAL LAW REVIEW 403, 415-25 (2018) (noting that without subordination shareholders would give preference to debt over equity financing and shareholder-creditors would inefficiently combine control power over the firm with a disproportionate protection against the risk of loss).

6. See James H.M. Sprayregen, Jonathan Friedland & James R. Mayer, *Recharacterization from Debt to Equity: Lenders Beware*, 22 AMERICAN BANKRUPTCY INSTITUTE JOURNAL

But insiders unlikely are blind to the escalating risk of loss on any additional investment in the firm. Therefore, depriving them of the possibility to advance loans having the same priority enjoyed by outside debts might have a chilling

30, 31 (November 2003) (“Often, a company in financial distress may find its best avenue for additional funds to be from insiders who already have a vested interest in the company”); Matthew Nozemack, *Making Sense Out of Bankruptcy Courts’ Recharacterization of Claims: Why Not Use § 510(c) Equitable Subordination?*, 56 WASHINGTON & LEE LAW REVIEW 689, 715 (1999) (“Often an insider is the only source of funds for a struggling company.”); James M. Wilton & William A. McGee, *The Past and Future of Debt Recharacterization*, 74 BUSINESS LAWYER 91, 104 (2019) “[F]or an insolvent company, insiders are often the only source of credit”). In sharing these concerns, some United States’ federal circuits and state courts have been wary of attempts to force insiders into judicially-determined financing schemes, as such attempts might discourage the provision of liquidity essential for a firm’s survival at a time when nobody else stands ready to financially support the firm. See *In re Mid-Town Produce Terminal, Inc.*, 599 FEDERAL REPORTER (SECOND SERIES) 389, 392 (United States Court of Appeals for the 10<sup>th</sup> Circuit, 1979) (“We are unwilling to find a dominant shareholder may not loan money to a corporation in which he is the principal owner and himself become a secured creditor. To hold the debt may be subordinated on that basis alone would discourage owners from trying to salvage a business, and require all contributions to be made in the form of equity capital. We do not think that is desirable as social policy, nor required by the cases.”); *Sender v. Bronze Group, Ltd. (In re Hedged-Investments Associates)*, 380 FEDERAL REPORTER (THIRD SERIES) 1292, 1299, nt. 1 (United States Court of Appeals for the 10<sup>th</sup> Circuit, 2004) (“[E]xcessive suspicion about loans made by owners and insiders of struggling enterprises would discourage legitimate efforts to keep a flagging business afloat.”); *Redmond v. Jenkins (In re Alternate Fuels, Inc.)*, 789 FEDERAL REPORTER (THIRD SERIES) 1139 (United States Court of Appeals for the 10<sup>th</sup> Circuit, 2015) (“We have been careful not to ‘discourage owners from trying to salvage a business’ by requiring ‘all contributions to be made in the form of equity capital.’” quoting *In re Mid-Town Produce Terminal, Inc.*, 599 FEDERAL REPORTER (SECOND SERIES) at 392); *Fairchild Dornier GmbH v. Official Committee of Unsecured Creditors (In re Official Committee of Unsecured Creditors for Dornier Aviation (North America), Inc.)*, 453 FEDERAL REPORTER (THIRD SERIES) 225, 234 (United States Court of Appeals for the 4<sup>th</sup> Circuit, 2006) (“In many cases, an insider will be the only party willing to make a loan to a struggling business, and recharacterization should not be used to discourage good-faith loans.”); *Braas Systems, Inc. v. WMR Partners (In re Octagon Roofing)*, 157 BANKRUPTCY REPORTER 852, 858 (United States District Court for the Northern District of Illinois, 1993) (“Any other analysis would discourage loans from insiders to companies facing financial difficulty and that would be unfortunate because it is the shareholders who are most likely to have the motivation to salvage a foundering company”); *Robson v. Smith*, 777 PACIFIC REPORTER (SECOND SERIES) 659, 663 (Supreme Court of Alaska, 1989) (“A corporation in [financial difficulty] needs to be able to rely on those most interested in its survival. Directors and shareholders may be the only persons willing to assist the corporation in such a position.”); *In re Mader’s Store for Men, Inc.*, 77 WISCONSIN REPORTER (SECOND SERIES) 578, 609 (Wisconsin Supreme Court, 1977) (“Where a corporation is once provided with a reasonably adequate fund of stated capital but subsequently requires additional funds, the stockholders may advance those funds as a loan in an attempt to enable the corporation to continue in business, and, provided no inequitable conduct is shown, the stockholders may participate with other creditors in the distribution of the insolvent estate.”).

effect on efforts to work out plans preventing financially flagging companies from entering bankruptcy. Legal strategies aimed at relegating an insider's debt claim to the back of the claim repayment line in bankruptcy might have this unfortunate side effect.<sup>7</sup>

In light of the many arguments advocating for subordination or no-subordination of insiders' debt claims, we are confronted with a subordination dilemma. The conflicting views on the desirability of inside debt as a source of financing for firms have unsurprisingly led to radically different regulatory approaches. Europe alone provides a sample of many of them. European Union ("EU") law encourages new financing and interim financing in connection with restructuring plans of financially-distressed firms,<sup>8</sup> but remains silent on pre-petition debt financing from a firm's insiders.<sup>9</sup> In the absence of any specific EU law, a few current and former EU Member States refrain from adopting *ad hoc* remedies to cope with allegedly opportunistic insider loans and choose to rely on general rules on directorial liability for misconduct and equity capital maintenance. In stark contrast, other prominent EU jurisdictions take a harsh

7. See Hilary A. Goehausen, *You Said You Were Going to Do What to My Loan – The Unequitable Doctrine of Recharacterization*, 4 DEPAUL BUSINESS & COMMERCIAL LAW JOURNAL 117, 142 (2005) (“[R]echaracterization has disastrous implications for potential lenders and may spell the end for financially struggling companies.”); Martin Gelter, *The Subordination of Shareholder Loans in Bankruptcy*, 26 INTERNATIONAL REVIEW OF LAW & ECONOMICS 478 (2006) (arguing that subordination of shareholder loans as well as their recharacterization as equity might deter efficient rescue attempts); Paul Wallace, *Simplifying the Muddled Doctrine of Debt Recharacterization*, 86 MISSISSIPPI LAW JOURNAL 184, 199 (2017) (“[F]ear of debt recharacterization may lead to the extinction of companies who rely on insider financing.”); Patricia A. Redmond & Jessica D. Gabel, *Not All Loans Are Created Equal: Equitable Subordination and Prepetition Insider Lending After SI Restructuring*, 27 AMERICAN BANKRUPTCY INSTITUTE JOURNAL 22 (November 2008) (“Essentially, equitable subordination and recharacterization disincentivize eleventh-hour restoration financing”); Michael R. Tucker, *Debt Recharacterization during an Economic Trough: Trashing Historical Tests to Avoid Discouraging Insider Lending*, 71 OHIO STATE LAW JOURNAL 187 (2010) (opining that recharacterization of inside debt as equity “encourages underinvestment”, thereby increasing the probability of corporate failures in times of credit rationing).

8. See Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency).

9. Although the Report of the High Level Group of Company Law Experts had entertained the possibility of having insiders' claims subordinated as part of a more modern European regime for creditor protection (see High Level Group of Company Law Experts, REPORT ON A MODERN REGULATORY FRAMEWORK FOR COMPANY LAW IN EUROPE 86 (2002)), such a suggestion was never acted upon at the EU level.

stance by providing for the automatic subordination of insider loans for the benefit of all external creditors and regardless of the financial conditions of the firm, a broad notion of insider, as well as tight preference rules for the avoidance of preferential payments to a company's related parties. In between these two extremes there lie countries providing for equitable subordination of inside debt if the financing was provided to an overleveraged or insolvent company.<sup>10</sup> Once we broaden the scope of a comparative assessment of regulatory choices by including the United States ("US") and other jurisdictions from around the world, we may appreciate even further how diverse the regulatory approaches to inside debt financing might be.

Much has been written with regard to the benefits and costs of inside debt financing from the perspective of social efficiency. On the contrary, the literature is surprisingly sparse when it comes to highlighting in what corporate contexts insider loans figure prominently and what effects inside debt has on a firm's capital structure, insider behavior and creditor interests once the financial conditions of the company are taken into account. This work aims to fill a gap in the existing literature in that it illustrates in what settings and under what conditions inside debt financing is mostly used and how the effects inside debt generates on insiders' incentives and creditors' interests vary as a company moves from a condition of full solvency to one of insolvency. But the goal is even more ambitious. After comparing existing and potential regulatory approaches to insider lending and highlighting their respective pros and cons, this book sketches a novel regulatory remedy to dealing with insider loans, which in essence recommends automatic subordination of insiders' debt claims if originated while the company was fully solvent and, somehow counterintuitively, no-subordination of insiders' debt claims if originated while the company was financially distressed, in the latter case provided that adequate disclosure of the debt financing was made. This book also proposes the use of stringent avoidable preference rules targeting insiders so as to avoid that the subordination remedy might be circumvented.

The premise on which this work is built is that firm value is not indifferent

10. Interestingly, Europe seems to be almost evenly split between jurisdictions that provide for specific rules on subordination of insiders' debt claims and jurisdictions that do not, with the latter representing only a slight majority. There is however no clear pattern underlying this divide. Some countries whose corporate finance practices as well as corporate and bankruptcy laws have much in common take different approaches to inside debt financing, whereas other countries with large differences in corporate culture and corporate and insolvency regimes converge on similar if not identical rules on inside lending. The only certainty notably is that the number of European countries embracing some form of legal subordination of insider loans has increased over the past few years.

to a company's capital structure, as any given choice of capital structure has repercussions on type and size of agency costs, which in turn reduce firm value. Different regulatory options as to the ranking of debt claims of a firm's owners in bankruptcy vary in their impact on the latter's *ex ante* financing decisions, the resulting capital structure and the ensuing agency relationship between the firm and its external constituencies. A regulatory intervention should therefore aim at setting the proper incentives for the insiders to take financing decisions that, by putting in place a balanced capital structure and alleviating the shareholder-creditor agency problem, prove instrumental in maximizing firm value<sup>11</sup> and ensuring fairness.

The book is organized as follows. Part I discusses the benefits and costs of debt advances made by a firm's insiders as commonly identified in the literature. This Part shows that there are as many theoretical arguments to defend inside debt financing as there are theoretical arguments to look at it with skepticism. Therefore, any regulatory approach that would want to be premised on a one-sided judgment about the efficiency or inefficiency of insider loans is likely to be misguided. Part II highlights the irrelevance of inside debt for widely-held firms as opposed to the importance of inside debt to closely-held ones. In doing so, Part II explains why a firm's insiders are better off extending credit than infusing equity and why a firm's major lenders, too, are better off when insiders choose debt in lieu of equity. Part II continues by illustrating the practice and magnitude of insider lending to small firms and subsidiary companies in business groups (*i.e.* groups of affiliate corporations). These two are the corporate contexts in which financing through issuance of inside debt takes place more frequently and poses a bigger threat to outside creditors. Next, this Part examines the practice of insider lending in the context of leveraged transactions, such as leveraged buyouts and project financing.

11. To be sure, the directive of firm value maximization might mean different things to different authors. See, *e.g.*, Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VANDERBILT LAW REVIEW 1485, 1497 (1993) (observing that "directors should pursue projects that have positive net present value to the company as a whole, and not just a positive effect on either debt or equity"); Thomas A. Smith, *The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty*, 98 MICHIGAN LAW REVIEW 214, 237-43 (1999) (arguing that managers should make decisions maximizing the aggregate value of all financial claims rather than the value of any specific class of financial claims); Alon Chaver & Jesse M. Fried, *Managers' Fiduciary Duty Upon the Firm's Insolvency: Accounting for Performance Creditors*, 55 VANDERBILT LAW REVIEW 1813 (2003) (contending that managers should maximize the aggregate value of all financial and nonfinancial claims against the firm); Douglas G. Baird & M. Todd Henderson, *Other People's Money*, 60 STANFORD LAW REVIEW 1309 (2008) (refining the firm value maximization maxim by arguing that it should be a default which investors are allowed to bargain out of *ex ante*).

Finally, Part II provides a tentative answer to the question why inside debt is often subordinated to outside lenders' debt but it is so less often than expected. Overall, Part II shows that inside debt financing is commonplace in many quarters, is strategically used to reduce risk to the benefit of corporate insiders and some privileged lenders and deviations from common patterns of inside financing still stem from strategic bargaining between a firm's insiders and its most influential lenders. Part III illustrates how the direction of shareholders' incentives is contingent on the state of a firm's finances. This Part recalls the familiar description of shareholders' incentives as optimal as long as the firm is fully solvent, distorted when the firm is financially distressed, and perverse after the firm has collapsed into insolvency. Part IV inquires into the desirability of debt financing from a firm's insiders at various stages of a firm's existence in light of the impact that the financing has on a firm's capital structure, insider incentives and ensuing agency costs of debt. This Part argues that, contrary to received wisdom, inside debt should worry more when it is provided to a fully solvent firm than to a nearly-insolvent firm, because the choice of debt as opposed to equity at a time when the firm is solvent may exacerbate the moral hazard problem while simultaneously reducing the potential payoff in bankruptcy to creditors unable to adjust the term of their claims to the firm's capital structure. Conversely, inside debt financing may well be the only viable financing option for financially struggling firms. Besides, when provided to a firm teetering on the brink of insolvency, it both increases insiders' financial exposure, thereby mitigating their moral hazard, and enhances the chances of out-of-the-money creditors to be wholly or partially paid back. Part V focuses on the regulatory approaches to loans made by insiders which prevail in Europe, the US and other jurisdictions from around the world. This Part identifies three main regulatory approaches, which I call the no-subordination approach, the equitable subordination approach and the automatic subordination approach, respectively. After examining the main features of these regulatory options, Part V also sheds light on the advantages and disadvantages of each of them by pitting one against the others. Part VI investigates the determinants of an efficient and fair legal response to the practice of debt advances from insiders to finance their companies. An efficient and fair regime is assumed to have to deal with insider lending by preventing the strengthening of moral hazard incentives for insiders when doing so poses little risk of producing efficiency losses. Therefore, the proposal argues in favor of automatically subordinating inside debt financing to a solvent firm to all other outside debts. A socially desirable regime is also assumed to have to avoid disincentivizing lending by insiders whenever the insiders are the only ones left in town to stand ready to finance an out-of-court turnaround of a financially-distressed company. Thus,

the proposal goes as far as claiming that inside debt financing to a financially troubled firm, absent insider creditor misconduct, should be exempt from subordination provided that the debt investment by the insider is properly disclosed to the public. Part VII describes the main features of a novel regulatory approach to inside debt financing, which requires that insiders' advances be subject to or exempt from subordination based on the time of the insider's advance relative to the event of bankruptcy and the disclosure of the advance (or lack thereof). While a distinction based on the timing of the insider loan would trade off certainty against imprecision, it would still be consonant to most bright-line, backward-looking bankruptcy rules. Moreover, according to this novel approach the repayment of loans to insiders within the year prior to bankruptcy should be avoidable as a preference, regardless of the loan's origination and maturity dates. The voidability of the reimbursement of inside debt, besides ensuring equality of treatment of creditors, would be instrumental in preventing circumvention of the advocated-for rules on subordination of inside debt financing.



PART I  
BENEFITS AND COSTS  
OF INSIDE DEBT FINANCING

This Part provides an account of the many potential benefits which insider lending may provide to a firm as well as the many countervailing costs that insider lending may give rise to. In doing so, this Part draws on the extensive literature that has dealt with insider lending. Section A analyzes the benefits, whereas Section B focuses on the costs.

**A. Benefits of Inside Debt Financing**

In an ideal, frictionless world, firms would have no obvious advantage from raising debt from their insiders. Quite the opposite, in a perfectly competitive loan market companies would unlikely obtain more favourable terms and conditions on loans from shareholders and management than on loans from outside lenders.<sup>1</sup> After all, shareholders and managers are not necessarily lenders by profession. And lenders by profession such as banks should possess all necessary resources to provide debt financing on more competitive terms, if only for the expertise, synergies of scale and access to low-cost money<sup>2</sup> they may count on. In such an ideal world, even a financially-distressed, cash-starved firm would be able to obtain much-

1. Klaus Gugler, Evgeni Peev & Esther Segalla, *The Internal Workings of Internal Capital Markets: Cross-Country Evidence*, 20 JOURNAL OF CORPORATE FINANCE 59 (2013), finds empirical confirmation that the better the access to external capital markets is, the less important the use of internal capital markets becomes.

2. By low-cost money I mean that unique mix of sources of funding that banks, unlike other financiers, can avail themselves of, which range from the liquidity deposited on bank and savings accounts by bank clients, to capital markets, securitization of their illiquid assets, interbank lending market, and credit facilities provided by central banks in ordinary and extraordinary circumstances.

needed liquidity from outside lenders if its going-concern value exceeded its liquidation value.<sup>3</sup>

In the real world, by contrast, borrowing firms and outside lenders face positive transaction costs ranging from information and bargaining costs to enforcement costs, which undermine viability and optimality of external debt financing. First, borrowers must seek out lenders available to fund their operations. Second, outside lenders have to expend resources on assessing the creditworthiness of the borrower based on the information publicly available and the specific information voluntarily provided to them, which itself entails evaluating the reliability of such information. Outside lenders also have to closely monitor the borrower's solvency and creditworthiness until the successful repayment of the loan.<sup>4</sup> Overcoming the problem of asymmetrical information is onerous, and it is increasingly so the less the firm is subject to statutory disclosure requirements.<sup>5</sup> Third, negotiating the terms of a credit facility with outside lenders entails reconciling the interest of the borrower to being charged lower interest rates and benefiting from longer durations and the opposing interest of the lender to charging higher interest rates and demanding shorter durations. Besides, loan terms might need to be renegotiated in light of the borrower's changing needs and circumstances. Even when the negotiating process does not fall apart, haggling over contract terms is time consuming. Fourth, should the debtor company fail to pay its

3. See Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy Law as a Liquidity Provider*, 80 UNIVERSITY OF CHICAGO LAW REVIEW 1557, 1569 (2013) (noting that a cash-strapped firm should ideally be able to finance efficient investments by borrowing against the value of its future income stream).

4. An external financier with no control over the use of the corporate assets may have less incentives to monitor compared with an internal financier having control over the assets to the extent the former, unlike the latter, does not reap all of the benefits from the monitoring activity. See Robert H. Gertner, David S. Scharfstein & Jeremy C. Stein, *Internal versus External Capital Markets*, 109 QUARTERLY JOURNAL OF ECONOMICS 1211 (1994).

5. While securities regulations worldwide force publicly-traded corporations to reveal a substantial amount of private information for the benefit of both internal and external constituencies, privately-held corporations are subject to fewer and less detailed disclosure mandates in most countries and few if any disclosure mandates in the US. See John Armour, Gerard Hertig & Hideki Kanda, *Transactions with creditors*, in THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 109, 120 (Reinier Kraakman *et al.* eds., 3<sup>rd</sup> ed. 2017). State laws in the US hold out as particularly lenient to the extent they require disclosure of a close corporation's annual accounts solely for the benefit of the shareholders. See, *e.g.*, William J. Carney, *The Production of Corporate Law*, 71 SOUTHERN CALIFORNIA LAW REVIEW 715, 761 (1998). To the extent producing and disseminating information is costly, absent disclosure obligations the incentive to disclose private information voluntarily becomes a function of the benefit to be achieved from the recipient of the information being disclosed.

debts when they fall due because unwilling or unable to do so, the lenders must enforce their claims. But the effectiveness of claim enforcing depends on the strength of creditor rights. Where they are weak, so are the chances of reimbursement.<sup>6</sup> In any event, vindicating one's own rights is notoriously costly and does not necessarily pay off if the debtor is in financial difficulty.<sup>7</sup> Moreover, professional lenders such as banks are subject to prudential regulation restricting their liberty to finance firms as they please, resulting in a lower amount of credit extended to any one firm and at a higher cost for them.<sup>8</sup> All these transaction costs and regulatory burdens are reflected in the terms and conditions on which external borrowing is obtained. As a result, they make outside debt financing for firms a less obvious and costlier proposition than it could ideally be.

The above-mentioned hurdles are compounded when a firm plummets into severe financial distress. When a firm is debt-laden, it might face a liquidity crisis. As the risk of insolvency begins to loom large, external lenders may grow uncomfortable with providing additional funding despite room for efficient continuation. Reluctance of outside lenders to extend credit to financially struggling companies is usually aggravated by the lack of unencumbered assets.<sup>9</sup> If a firm nears bankruptcy with its current and prospective assets fully

6. See Mihir A. Desai, C. Fritz Foley & James R. Hines, Jr., *A Multinational Perspective on Capital Structure Choice and Internal Capital Markets*, 59 JOURNAL OF FINANCE 2451, 2479-80 (2004) (evidencing that weak legal protection accorded to lenders implies fewer chances for them to be paid back, to which scenario they respond by charging borrowers higher interest rates).

7. Even assuming there exist assets for the lender to seize and liquidate, their redeployment through a sale to a third party does not allow the seller to capture the value it would take for itself if it could redeploy the assets internally. See Gertner, Scharfstein & Stein, *supra* note 4, at 1224.

8. Banks must fulfill equity capital requirements, which become more stringent as the bank lends more and/or takes on greater credit risk. The higher the credit risk, the more the equity capital that must be set aside. As issuing additional equity is costly to a bank's existing shareholders, banks must make sure to seek compensation for such extra costs by charging borrowers higher interest rates. Besides, there exist limitations as to the maximum amount that a bank can lend to a given borrower, which are usually expressed as a percentage of the bank's own capital.

9. See Douglas G. Baird, *The Reorganization of Closely Held Firms and the Opt Out Problem*, 72 WASHINGTON UNIVERSITY LAW QUARTERLY 913, 913 (1994) ("The typical closely held firm in financial distress has a simple capital structure. There is a single large institutional lender with a security interest in all of the firm's assets."); Markus C. Stadler, *Treatment of Shareholder Loans to Undercapitalized Corporations in Bankruptcy Proceedings*, 17 JOURNAL OF LAW & COMMERCE 1, 2 (1997) ("In most instances, corporations in bad financial shape already have all of their assets over-encumbered with security interests. Thus, it is not possible to acquire loans from outside financial sources since adequate security is not available.").

collateralized,<sup>10</sup> further borrowing on a secured basis becomes unavailable. Although unsecured lending could theoretically be feasible, new lenders may well back away if the firm cannot afford paying the extra-compensation such lenders would likely demand in exchange for the enhanced risk they would take on.

Debt financing from a firm's insiders may thus be understood as playing a gap-filling role. Inside debt may prove a viable alternative to a market for external debt finance which is tainted by transactional and regulatory frictions, thereby enriching the corporate capital structure and potentially contributing to firm value creation.<sup>11</sup> In effect, when debt financing is offered by a firm's insiders, debt transaction costs can be expected to be minimal. At any rate transaction costs should be lower than those weighing on outside financiers. The reasons are manifold.

First, providers of internal finance face lower information and monitoring costs, thereby being able to allocate resources more efficiently.<sup>12</sup> By directly managing the firm or having timely access to key corporate information, insiders know, or ought to know, the company and its creditworthiness better than does any third party. As a result, the company needs not make any special efforts in signalling its quality, thereby saving on information-producing costs. Insiders and their companies incur lower bargaining costs, too, inasmuch as the former admittedly are aware of the latter's reservation price. More generally, bargaining takes place in a context of complete information. At the same time, the pecuniary and nonpecuniary private benefits arising out of an insider's controlling equity stake should curb incentives to demand more than the company can afford, because an insider's becoming a dual-claim holder presents it with a tradeoff. Any greater return required of debt investments correspondingly reduces the expected return on equity investments.<sup>13</sup> As a

10. See Ayotte & Skeel, *supra* note 3, at 1611-12 n.130 (noticing that over the past few decades US firms have entered bankruptcy with their assets fully encumbered or nearly so).

11. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 JOURNAL OF FINANCIAL ECONOMICS 305, 352 (1976) (hypothesizing that an owner-manager could eliminate a large part of the agency costs of debt by holding debt herself).

12. See Gertner, Scharfstein & Stein, *supra* note 4, at 1219-20 (claiming that internal providers of capital have stronger incentives to monitor since their residual control rights over the assets allow them to reap more of the gain from monitoring); Jeremy C. Stein, *Internal Capital Markets and the Competition for Corporate Resources*, 52 JOURNAL OF FINANCE 83 (1997) (explaining that the rationale behind an internal capital market is that headquarters, unlike a bank lender, has the authority and incentive to allocate resources to higher-value projects and away from lower-value projects).

13. Net of the incidence of taxes, a firm's insider holding 100% of the equity capital and

result, insider creditors owning up to 100% of a firm's equity – as is usually the case in closely-held companies – have no incentives to charge their companies any particular interest rate, let alone excessive interest rates. All these circumstances shorten the time to reach an agreement and increase the chances of reaching one.

Second, insiders sustain lower enforcement costs insofar as they can safely expect to have their claims spontaneously satisfied if and when the company has the resources to do so. An opportunistic holdup by their own company is admittedly out of the picture. Because of the sharing of complete information, the costs of renegotiating internal debt arguably are negligible, too.

Third, by providing an alternative, competitive, lower-cost source of funding, insiders also cause outside lenders to exercise some self-restraint in their attempt to entirely pass the costs of transacting on to borrower firms. As a result of such constraint on providers of outside funds, debt financing from a firm's insiders may reduce overall borrowing costs.

Fourth, inside debt financing may also attenuate the well-known “underinvestment” problem that affects a firm's equityholders when their firm suffers from a large debt overhang, as is usually the case with overindebted firms in the vicinity of insolvency.<sup>14</sup> As the debt-to-equity ratio increases, equityholders' incentives to seek out firm value-creating business opportunities diminish accordingly. Knowing that they bear all the costs of devising value-enhancing business strategies while reaping the benefits therefrom only if the strategy proves exceedingly fruitful, equityholders may forego all those positive-net present value (“NPV”) opportunities they stand to gain nothing from. Therefore, if allowed to claim back a percentage of cash flows by propping up their claims' degree of priority to the same level of outside debt claims, the expectation of a return may persuade equityholders to provide a financially struggling firm with further funds. For inside debt financing allows equityholders to participate *pro rata* in the surplus captured by the creditor class at whatever level of firm value creation, it may alleviate the magnitude of this underinvestment problem.

willing to make an interest-bearing loan is confronted with a zero-sum game. The value that the insider decides to extract from the firm in the form of interest payments is exactly offset by a correspondent drop in the firm's equity value. Therefore, the closer to 100% the shareholding an insider owns is, the lower the financial benefit the insider can derive from making interest-paying loans to the company.

14. See Stewart Myers, *Determinants of Corporate Borrowing*, 5 JOURNAL OF FINANCIAL ECONOMICS 147 (1977) (pointing to the diminished incentives of shareholders to infuse additional equity into an overly indebted company as value resulting from new investments would largely be captured by creditors).

Fifth, insider lending may help counteract the adverse selection problem affecting firms in critical financial conditions.<sup>15</sup> Prospective lenders suffering informational asymmetries, when asked to extend unsecured credit, would likely take it as a negative signal that existing lenders and corporate insiders do not tap themselves for additional credit. Lack of knowledge of the reasons why existing lenders and the firm insiders have halted their funding of the firm would rationally induce outside lenders to entertain the view that the firm might now be a wrong bet. To the extent insiders cannot otherwise signal to prospective lenders that the financing of the firm is still worthwhile, the only means left to them to send out a signal about the quality of the investment opportunities lying ahead may well be a commitment to providing unsecured debt financing alongside the other funding furnished by the sought-for new outside lenders.<sup>16</sup> Besides, insofar as a firm is still of value to its insiders despite its insolvency,<sup>17</sup> the latter may be prepared to extend credit to get the firm out of its financial woes even though outside lenders turn their back on it.

## **B. Costs of Inside Debt Financing**

While insider loans may prove beneficial to the firm, they are not necessarily risk-free for the company and its non-insider stakeholders. Inside debt financing may directly or indirectly exacerbate most of the agency costs of debt.

The relationship between a company's equityholders and debtholders is defined by both the priority ranking of their respective claims against the firm assets and the allocation of control rights over such assets in both favorable and adverse states of the world. The attribution of priority rights establishes which class of financial claimants takes precedence in extracting a definite measure of value from the firm and which class of financial claimants is entitled to receive

15. See Ayotte & Skeel, *supra* note 3, at 1579-85.

16. To be sure, advancement of funds to a firm by its insiders does not *per se* guarantee that the borrower firm is worth being financed by outsiders, either. In fact, the more the firm is viable, the less it needs financing from its insiders. Heavy internal financing may therefore follow from the lack of viable financing alternatives due to critical financial conditions. See *infra* Part IV, Section B, notes 13-15 and accompanying text. Yet, when it is in the public domain that a firm is in financial distress, provision of additional unsecured debt financing by a firm's owners might persuade outside lenders to give the firm one more chance. See *infra* Part IV, Section C, note 16 and accompanying text.

17. See Henry T.C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUMBIA LAW REVIEW 1321, 1382 (2007) (“[I]rrespective of the immediate financial condition of the company, the shareholders have something in the nature of a call option on a brighter future. And call options always have value.”).

unlimited residual value after full satisfaction of senior claims. The allocation of control rights, in turn, identifies which class of financial claimants has the right to run the firm. While debtholders are given claim priority, equityholders are given corporate control.

Priority rights and control rights, taken together, offer a solution to what in essence is a conflict of interest in the appropriation of limited corporate resources among claimholders entertaining different expectations. First comes claim priority. Claim priority serves as a mechanism to sort out investors according to their risk preferences. By offering a priority scheme, the law is able to distinguish investors who are prepared to earn more in exchange of risking more from investors who agree to earn less in exchange of risking less. To the extent debt is accorded priority over equity, the former class of investors is driven to buy equity while the latter is driven toward debt. Then come control rights. Control rights are efficiently allocated if they are afforded to the claimholders that have the best incentives to maximize firm value. Incentives to maximize firm value are stronger for those investors who enjoy the marginal benefits and incur the marginal costs of decision-making.<sup>18</sup> Therefore, control rights are given to holders of residual claims, *i.e.* the equityholders. In short, equityholders are accorded control because creditors are accorded priority.<sup>19</sup>

Yet, ownership interests, including control rights, are allocated on a contingent basis.<sup>20</sup> From the date on which the company incurs liabilities,

18. See Frank H. Easterbrook & Daniel R. Fischel, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 68 (1991).

19. From an economic perspective, it is claim priority that justifies the allocation of control rights rather than vice versa. Reasoning the other way around, one would struggle to find the rationale behind the allocation of control rights to equityholders as opposed to other claimholders. All other rationales supporting equityholder ownership of the firm commonly provided in the literature lead back to the fact that equity provides a residual interest in the firm. Oliver Williamson, *Corporate Governance*, 93 *YALE LAW JOURNAL* 1197, 1210-11 (1984), argues that equityholders as a class are given representation on the board of directors because they cannot easily be protected by contract. But the reason why it is so is that they are made residual claimants in the first place. As such, they would bear an offsetting cost for any gain derived by enforcing contractual rights against their firm. Henry Hansmann, *THE OWNERSHIP OF ENTERPRISE* 62 (1996), argues that the cost of collective decision-making is comparatively lower for the equityholders to the extent they entertain relatively homogenous expectations, in that they aim for share value maximization. But why do they share such goal? Because the high risk and high upside potential associated with equity, themselves resulting from the priority rule, make it compelling that equity be bought only or mostly by investors who are uniquely interested in maximizing profits.

20. See Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 *YALE LAW JOURNAL* 387, 407 (2000) (“[T]he creditors each have... a contingent claim on the assets that can be exercised in case of the entrepreneur’s nonperformance.”); John Armour & Michael J. Whincop, *The Proprietary Foundations of Corporate Law*, 27 *OXFORD JOURNAL OF*

the allocation of ownership interests and rights is based on the financial conditions of the firm. Once the equityholders have their company issue outside debt, they implicitly agree that outside creditors will take over should the company default on its payment obligations. Equityholders may hold onto their proprietary interests, and the rights conferred by them, as long as they keep the firm outside of bankruptcy. The threat of having their interests and rights erased in the event of bankruptcy for the benefit of debtholders warns equityholders against exercising their control power in the direction of value destruction.

This pattern reflects what equityholders and debtholders would seemingly agree *ex ante* if they could bargain at low cost over the issue, and thus is efficient. The priority rule is therefore provided by corporate law to let the parties economize on transaction costs<sup>21</sup> and is made mandatory to protect “nonadjusting” creditors against the risk of exploitation.<sup>22</sup> While this fundamental priority scheme is formally upheld even when equityholders provide debt financing along with equity financing, its goals may nevertheless come under threat.

First, a loan agreement between a firm and one of its insiders, as with any related-party transaction,<sup>23</sup> may be used to tunnel resources away from the

LEGAL STUDIES 429, 440 (2007) (“If an entrepreneur... borrows money to fund her business, this can be understood as a *sequential* sharing of entitlements between the creditor and the entrepreneur.”) (emphasis in the original).

21. See Hansmann & Kraakman, *supra* note 20, at 407-9 (explaining that a mandatory priority rule supplied by corporate law is needed to overcome the transactional obstacles that would make it unlikely or utterly impossible for an entrepreneur to, first, bargain with all of its present and future personal creditors the subordination of the latter’s claims on the firm’s assets to those of the firm’s creditors and, second, credibly commit to safeguard the priority contractually conferred on the firm’s creditors).

22. “Adjusting” creditors are said to be those creditors who are able to adjust the size of their claim to the changing riskiness of the borrower. “Nonadjusting” creditors are said to be those creditors who are unable to do so. Among the former are lending institutions, except when they extend credit on terms insensitive to the increasing probability of a borrower’s default. Among the latter are tort creditors, tax and regulatory authorities, customers, employees, trade suppliers and lenders making loans on terms not reflecting changes in the probability of a borrower’s default. See Lucian A. Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE LAW JOURNAL 857 (1996). Trade creditors do however vary the quantity of credit they offer to borrowers depending on the latter’s credit quality. See Mitchell A. Petersen & Raghuram G. Rajan, *Trade Credit: Theories and Evidence*, 10 REVIEW OF FINANCIAL STUDIES 661, 678 (1997).

23. See George G. Triantis, *Organizations as Internal Capital Markets: The Legal Boundaries of Firms, Collateral, and Trusts in Commercial and Charitable Enterprises*, 117 HARVARD LAW REVIEW 1102, 1125 (2004) (mentioning interaffiliate loans, *i.e.* loans between parent and subsidiary or between subsidiaries of the same parent, as typical related-party transactions).

company.<sup>24</sup> While the holding of an equity stake or executive office should deter demands for a life-threatening return on the loan,<sup>25</sup> insider lenders holding short of 100% of the equity capital, in sitting at both sides of the negotiating table, may seek to opportunistically appropriate corporate value at the expense of outside stakeholders by forcing upon the company a loan it does not need or charging a sustainable, yet unreasonable interest rate on a loan it needs. Besides, an insider might abruptly demand the repayment of an indefinite term loan, unexpectedly object to the renewal of a definite term loan or, worse, pursue an early termination of a definite term loan if the insider becomes subject to a pressing need of liquidity. Following the unanticipated termination of a loan from an insider the financial conditions of the company may well deteriorate, thereby prejudicing holders of other debt claims. Put succinctly, by undertaking a credit transaction with an insider a company may be forced to sustain a form of “asset dilution”<sup>26</sup>

A second argument pointing to the riskiness of debt capital provided by a firm’s insiders is that, instead of exiting from an already existing loan and thus hastening the unfolding of a liquidity crisis, the owner-manager of a failing company may react to pending financial troubles by recklessly extending credit to her financially-distressed company in order to keep it afloat and salvage her equity value despite the lack of attractive investment opportunities in sight. Out of a rationally opportunistic strategy aimed at maximizing the option value of equity<sup>27</sup> or a behavioural bias that clouds the business judgment of

24. An insider’s incentive to extend excessive interest-paying credit to its firm is inversely correlated with the size of its equity stake, since a smaller equity stake allows it to extract a larger payoff. David Buchuk, Borja Larrain, Francisco Muñoz & Francisco Urzúa I., *The Internal Capital Markets of Business Groups: Evidence from Intra-Group Loans*, 112 JOURNAL OF FINANCIAL ECONOMICS 190 (2014), documents how often low-cash-flow-right subsidiaries enter into lending agreements with high-cash-flow-right subsidiaries which charge the former subsidiaries an interest rate above the market rate. But tunneling in corporate groups may also flow in the opposite direction. Jiang G. Lee & C.M.C. Yue, *Tunneling through Intercorporate Loans: The China Experience*, 98 JOURNAL OF FINANCIAL ECONOMICS 1 (2010), for instance, provides evidence that controllers of Chinese business groups make sure that the subsidiaries where they hold low cash-flow rights loan to subsidiaries where they hold high cash-flow rights on terms benefitting the borrower.

25. The smaller the shareholding an insider owns, the larger the net financial benefit the insider can obtain by extending interest-paying loans to its firm. See *supra* note 13 and accompanying text.

26. See Clifford W. Smith, Jr. & Jerold B. Warner, *On financial contracting: An analysis of bond covenants*, 14 JOURNAL OF FINANCIAL ECONOMICS 117, 118 (1979). The phrase “asset dilution” is found in Lucian A. Bebchuk, *Ex Ante Costs of Violating Absolute Priority in Bankruptcy*, 57 JOURNAL OF FINANCE 445, 456 (2002).

27. See *infra* Part III, Sections C and D.

whom has developed a deep affection for the firm or its current business model, insiders may insist in providing liquidity to the firm with a view to catching any remaining business opportunity even though there is little or no probability of value creation or firm survival under their management. More generally, a flagging firm's insiders have a strong incentive to engage in "overinvestment" or "asset substitution",<sup>28</sup> *i.e.* to replace less risky assets with riskier assets to the extent they gain from the increased variance in asset value at the creditors' expense.<sup>29</sup> Such risk-shifting might go as far as to destroy firm value, as is the case when insiders invest in negative-NPV projects.<sup>30</sup>

It also is feared that prolonging the life of a company that is invariably doomed to fail by increasing its overall indebtedness may just create an optical illusion of survival as a going concern. When coupled with stockholders' incentives toward asset dilution and substitution, an artificially-prolonged existence may further reduce the chances of repayment for current outside creditors, get further misinformed creditors to embark on the financing of an already sinking business venture, delay the start of an insolvency proceeding, and ultimately compromise the possibility of a healthy reorganization of the firm.<sup>31</sup>

On closer look, corporate debt, when owed to insiders, is much like a form of state-contingent, convertible equity. The insider invests in a type of equity which incorporates the feature of convertibility into debt in the event

28. Smith & Warner, *supra* note 26, at 118-19.

29. This perverse incentive effect of debt issuance on holders of equity interests is illustrated in Jensen & Meckling, *supra* note 11, at 336.

30. See *infra* Part III, Section C. Overinvestment and underinvestment are the two opposite sides of the same moral hazard problem induced by shareholder limited liability. Just like insiders face no financial penalty for indulging in underinvestment, so too do they face no financial penalty for engaging in overinvestment.

31. Timely advances from a financially-distressed firm's insiders, by providing liquidity to pay off debts as they become due, may steer the firm away from the failure-to-pay condition that under most bankruptcy laws, including that of the US, allows creditors to file involuntary bankruptcy petitions. See United States Code, Tit. 11, § 303(h)(1). In preventing creditors from bringing an involuntary case, insiders may get to push back the eventual demise of their firm, thereby aggravating the insolvency. Yet, the logic of allowing involuntary petitions is to hasten the commencement of a bankruptcy proceeding over management's head to either favor an earlier rehabilitation of the debtor whenever feasible or preserve and distribute as much firm value as possible to the creditor body. See Susan Block-Lieb, *Why Creditors File So Few Involuntary Petitions and Why the Number Is Not Too Small*, 57 BROOKLYN LAW REVIEW 803, 816-17 (1991). Leaving inside debt financing unconstrained might encourage short-lived attempts to keep almost-defunct companies afloat while creditors are foreclosed from counteracting attempts of this sort by the limited scope of their own filing prerogatives. Therefore, facilitating ill-fated insiders' debt funding may end up contradicting the rationale behind rules on involuntary bankruptcy petitions from creditors.

of bankruptcy. The claim inuring to the insider as a debtholder is unlikely to be asserted against the borrower company if the company cannot safely honor it. In such an event, the insider will spontaneously subordinate its claim to those of the other debtholders if it is necessary to preserve the financial viability of the company and avoid any risk of personal liability, however small it may be.<sup>32</sup> Nevertheless, if other unpaid debtholders plunge the company into bankruptcy, the downside protection kicks in, for the lending insider can emerge in bankruptcy as a holder of debt claims just like any other pure creditor does. In opting for a form of state-contingent, convertible equity in addition to straight equity, however, the insider sets for itself *ex ante* incentives to engage in riskier projects at a later stage than it would otherwise pursue had it invested its endowment in equity only. In making a debt advance rather than a capital contribution, the insider partially externalizes the risk of loss onto the unsecured creditors' class. Therefore, inside debt financing may raise concerns to the extent it paves the way for self-induced moral hazard by the insiders at the expense of the creditor constituency beyond what shareholder limited liability alone is already responsible for.<sup>33</sup>

32. Indebtedness to insiders does not *per se* increase bankruptcy risks, because insiders are unlikely to ever file a petition for bankruptcy. To be sure, debt owed insiders is listed among the liabilities for accounting purposes and might contribute to render the company insolvent on a balance-sheet basis. Besides, equity and debt financing as opposed to full equity financing makes it more likely that legal capital maintenance requirements, if applicable, are breached in the event of a setback. But management shareholders can be expected to not demand repayment of their debt fallen due if it were such a repayment to throw the company into a cash-flow insolvency and to spontaneously agree to postpone it to other reimbursements if in their view such move would help their company to stay afloat with good probability.

33. To be sure, limited liability and inside debt are not the only potential sources of moral hazard problems in the corporate arena. The business judgment rule and dual-class capital structures, for instance, might play a role in fueling moral hazard. On the one hand, the business judgment rule might indirectly create incentives for managers to take on undue risks insofar as courts invoke it to refrain from curbing overly risky behavior. See *In re Citigroup Inc. Shareholder Derivative Litigation*, 964 ATLANTIC REPORTER (SECOND SERIES) 106 (Court of Chancery of Delaware, 2009) (“To impose oversight liability on directors for failure to monitor ‘excessive’ risk would involve courts in conducting hindsight evaluations of decisions at the heart of the business judgment of directors.”). On a different but equally critical note, dual-class capital structures are blamed for upending the alignment between voting rights and cash-flow rights which in the view of many commentators is key to optimal decision-making. See Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 JOURNAL OF LAW & ECONOMICS 395, 409 (1983) (“Those with disproportionate voting power will not receive shares of the residual gains or losses from new endeavors and arrangements commensurate with their control; as a result they will not make optimal decisions.”); Lucian A. Bebchuk, Reinier Kraakman & George Triantis, *Stock Pyramids, Cross-Ownership and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control From Cash-Flow Rights*, in CONCENTRATED

Jensen and Meckling<sup>34</sup> argue that inside debt should be looked at with favor as it might be an antidote to opportunistic wealth transfers inflicted on debtholders by equityholders. Inside debt's proprieties are viewed by Jensen and Meckling as helping to eliminate "a large part (perhaps all) of the agency costs of debt".<sup>35</sup> In particular, Jensen and Meckling notice that if an owner-manager held the same fraction of equity and debt, any dollar accruing to equity at the expense of debt would result in a zero-sum game for her, because any gain on the equity holding would be offset by a corresponding loss on the debt holding. As a result, to the extent corporate decision-makers hold both equity and debt in equal proportions, the incentives to engage in strategic behaviors are reduced. However, this analysis does not hold in the context of decision-making by an owner-manager of a closely-held firm whenever the owner-manager is assumed to have a certain amount of dollars to invest and may choose either to invest the entire amount in equity or to invest it in equity and debt in the same percentage. In fact, providing inside debt financing is

CORPORATE OWNERSHIP 295 (Randall K. Morck ed. 2000) (arguing that structures allowing insiders to exert control over a firm without holding a proportionate amount of cash-flow rights aggravate the moral hazard problem); Lucian A. Bebchuk & Kobi Kastiel, *The Perils of Small-Minority Controllers*, 107 GEORGETOWN LAW JOURNAL 1453, 1465 (2019) ("[D]ual-class structures with small-minority controllers generate significant governance risks because they feature a unique absence of incentive alignment."). But the net social benefits of the business judgment rule are undisputed. See Bernard S. Sharfman, *The Importance of the Business Judgment Rule*, 14 NEW YORK UNIVERSITY JOURNAL OF LAW & BUSINESS 27, 28-29 (2017) ("The business judgement rule... is an equitable doctrine that is the most prominent and important standard of judicial review under corporate law."). Even dual-class structures, for their part, have as of late earned a more benign evaluation from skeptical scholars, provided that they are not left unconstrained. See Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VIRGINIA LAW REVIEW 585 (2017) (advocating the use of sunset provisions to end perpetual dual-class stocks). On the contrary, a similarly benign judgment for unsubordinated inside debt financing of solvent firms is unwarranted. Take dual-class structures as a term of comparison. There is a fundamental difference between detaching power from risk by means of a dual-class structure and the use of inside debt. To be sure, when the priority of cash flow rights enjoyed in bankruptcy by the controller is flipped from low to high, the resulting upgrade of the controller's rights separates *ex ante* control over the firm from proportionate risk bearing just like voting rights in excess of cash-flow rights do. If in the latter case the outcome is obtained by leveraging control power while holding financial exposure constant, in the former case the same outcome is reached by deleveraging financial exposure while holding control power constant. But a dual-class structure is a matter of allocation of voting rights between shareholders, who voluntarily establish and maintain a relationship with the company on terms they ought to be aware of. Debt financing allows insiders to meddle with creditor rights even when creditors have acquired their status involuntarily, thereby having no possibility to object to inside debt financing or cope with it. See *infra* Part IV.

34. See Jensen & Meckling, *supra* note 11, at 352-53.

35. See *id.* at 352.

not akin to merely holding inside debt. While issuing to an insider debt *in addition to* equity may have the propriety to balance the insider's incentives as a shareholder and the same insider's incentives as a creditor, financing the company with debt *in lieu of* equity gives the insider an incentive to take on larger if not excessive business risks to the detriment of the outside creditor constituency.

To begin with, each investment decision taken when the firm is solvent, while possibly transferring market value from debt to equity in the expectation of its outcome, that is, on an expected-value basis, ultimately must result in one only of three possible scenarios, *i.e.* an increase in asset value benefitting equity and leaving debt indifferent; a reduction in asset value to a level equal to or exceeding debt size, which would harm and possibility wipe out equity with no detrimental effect on debt; a decline in asset value below debt size, which in addition to erasing all of the equity would reduce unsecured debt value in proportion to the liabilities left uncovered. For analytical purposes, an owner-manager of a closely-held firm should be expected to stick to her holdings until the final period of her investment decisions, *i.e.* when their outcome is unveiled, as opposed to a minority investor who might be more willing to turn over its portfolio of corporate claims beforehand. Therefore, we should expect an owner-manager to make a decision based on her subjective estimate of the probability of a final-period increase in equity value, decrease of equity value or destruction of the whole equity value coupled with some decrease in, or the entire destruction of, unsecured debt value.

For sake of illustration, assume two equally risk-neutral owner-managers each investing in one of two companies, Company A and Company B, having each an asset value of \$200 and the same capital structure consisting of \$100 of equity and \$100 of debt. Both owner-managers are assumed to make an investment totaling \$100 but receive a different mix of claims depending on which company they invest in. The owner-manager investing in Company A owns 100% of \$100-worth of equity (or \$100) and no debt, 100% of it (or \$100) being held by an outside lender. Conversely, the owner-manager investing in Company B owns 50% of \$100-worth of equity (or \$50), with the remaining 50% of it (or \$50) pertaining to a minority equityholder, and holds 50% of \$100-worth of debt (or \$50), with the remaining 50% of it (or \$50) being in the hands of an outside lender. Following Jensen and Meckling's line of reasoning, the riskiness of outside debt issued by Company A is greater than that of outside debt issued by Company B, because while the owner-manager of Company B would have no incentive to transfer wealth from debt to equity, the owner-manager of Company A would have an incentive to take decisions transferring wealth from debt to equity. Yet, by focusing on the outcome of

possible investment decisions, one might appreciate that with respect to investments ultimately increasing asset value, the owner-manager of Company B appropriates 50% of any increment of asset value compared with 100% of any increment of asset value earned by the owner-manager of Company A; with respect to investments ultimately decreasing asset value by a dollar amount between \$0 and \$100, the owner-manager of Company B incurs 50% of the loss compared with 100% of said loss incurred by the owner-manager of Company A; with respect to investments ultimately shaving between \$100 and \$200 off the asset value, the owner-manager of Company B holds on to 50% of any residual asset value while the owner-manager of Company A loses everything. Besides, in the event of a loss ranging from \$100 and \$200, the owner-manager of Company B also retains control in a corporate reorganization exchanging debt for equity, while the owner-manager of Company A must relinquish control.

This numerical example shows that the incentive to make risky bets is greater at Company B than at Company A. On reflection, this different incentive structure should be unsurprising, as it is the resultant of a diversification of the owner-manager's claim portfolio and the ensuing mix of cash-flow and priority rights. Holding the overall invested owner-manager's wealth constant, by diversifying investments in both equity instruments and debt instruments as opposed to equity instruments only, the owner-manager of Company B reduces both the risk of loss in downside scenarios and the expected benefit in upside scenarios. In doing so, she has a greater incentive to take on risk than has the owner-manager of Company A. In effect, in light of her lower equity interest, the owner-manager of Company B, if willing to obtain the same payoff available to the owner-manager of Company A in upside scenarios, would have to squeeze more profits out of Company B's operations than would be necessary at Company A, with the payoff from the debt purchased from Company B unlikely making up for the gap between the different wealth effects of two equity investments of a sufficiently different size. At the same time, because of both the loss-spreading feature and the potential control-retaining feature of her inside debt, the owner-manager of Company B would care less about the downside of her decisions. As a result of her holding debt on top of equity, the owner-manager of Company B has an incentive to look for a larger variance of investment outcomes through riskier or more opportunistic bets, which all else equal would increase the riskiness, and lower the value, of the outside debt of Company B relative to riskiness and value of the outside debt of Company A.

In addition to increasing the probability of overinvestment, insiders' debt claims accompanied by a seniority equal to that enjoyed by outsiders' debt

claims are also blamed for diluting the value of the outstanding unsecured debt whenever the outstanding unsecured debt received no *ex ante* compensation or cannot adjust its terms *ex post* to increasing levels of risk. As the company piles up debt and the risk of default increases, chances of fully honoring payment obligations to older creditors diminish and so does the value of their debt.<sup>36</sup> Who benefits are the equity owners, who will have obtained outside finance at a lower cost than they deserved. By extending credit to the company after outside creditors have already loaned money to it so as to share the firm's assets along with them in case of failure, insiders may transfer value from outside creditors' debt to their equity. In other words, along with asset dilution and asset substitution, insiders may further their private interest in their capacity as creditors at the expense of external creditors' interests by also engaging in "claim dilution"<sup>37</sup> (also referred to as "debt dilution").<sup>38</sup>

Such a misalignment of incentives between insiders and outside constituencies would further be exacerbated if the former were allowed to provide secured lending. When obtaining a first-ranking security interest in the firm's assets, shareholder-creditors fully edge their risk of loss on their debt claim the event of bankruptcy. As a result, shareholder-creditors face less of a deterrent against wasteful secured loans diluting the value of the outstanding outside debt and allowing them to venture into counterproductive investments.

36. See Alan Schwartz, *A Theory of Loan Priorities*, 18 JOURNAL OF LEGAL STUDIES 209, 229-30 (1989).

37. See Smith & Warner, *supra* note 26, at 118.

38. See Armour, Hertig & Kanda, *supra* note 5, at 112.

## PART II

# PATTERNS OF INSIDE DEBT FINANCING

Only by examining why and in what contexts a firm's insiders make use of debt financing might one fully appreciate the overall implications of inside debt for the governance of the firm. Such an examination is also key to assessing soundness and viability of the various regulatory options and preventing regulatory failures. Section A compares widely-held firms with closely-held firms to show that a firm's ownership regime matters in dictating the use of inside debt or not. Section B explains the extent to which a rational insider of a closely-held firm is incentivized to make debt investments rather than capital contributions. Sections C and D shed light on the practice of inside debt financing with regard to small firms and companies organized in a group, respectively. Another context in which insider loans play a major part is that of leveraged transactions, such as leveraged buyouts and project finance deals. Rather than the nature and ownership structure of the recipient of the financing, as is the case with closely-held companies, what dictates the use of internal borrowing in this context is the nature and structure of the transaction. Section E illustrates how subordinated insider lending has become a critical feature for acquisition deals financed through the issuance of large amounts of debt as well as to finance high-risk, capital-intensive projects. Section F compares the legal mode of subordinating inside debt with the contractual mode of doing so. Section G seeks to answer the question why contractual subordination of inside debt may be seen in practice less often than one would expect at first blush.

### **A. Widely-Held Firms and Closely-Held Firms**

The probability of an insider making a loan to its firm is negatively correlated with the degree of ownership concentration. Widely-held firms can tap external capital markets, such as the stock and bond markets, to raise outside finance.<sup>1</sup>

1. For the purpose of this observation, it does not matter whether a firm has to be widely-

Because of the availability of outside equity or debt on favorable terms, blockholders, *i.e.* holders of large minority shareholdings, and managers are less likely and willing to loan money to the firm. Blockholders are not well-positioned to provide debt advances at competitive interest rates compared with professional lenders. Besides, by lending to the firm they would further concentrate their investments in the firm, thereby increasing the sensitivity of their overall investment portfolio to firm-specific risk. Managers, in turn, have their undiversifiable human capital and the value of their stock options tied to the firm's fortunes. By making debt advances to the firm, they would add to the risk of loss on these investments the financial risk associated with the debt investment.

Moreover, when a firm is widely-held inside debt can hardly be a functional substitute for inside equity. First, inside equity and the voting rights associated with it are needed for whoever wishes to exert influence over the firm. Second, any additional investment in inside debt as an alternative to additional investments of an equal dollar amount in inside equity with the aim of funding new positive-net present value ("NPV") projects would not expand the inside investor's percentage of residual claims on the cashflows obtained from corporate investment. Hence, the prospect for an insider at a widely-held firm of not reaping all the benefits resulting from its financing efforts cannot but have a deterrent effect on inside debt as a source of funding for companies characterized by diffuse ownership.<sup>2</sup>

To the contrary, when the firm is closely-held, outside finance might be precluded or too costly to obtain. While raising outside equity is routinely ruled out to avoid dilution of insiders' control, outside debt might become more expensive to a closely-held firm than is to a widely-held firm owing to an increase in shareholder-creditor agency costs.<sup>3</sup> But even when external debt financing is available at low cost, majority shareholders and their managers may be unwilling to take advantage of it for several reasons, ranging from reluctance to sustain monitoring by outside investors to bankruptcy risks. With respect to closely-held firms, internal borrowing, *i.e.* borrowing from

held to easily tap outside funding sources or it is the ease which a firm can tap such sources of outside capital that will ultimately drive the firm into a dispersed ownership regime. In all likelihood, dispersed ownership and access to outside capital markets are mutually reinforcing.

2. That being said, to the extent that widely-held firms, too, may occasionally take advantage of insider lending, such firms and their insiders should be subject to the same rules on insider loans which closely-held firms are subject to. While the probability of an insider making a loan to its firm is negatively correlated with the degree of ownership concentration, once an insider has made a loan the types of risks which the firm and its other stakeholders confront are the same regardless of the firm's having a dispersed or concentrated ownership.

3. See Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 UNIVERSITY OF PENNSYLVANIA LAW REVIEW 1907 (2012).

insiders, may prove more advantageous than external borrowing to the extent no extra compensation for the agency costs of debt has to be paid to external financiers, and external monitoring is avoided.

## **B. Dominance of Inside Debt Financing over Inside Equity Financing in Closely-Held Firms**

Insider loans dominate capital contributions as the preferred financing tool when the firm is closely-held. This fact is unsurprising. Debt investments are more advantageous to both a firm's insiders and a firm's outside lenders than are equity investments.

Assume first that a firm's sole owner-manager is willing to invest \$100 to seize a business opportunity, and such an owner-manager is enabled to either invest the whole \$100 in equity or, as an alternative, \$50 in equity and \$50 in unsubordinated debt, *i.e.* debt that by law ranks on a par with outside debts in bankruptcy. Assume further that some outside debt is already outstanding or that, in the absence of already outstanding debt, the owner-manager believes that outside debt might be incurred in the future. There exist two opportunistic motives driving the owner-manager toward the half-equity-half-debt funding pattern as opposed to the full-equity one. To be sure, neither of the two motives is related to transaction costs. In other words, debt is not advantageous relative to equity because of lower issuance costs. At first glance, one might think the opposite to the extent raising debt calls for a loan agreement entered into by the borrower company and the lending insider while raising equity consists of a lengthier and more expensive procedure involving a board resolution (in the US and the EU), approval from the shareholders (in the EU) and the issuance of shares. This hypothesis, however, is unconvincing. At the company's inception, when an initial amount of shares must be issued to the founders, making an equity-only investment is arguably less costly than an equity investment plus a debt investment, which itself would require the drafting of a loan agreement. Thereafter, capital contributions to firms wholly owned by insiders can still be made without necessarily undergoing a share issuance, if there is no need to change the relative percentage of their shareholdings. Besides, unlike debt financing, equity financing does not require an underlying contract between the firm and the equity investor. Funds may simply be credited on the company's bank account and labeled as equity for accounting purposes.<sup>4</sup>

4. If anything, the doctrine of recharacterization of debt as equity itself confirms that there is no need of any corporate formality for a financial claim to be treated as equity. It is the very

Rather, a first plausible motivation standing behind an insider's preference for debt over equity financing is taxation. To extent interest expenses are wholly or partially deductible from taxable corporate income, by holding equity and debt as opposed to solely equity an owner-manager can get the government to subsidize an increase in the return on equity proportional to the amount of the tax shield. Such a financial engineering aimed at increasing the market value of the claims in the owner-manager's portfolio, however, produces no net social efficiency gain in that it merely amounts to a wealth redistribution to the detriment of other taxpayers, unless the personal income tax applicable to the owner-manager is designed to undoing such an effect.<sup>5</sup>

A second, compelling motivation is partial protection against downside risks. Opting for the half-equity-half-debt split, the owner-manager foregoes no gains in the best-case scenario of a profit-making business outcome<sup>6</sup> while retaining chances to recoup some cents on the dollar in the worst-case scenario of bankruptcy, regardless of whether bankruptcy looms large at the time of the financing decision or not. In effect, if there exist liabilities to third parties, any capital loss beyond the equity value proportionately affects all of the unsecured creditors, with the insider creditor sharing capital losses with the outside creditors according to their respective debt claim percentage. The insider, by making loans as opposed to capital contributions, may therefore transfer financial risks to the outside creditors.<sup>7</sup>

absence of corporate formalities unequivocally attesting to the debt nature of the financing that leads courts to view an infusion of money by an insider as an equity contribution rather than a debt investment. See *infra* Part V, Section B, Paragraph 1, notes 47-64 and accompanying text. But even where outside shareholders exist and a share issuance becomes necessary to reflect the additional equity investment by inside equityholders to the exclusion of outside equityholders, insiders will not incur higher costs in promptly providing money to the firm when needed, have the financing dealt with in the accounts as equity rather than debt, and resolving and issuing shares to the insider compared to formalizing a lending agreement and issuing a corresponding debt instrument to the lender.

5. Taking a government's fiscal needs as fixed, a reduced tax burden on one taxpayer has to be offset by a corresponding increase in the taxes collected from other taxpayers. See Katherine Pratt, *The Debt-Equity Distinction in a Second-Best World*, 53 *VANDERBILT LAW REVIEW* 1055, at 1069-70 (2000) (noticing that shareholders of closely-held firms have always had an incentive to reduce corporate income by making loans in lieu of capital contributions, thereby benefiting from corporate income tax-deductible interest payments rather than non-deductible dividend payments). Thin-capitalization rules, and in particular rules limiting deduction of interest payments made to a company's related party, hold out as proof of this tax distortion.

6. To the extent the owner-manager is assumed to own 100% of the share capital whether she has made a capital contribution of \$100 or \$50, her share of cash-flow rights does not change.

7. This effect is easy to see. Assume now that there exist two wholly-owned companies,

The more closely the firm is held, the more inside debt becomes a functional substitute for inside equity in providing liquidity to the firm.<sup>8</sup> As the fraction of voting rights and cash-flow rights that the controller holds increases, the beneficial effects of marginal investments in equity as opposed to debt diminish. When the controller holds the entirety of the share capital, the superiority of inside debt over inside equity to fund a new project becomes readily apparent, as the controller would gain nothing from infusing further equity in terms of voting and cash-flow rights while increasing its risk of loss compared with the alternative of a debt advance. With a hundred-percent shareholding a controller would choose equity over debt to fund a new project only if it prospectively needed external financing alongside its internal financing and a lower debt-to-equity ratio today would promise lower costs of outside equity or outside debt finance going forward.<sup>9</sup>

One more reason why inside debt is a popular financing tool is because inside debt is preferred to equity by some outside creditors, too. An insider and an outside lender, *e.g.* a bank, may enter into a subordination arrangement whereby the former's debt is contractually subordinated to the latter's debt.<sup>10</sup> As a result, in the event of bankruptcy the bankruptcy dividend owed the insider

Company A and Company B, having the same asset value of \$150 but a different capital structure. Company A has \$100 of equity and \$50 of debt. Company B has \$50 of equity and \$100 of debt. Assume further two equally risk-neutral owner-managers who have made each an investment of \$100 in their respective companies. The owner-manager of Company A owns 100% (or \$100) of the equity and holds no debt, with 100% (or \$50) of the outstanding debt issued to an outside lender. By contrast, the owner-manager of Company B owns 100% (or \$50) of the equity and holds 50% (or \$50) of the outstanding debt (or \$50), with the remaining 50% (or \$50) of the outstanding debt allocated to an outside lender. In light of Company A's and Company B's capital structures, any profitable investment raising firm asset value would equally benefit both owner-managers to the extent both hold an 100% equity stake in their respective companies. Symmetrically, any investment diminishing asset value for an amount between \$0 and \$50 would equally damage both owner-managers. But investments decreasing asset value beyond \$50 would dramatically differ in their impact on the two owner-managers' private wealth. If the firm asset value drops by an amount between \$50 and \$100, the owner-manager of Company B incurs only 50% of the loss exceeding \$50, while the owner-manager of Company A incurs 100% of it. And whereas a decrease in asset value between \$100 and \$150 wipes out all the wealth invested in the firm by the owner-manager of Company A, the owner-manager of Company B is still able to claim 50% of the residual asset value, if any.

8. Assuming that the controller's debt, as opposed to the controller's equity, is unsubordinated in bankruptcy.

9. More precisely, the controller would balance the benefits of lowering outside finance costs to the firm against the cost of subjecting a portion of its investment portfolio to a higher risk of loss.

10. For more details about the notion of subordination and how it can be achieved by law and contract, see *infra* Section F.

is turned over to the bank that is a party to the subordination agreement to the exclusion of third-party creditors.<sup>11</sup>

From the standpoint of a bank, contractually-subordinated debt is therefore superior to equity capital. While equity capital benefits *pro rata* all the creditors without distinction because of its lowest priority in bankruptcy, contractually-subordinated debt allows the senior creditor to receive both the share of the estate owed the senior creditor and the share of the estate owed the subordinated insider creditor.<sup>12</sup> In light of the possibility of a targeted contractual subordination, it comes as no surprise that a major lender may want to talk the insider into lending rather making a capital contribution whenever the firm is in need for financing. At the same time, to the extent a lender is enabled to receive such a windfall by contract, it may be prepared to lower the borrowing cost for the firm, which in turn reverberates to the benefit of the insider. Ultimately, contractual subordination of inside debt is mutually advantageous to both a firm's insiders and a firm's lenders, although the benefit that the ones and the others obtain originates from a transfer of value to the detriment of defenceless outside creditors, *i.e.* creditors who can neither demand *ex ante* compensation for the increased risk they are subject to nor adjust *ex post* the terms of their relationship with the corporate debtor.

As the interest of both insiders and major lenders converge in having firms issue debt to the former so that it can be subordinated for the exclusive benefit of the debt of the latter, inside debt financing is commonplace with bank-financed companies and leveraged financial transactions.

### C. Small, Privately-Owned Firms

Empirical research confirms that small firms in the US<sup>13</sup> and elsewhere in the world<sup>14</sup> fund their operations by making a large use of internal finance, *e.g.* cash savings of the founders, funds from family members and retained earnings.

11. See Dee M. Calligar, *Subordination Agreements*, 70 YALE LAW JOURNAL 376, 376-77 (1961).

12. See *infra* Section F, notes 52-55 and accompanying text.

13. Thorsten Beck, Asli Demirgüç-Kunt & Vojislav Maksimovic, *Financing patterns around the world: Are small firms different?*, 89 JOURNAL OF FINANCIAL ECONOMICS 467, 472 (2008), shows that internal finance accounts for more than 50% of the overall finance available to US small firms.

14. Similar to the US, small firms' ratio of internal finance relative to total finance stands at or above 50% in countries such as France, Mexico, UK, Canada and Brazil, and is slightly lower than 50% in Germany. See *id.*

Internal funding sources, whether in the form of equity or debt, minimize external interference with founders' ownership of the enterprise<sup>15</sup> and, to the extent internal funding sources are within the owner's control, obtaining them requires less effort than seeking financial support elsewhere, especially when a financial shortfall or unexpected expenses call for an immediate response.<sup>16</sup>

Small, private firms are mostly owned by a single owner, a single family or a close group of families and their relatives.<sup>17</sup> In such firms, top managers hold a majority of the stock and the CEO is by far the largest equityholder.<sup>18</sup> Equity from owners is the second most significant source of capital for small firms ranking behind bank finance only. The equity ownership of small firms is consistent with theoretical predictions that the lack of access to equity capital markets and the agency costs of equity force insiders to hold a large fraction of the firm's equity.

The debt structure of small firms, too, is consistent with theoretical models. The debt-to-equity ratio is higher than is at large, publicly-traded firms, which fact can be explained in light of the owners' wealth constraints and their attempt to reduce their risk of loss. Credit is extended to small firms mainly in the form of bank loans,<sup>19</sup> consistent with the view that the agency costs of debt require close monitoring of the firm's affairs and banks are best-equipped to engage in it by taking security interests in the corporate assets and developing relational financing arrangements.<sup>20</sup> While trade credit proves the second most important source of debt,<sup>21</sup> loans from stockholders and directors rank third

15. See Robert T. Hamilton & Mark A. Fox, *The financing preferences of small firm owners*, 4 INTERNATIONAL JOURNAL OF ENTREPRENEURIAL BEHAVIOR & RESEARCH 239 (1998).

16. See Tansel Yilmazer & Holly Schrank, *Financial intermingling in small family businesses*, 21 JOURNAL OF BUSINESS VENTURING 726, 749 (2006).

17. See Chenchuramaiah T. Bathala, Oswald D. Bowlin & William P. Dukes, *Sources of Capital and Debt Structure in Small Firms*, 9 JOURNAL OF ENTREPRENEURIAL FINANCE & BUSINESS VENTURES 29 (2004).

18. Besides, the CEO of a US firm holds more equity when the firm is privately-owned than when it is publicly-owned. See Bathala, Bowlin & Dukes, *supra* note 17, at 33.

19. See Bathala, Bowlin & Dukes, *supra* note 17, at 35 (with regard to US firms). See also Beck, Demirgüç-Kunt & Maksimovic, *supra* note 13, at 470 (with regard to a sample of firms from 48 countries).

20. See Robert E. Scott, *Relational Theory of Secured Financing*, 86 COLUMBIA LAW REVIEW 901 (1986). The smallest firms borrow almost all of the outside debt capital from one bank. See Mitchell A. Petersen & Raghuram G. Rajan, *The Benefits of Firm-Creditor Relationships: Evidence From Small Business Data*, 49 JOURNAL OF FINANCE 3, 10 (1994), which shows that size of the firm and concentration of borrowing are inversely correlated.

21. See Bathala, Bowlin & Dukes, *supra* note 17, at 35 (with regard to US firms). See also Beck, Demirgüç-Kunt & Maksimovic, *supra* note 13, at 470 (with regard to a sample of firms from 48 countries).

in the US among the sources of debt and fourth among all financing sources.<sup>22</sup> The importance of trade credit and inside debt is plausibly a response to the inaccessibility to public equity and debt markets as well as the higher costs of private debt that private firms of small size face, with most of them paying interest rates equal to or above the prime rate.<sup>23</sup>

22. See Bathala, Bowlin & Dukes, *supra* note 17, at 34. When a US small firm is publicly-held, loans from insiders however matter less. See *id.* Data from the 1988-1989 National Survey of Small Business Finances in the US show that the smallest 10% of small firms having debt on their balance sheet borrow about half of their debt from banks, while 27% of debt comes from the firm's owners and their families. See Petersen & Rajan, *supra* note 20, at 8. Similarly, data from the 1993 National Survey of Small Business Finances in the US indicates that 20% of small family-owned businesses receive loans from their owners. See Susan Coleman & Mary Carsky, *Sources of Capital for Small Family-Owned Businesses: Evidence from the National Survey of Small Business Finances*, 12 FAMILY BUSINESS REVIEW 73, 79 (1999). Similar results are found in a study examining intermingling of household and business resources by small family businesses based on Surveys of Consumer Finances from 1989 to 2001. See Yilmazer & Schrank, *supra* note 16. Empirical findings therein also show that "households managing businesses with negative net profits and those managing younger businesses are more likely to be owed money by the business than their counterparts", suggesting that "households choose to lend money as start-up funds or to compensate for negative income" and giving credit to the "financial shortfall" hypothesis behind a firm's indebtedness to its owners. See *id.* at 749. See also Douglas G. Baird, *The Reorganization of Closely Held Firms and the Opt Out Problem*, 72 WASHINGTON UNIVERSITY LAW QUARTERLY 913, 915 (1994) (noticing that a majority of US' closely-held firms entering Chapter 11 have loans outstanding from the shareholders and their close family).

23. On the contrary, inside debt financing is uncommon in venture-backed start-ups, especially in the US. While venture capital firms invest in preferred stock, they want the founders to hold common stock. This capital structure design allows venture capitalists to gain priority over owner-managers in cash distributions and liquidation without entirely foregoing the upside potential inherent to having equity securities. Although it does not provide the bulk of the financing, debt does however play a role. But when needed, as is the case when a firm needs liquidity to bridge the gap between two successive rounds of equity financing, debt funding is provided by venture lenders, that is, banks or non-bank lenders which specialize in loaning to early-stage, rapid-growth, high-risk firms. As venture debt advanced by venture lenders aims to rank higher than the financing from founders and venture capitalists, venture lenders must avert the risk of equitable subordination of their claims. (The doctrine of equitable subordination of debt claims is illustrated *infra*, in Part V, Section B). To this end, they steer clear of holding board seats or behaviors that might render them insiders and consequently make equitable subordination of their debt claims more likely. See Darian M. Ibrahim, *Debt as Venture Capital*, 2010 UNIVERSITY OF ILLINOIS LAW REVIEW 1169, 1193-94 (2010). At the same time, the higher risk that debt be subordinated when it is provided by insiders, coupled with the conflicted nature of an inside debt transaction which could attract a fairness judicial review, deters venture capitalists acting as insiders against extending credit in the first place. See *id.* at 1208. To the extent venture debt is provided by entities other than venture capital firms and in light of venture lenders striving to not qualify as insiders, inside debt financing in venture capital-backed start-ups is a rare occurrence.

## D. Groups of Companies

Groups of companies rely on internal capital markets as a complement to, or substitute for, external capital markets to fund their projects.<sup>24</sup> While the intercompany reallocation of a group's financial resources may be more or less efficient depending on the objective pursued with transferring money to one affiliate as opposed to another,<sup>25</sup> all else being equal external funds are more costly to obtain and allocate than are internally-generated funds due to information asymmetries and agency costs.<sup>26</sup> Therefore, parent companies have an incentive to directly fund their subsidiaries rather than cause them to incur external debt. As regards the means by which to allocate a group's internal resources, parents have a preference for internal debt over internal equity.

Extending credit rather than seeking external debt or making capital contributions is advantageous to the parent for a number of reasons. To begin with, intra-group loans allow low-cost, readily available finance to reach subsidiaries as they need it, and are easy to renegotiate in case of financial distress.<sup>27</sup> Second, internal loans do not increase the probability of a financially-strained borrower being placed into a bankruptcy proceeding,<sup>28</sup> since the parent will not exercise its creditor rights before and unless other creditors

24. See Oliver Williamson, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS: A STUDY IN THE ECONOMICS OF INTERNAL ORGANIZATION* 147-148 (1975).

25. See Jeremy C. Stein, *Internal Capital Markets and the Competition for Corporate Resources*, 52 *JOURNAL OF FINANCE* 83 (1997) (illustrating the conditions under which headquarters are incentivized to allocate resources to successful projects at the expense of poor ones); David S. Scharfstein & Jeremy C. Stein, *The Dark Side of Internal Capital Markets: Divisional Rent-Seeking and Inefficient Investment*, 55 *JOURNAL OF FINANCE* 2537 (2000) (pointing to the causes of inefficient cross-subsidization between strong and weak divisions).

26. But see Hyun-Han Shin & René M. Stulz, *Are Internal Capital Markets Efficient?*, 113 *QUARTERLY JOURNAL OF ECONOMICS* 531 (1998) (finding that cash-flow shortfalls affecting a diversified firm's segment are not compensated by the overall firm cash-flow).

27. For instance, Radhakrishnan Gopalan, Vikram Nanda & Amit Seru, *Affiliated Firms and Financial Support: Evidence from Indian Business Groups*, 86 *JOURNAL OF FINANCIAL ECONOMICS* 759, 778 (2007), reports that most intra-group loans within Indian business groups are charged no interest rate. See also Stijn Claessens, Joseph P.H. Fan & Larry H.P. Lang, *The Benefits and Costs of Group Affiliation: Evidence from East-Asia*, 7 *EMERGING MARKETS REVIEW* 1 (2006), for the contention that group affiliation may occur in the first place precisely to overcome the financing hurdles that a firm would encounter on a stand-alone basis.

28. See Arthur Stonehill & Thomas Stitzel, *Financial Structure and Multinational Corporations*, XII *CALIFORNIA MANAGEMENT REVIEW* 91, 93 (1969) ("A parent company loan... does not represent the same threat of insolvency as an external loan."); Bhagwan Chowdhry & Vikram Nanda, *Financing of Multinational Subsidiaries: Parent Debt vs. External Debt*, 1 *JOURNAL OF CORPORATE FINANCE* 259, 260 (1994) ("The advantage of an intra-firm

have enforced their own. Rather, the parent will direct the subsidiary to use the scarce resources available to pay back other debts while agreeing to a delay of the reimbursement schedule of the debt it is owed.<sup>29</sup> Holding overall leverage constant, outside lenders should therefore prefer borrowers with a higher degree of internal borrowing relative to external borrowing as a higher ratio of internal debt to external debt diminishes the risk of default. On the whole, the very existence of internal debt as a substitute for equity actually reduces the probability of a petition for bankruptcy ever being filed if the parent's claim ranks *pari passu* with, or higher than, the unsecured creditors' claims and is sufficiently large to threaten unsecured creditors' rate of recovery.<sup>30</sup>

Tax benefits in turn make a case for internally-financed debt as opposed to internally-financed equity. When, as might be with multinational corporations operating in different jurisdictions, the subsidiary is subject to a tax rate higher than the tax rate which the parent is subject to and interest payments are treated as expenses deductible from the subsidiary's taxable income, making an interest-bearing loan to the subsidiary allows the parent to lower the tax burden on the group as whole.<sup>31</sup> There is strong evidence that multinational groups take advantage of this form of tax arbitrage.<sup>32</sup> But even domestic groups, whose group members are all subject to the same tax framework, may find it advantageous to have a loss-making group member provide an interest-bearing

parent loan over external subsidiary debt is that there are no bankruptcy costs associated with internal loans.”).

29. See David Buchuk, Borja Larrain, Francisco Muñoz & Francisco Urzúa I., *The Internal Capital Markets of Business Groups: Evidence from Intra-Group Loans*, 112 JOURNAL OF FINANCIAL ECONOMICS 190, 193 (2014). Gopalan, Nanda & Seru, *supra* note 27, documents that intragroup loans in India are used to provide relief to financially-distressed firms in order to avoid their bankruptcy and the ensuing negative spillovers on the group as a whole.

30. The larger the equally-ranked claim of the parent is, the lower the rate of recovery is for the other creditors.

31. Conversely, if the tax rate applicable to the parent is higher than the tax rate applicable to the foreign subsidiary, equity may become more advantageous from a tax perspective whenever tax deferral applies to dividends from the subsidiary, that is, if dividends are taxed only when actually repatriated. See Bhagwan Chowdhry & Joshua D. Coval, *Internal Financing of Multinational Subsidiaries: Debt vs. Equity*, 4 JOURNAL OF CORPORATE FINANCE 87, 88 (1998).

32. See Mihir A. Desai, C. Fritz Foley & James R. Hines, Jr., *A Multinational Perspective on Capital Structure Choice and Internal Capital Markets*, 59 JOURNAL OF FINANCE 2451, 2466 (2004) (“[A]ffiliate leverage [of US multinational companies] responds strongly to local tax incentives”); Raj Aggarwal & NyoNyo A. Kyawb, *Internal Capital Networks as a Source of MNC Competitive Advantage: Evidence from Foreign Subsidiary Capital Structure Decisions*, 22 RESEARCH IN INTERNATIONAL BUSINESS AND FINANCE 409, 427-28 (2008) (likewise finding that the debt level of US multinational companies' subsidiaries increases when the host country tax rate is higher than the parent tax rate).

loan to a profit-making group member when doing so would reduce the taxable income of the latter without affecting the tax obligations of the former.<sup>33</sup>

Inside equity may prove less competitive than inside debt for one more reason. Insofar as inside debt is not made subordinated by law, a parent company which makes loans to its subsidiaries or direct some subsidiaries to make loans to other subsidiaries may seek to retain the benefit of specialization by different classes of external creditors in monitoring diverse subsidiaries' assets<sup>34</sup> and combine it with the benefit of flexible capital redeployment within the perimeter of the group. When, for example, a cash-rich subsidiary engaged in one industry conspicuously lends to a cash-strapped subsidiary involved in another industry, thereby replacing a large amount of cash with a loan of an equal amount, the comparative monitoring advantages of the two classes of external creditors holding separate claims against the assets of the lender and the assets of the borrower would not be compromised as much as they would if the one subsidiary would provide equity to the other subsidiary. In the latter case, the asset value of the giver would be more sensitive to the asset value of the taker, thereby forcing the giver's creditors to monitor the performance of the taker more closely than they would do in the former case despite an *ex ante* lack of specialization in monitoring the taker's assets.

Therefore, it comes as no surprise that intragroup financing is heavily dependent on debt. All available studies indicate that inside debt ranks first in the order of financing sources for subsidiaries, overtaking bank debt as well as internal equity. This financing choice is not only predominant when subsidiaries are located in foreign countries where underdeveloped credit markets, weak creditor rights, high political risk and inflation rate raise the costs of external borrowing for subsidiaries above the costs of external finance for the parent and the high level of local corruption augments the risk of expropriation of equity.<sup>35</sup> It also prevails in domestic groups.<sup>36</sup> Evidence shows that when the

33. To the extent the parent has negative income and the proceeds from a loan to a subsidiary do not make it positive, the parent would not suffer adverse tax consequences from the loan to the subsidiary. The subsidiary, in turn, benefits from a decrease in its taxable income to its advantage and to the advantage of the group as a whole.

34. See Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE LAW JOURNAL 387 (2000) (arguing that the reason of partitioning assets among separate corporate organizations is to pledge them to distinct classes of creditors, each of which specializes in monitoring a certain type of assets as opposed to others, so as to reduce the overall cost of credit).

35. See Aggarwal & Kyawb, *supra* note 32.

36. See Nico Dewaelheyns & Cynthia Van Hulle, *Internal Capital Markets and Capital Structure: Bank Versus Internal Debt*, 16 EUROPEAN FINANCIAL MANAGEMENT 345 (2010) (reviewing financing choices of a large sample of Belgian private business groups). See also Raffaele Santioni & Ilaria Supino, *Internal Capital Markets in Italian Business Groups: Evidence*

group can rely on internally-generated funds available for distribution, which is usually the case when profitability is high and overall group leverage is low, subsidiaries are preferably financed with internal debt than bank debt.<sup>37</sup> When external finance is needed, groups tend to centralize the fundraising at the level of the parent with a view to allocating resources to the operational companies by means of intragroup transfers. As the overall group indebtedness increases, so does the ratio of external borrowing to internal borrowing of subsidiaries, for the availability of cashflows for internal funding diminishes. Once overall group leverage reaches a high level, and the parent is close to exhausting its financing capability, subsidiaries are instructed to meet their cash needs by borrowing more from banks. Yet, internal financing does not cease altogether. As an alternative, or in addition, to taking security interests in subsidiaries' assets, banks may demand that the parent too make additional loans as a commitment to keeping the subsidiary viable.<sup>38</sup> As regards internal equity, empirical findings reveal that it plays a negligible role in the financing of subsidiaries belonging to privately-held groups.<sup>39</sup>

## E. Leveraged Transactions

In a leveraged transaction, such as a leverage buyout (“LBO”) of a publicly-traded company (“Target”) conducted by its management (“Management”) together with a private equity firm (“PE Firm”), the sponsors of the transaction (“Sponsors”) need and wish to finance the acquisition of Target by incurring external debt for the most part. Equity plays a minimal role in the financing of the deal.<sup>40</sup> Issuance of shares mostly serves to allocate governance rights to and among Sponsors.

*from the Financial Crisis*, 17 (Bank of Italy, Occasional Paper no. 421, 2018), [www.sipotra.it/old/wp-content/uploads/2018/02/Internal-capital-markets-in-Italian-business-groups-evidence-from-the-financial-crisis.pdf](http://www.sipotra.it/old/wp-content/uploads/2018/02/Internal-capital-markets-in-Italian-business-groups-evidence-from-the-financial-crisis.pdf) (finding that the most relevant channel through which Italian business groups make intra-group transfers of resources is internal borrowing).

37. See Santioni & Supino, *supra* note 36, at 19 (noticing that the main suppliers of funds to affiliates of Italian business groups, especially when they are financially constrained, are their holding companies, which usually benefit from a lower cost of debt and are better positioned to overcome tightening credit markets due to a financial crisis).

38. See Dewaelheyns & Van Hulle, *supra* note 36, at 348.

39. See Dewaelheyns & Van Hulle, *supra* note 36, at 347 n.4 (“[L]ess than 1% of the subsidiaries in our sample [of Belgian business groups] have issued stock during our 6-year sample period.”).

40. For accounts of common patterns of LBO financing in the US, see, e.g., Paul H. Hunn, *The Evolution of Leveraged Buyout Financing*, 1 COMMERCIAL LENDING REVIEW 36 (1986);

In light of the allocation of voting rights to Sponsors despite a less than proportional capital commitment made by them compared with the amount of debt to be raised from outside sources, outside lenders have to rest assured that Sponsors will earn a return only after full satisfaction of outside lenders' claims. Moreover, in light of the enhanced risk of default on the debt instruments resulting from a high leverage ratio, some classes of debt financiers may want to gain priority over other classes of debt investors in the ranking of payments both in the ordinary course of business and on the insolvency of Target and the accompanying debt issuers. Furthermore, PE Firm is likely to want to have an entitlement to the value created after full payment of outside lenders which partially ranks ahead of that of Management. Only by placing Management at the bottom of the chain of the beneficiaries of firm value creation will Management have the strongest incentive to maximize value for the benefit of all the financial claimants involved in the acquisition, including PE Firm. Therefore, while Management will be issued common stock only, PE Firm will be issued both common stock and higher-ranking securities such as preferred stock or debt, with preferred stock and debt being rewarded before any financial benefit accrues to Management.

A widely-used LBO deal structure would provide that Management and PE Firm form multiple corporate vehicles in order to achieve structural subordination of various sources of debt financing.<sup>41</sup> Under this acquisition scheme, they would form as many corporate vehicles as are the layers of debt they plan to incur. Such fresh-made, bankruptcy-remote corporate entities would be fully and vertically controlled by one another and ultimately controlled by Sponsors. Although it is only the entity at the bottom of the chain of control which buys shares in Target and pays the consideration to the sellers, entities at all levels are called on to raise the funds necessary to pay the sellers of Target. They accomplish this joint task by issuing multiple classes of debt instruments. Yet, the debt instruments issued by any one entity need to have a different degree of priority as to payment of interests and principal at maturity than the degree of priority enjoyed by debt instruments issued at other levels. This diversification is requested to meet the demands of different classes of debt investors, who vary in their appetite for risk and expectations on the return of their investment. Assurances as to the negotiated order of priorities are provided to creditors

Christian C. Day, Michael P. Walls & Lisa A. Dolak, *Riding the Rapids: Financing the Leveraged Transaction without Getting Wet*, 41 SYRACUSE LAW REVIEW 661 (1990).

41. For a review of the many deal structures which an LBO can take, see David Gray Carlson, *Leveraged Buyouts in Bankruptcy*, 20 GEORGIA LAW REVIEW 73, 81-83 (1985).

by the structural subordination of junior claims to senior claims and accompanying intercreditor agreements.

Structural subordination in the context of an LBO could be achieved as follows. PE Firm and Management first set up a company, called Holdco, which in turn incorporates and wholly owns another company, called Midco, which in turn forms and fully controls a third company, called Bidco. Bidco is tasked with effectuating the purchase of Target shares and paying the agreed-on price. The equity directly or indirectly contributed by Sponsors to each of these corporate vehicles, including Bidco, is kept at a minimum. To finance the payment of the acquisition consideration, therefore, Bidco takes out loans from banks. The equity capital and outside finance raised by Bidco are still insufficient, though. Fundraising by both Midco and Holdco is needed, too. Midco hence issues debt to hedge funds, while Holdco issues loan notes to PE Firm. Monies received at an upper level are pushed down to a lower level through downstream intercompany loans. In other words, Holdco reloans to Midco what Holdco has raised from its insiders, *i.e.* Sponsors; Midco in turn on-lends to Bidco the proceeds from loans made to Midco by its outside lenders as well as Holdco. But the outside lenders of Bidco, *i.e.* the banks, seek the most senior claim on the cashflows generated by Target with a view to limiting their risk of loss. And outside lenders of Midco, *i.e.* the hedge funds, in turn agree to provide finance in exchange for claims being junior to those of Bidco outside lenders but senior to those of Holdco and Holdco insiders, *i.e.* Sponsors. Likewise, PE Firm agrees to support Management only if PE Firm holds financial claims against Holdco assets which are junior to those of Bidco outside lenders and Midco outside lenders but senior to those held by Management.

Only if Midco made a debt advance subordinated to the claims of Bidco outside lenders would the latter achieve the seniority they aim for. Such subordination may be achieved by issuing security interests to Bidco outside lenders or, absent security interests to their benefit, by an intercreditor agreement between Midco and Bidco outside lenders whereby Midco agrees that its claim will be entirely subordinated to Bidco outside lenders' claims. As a result of either of these two arrangements, banks financing Bidco would hold senior debt. Likewise, only if Holdco provided subordinated debt to Midco would Midco hedge funds gain the seniority for their claims they wish for. To this end, Holdco may enter into an intercreditor agreement with Midco hedge funds whereby Holdco debt claim against the assets of Midco is fully subordinated to the claims of Midco outside lenders. As a result, Midco hedge funds will hold mezzanine debt.

This complex arrangement is on the whole referred to as structural subordination to the extent the intended beneficiaries of subordination, *i.e.*

lower-level outside lenders, gain priority over higher-level outside lenders indirectly through the intermediation of an insiders-owned corporate vehicle acting simultaneously as a borrower and a subordinated lender. Still, when a higher-level entity channels its resources down to a lower-level entity through lending rather than injecting equity, contractual activity, too, is required to ensure subordination of higher-level outside claims. In particular, the controller acting as an insider lender must agree to subordinate any intercompany loan to the borrower company's outside lenders.<sup>42</sup>

Another instance where inside debt financing may come to the fore and subordination of inside credit is commonplace is project financing. Project financing is a technique whereby a capital-intensive project, such as the building of infrastructure facilities, is mostly financed with third-party debt secured on the project assets rather than sponsors' assets. More precisely, project sponsors set up an undercapitalized special purpose vehicle ("SPV") tasked with running the project. To finance its operations, the SPV borrows heavily from professional lenders on a senior, nonrecourse basis. To the extent the SPV is meant to get started with little equity and no assets of value to outside lenders, the latter extend credit taking a security interest in the future cashflows and assets which the project is expected to generate. In addition to collateralization, senior credit may also be enhanced by contributions to the SPV from the project sponsors. But in order to not defeat the priority of outside lenders' senior debt, project sponsors' contributions must come solely in the form of equity or, as is also the case, subordinated internal debt.<sup>43</sup>

## **F. Legal versus Contractual Subordination of Inside Debt Financing**

When provided for, the subordination of insiders' debt claims to the claims of pure creditors reshapes a company's capital structure, which no longer consists solely of equity and debt but rather of equity, debt, and quasi-equity, *i.e.* a type of capital that is debt in good times and approximates equity in bad times. The claims of a firm's insiders in their quality as creditors rank lower than those of non-shareholder creditors but still rank higher than those of shareholders *qua* shareholders for distribution purposes. The net-worth of the

42. Intercreditor agreements solely flow between the outside lenders of the debtor company and the debtor company's controller and insider creditor. A comprehensive intercreditor agreement simultaneously involving all the various classes of outside lenders financing the deal becomes unnecessary to determine the sought-for order of priorities.

43. See Scott L. Hoffman, *Project Financing: Loans Based on Cash Flow and Contracts*, 4 COMMERCIAL LENDING REVIEW 18, 22, 33 (1989).

company shall first be used to pay back debts owed to pure creditors. Once such debts have been satisfied in full, what is left over may go to the advantage of shareholder-creditors *qua* creditors with priority over shareholders as such.<sup>44</sup>

In principle, the subordination of insiders' debt claims could equally be achieved by law or contract. Absent a law provision mandating subordination, a firm's owners could still agree to have their debt claims subordinated to those of all or some of the firm's pure creditors.<sup>45</sup> The question therefore is whether it makes any difference from an efficiency perspective that the subordination remedy be supplied by the law or, alternatively, by private ordering.

To start with, the same triggering events and modes of operation can apply whether subordination is legal or contractual. In both cases the subordination of insider creditors' claims can be made either "complete"<sup>46</sup> or "inchoate".<sup>47</sup> While in the presence of a complete subordination agreement the company is barred from paying an insider's debt claim until all other liabilities have been paid back in full, with an inchoate subordination agreement the subordination is conditional on, and triggered by, the opening of an insolvency proceeding. Therefore, only if and when the company formally enters bankruptcy will the payment of the shareholder-creditors' claim be postponed to the payment of all other debt claims.<sup>48</sup> Likewise, both legal subordination and contractual

44. The fact that claims of shareholders *qua* creditors rank higher than those of shareholders *qua* shareholders keeps subordinated debt owed shareholders from fully converting into or resembling straight equity. Although such a distinction might have little practical consequences in a world where bankruptcies leave little if anything for the benefit of unsecured creditors, the distinction is formally relevant and might have consequences. For example, a controlling shareholder that has financed the company by means of advances in addition to equity contributions will have claims for the reimbursement of the advances in bankruptcy which are senior to the claims of minority shareholders who have financed the company by means of equity contributions only.

45. The account of how leveraged transactions are typically structured has provided a thorough example of contractual subordination of inside debt financing. See *supra* Section E.

46. See Calligar, *supra* note 11, at 378. Bruce MacDougall, *Subordination Agreements*, 32 OSGOODE HALL LAW JOURNAL 225, 229-32 (1994), refers to the same type of subordination as "absolute".

47. See Calligar, *supra* note 11, at 377. Philip R. Wood, *THE LAW OF SUBORDINATED DEBT* 8 (1990), calls this type of subordination "springing", whereas Bruce MacDougall, *supra* note 46, at 229, names it "contingent" subordination.

48. "Private" subordinations, *i.e.* subordination arrangements between creditors of the same debtor whereby one or more creditors subordinate their claims to those of the other creditors which are party to the agreement, are usually complete. Private subordinations typically involve the insiders of the borrower as the subordinated creditors and the outside lenders as the senior creditors. Lenders may want the insiders' claims to be completely subordinated to their own as a condition to extending new debt financing to a financially-troubled firm so that no cash risks being subtracted from a flagging borrower firm until full payment of the senior claims. See James

subordination may in principle take effect as of the date on which the debt is incurred (so called “initial” subordination)<sup>49</sup> and/or in respect of the debt that is already outstanding (so called “subsequent” subordination).<sup>50</sup>

Both legal and contractual subordination of inside debt may be understood as a bonding device against wealth-reducing transactions.<sup>51</sup> In postponing the repayment of debt claims held by a firm’s insiders until after outside creditors’

L. Lopes, *Contractual Subordinations and Bankruptcy*, 97 *BANKING LAW JOURNAL* 204, 207-8 (1980). By contrast, “institutional” subordinations, that is subordination agreements between the debtor and the subordinated creditors whereby the purchasers of a debt issuance agree to be subordinated to the holders of other corporate debts (which themselves are third-party beneficiaries of the agreement), are usually inchoate. Subordination provisions of this sort are mostly found in indentures governing issuance of debentures offered to the public or privately placed with institutional investors. See *id.* at 206-7. A complete subordination provision in a subordinated debenture indenture may be untenable for the investors to the extent it would essentially bar the payment of interests and principal amount until the liquidation of the issuer. See Edward Everett, *Subordinated Debt – Nature and Enforcement*, 20 *BUSINESS LAWYER* 953, 956 (1965) (“Subordinated debt subject to such immediately operative subordination provisions, preventing any payments whatsoever on the subordinated debt until the senior debt is paid in full, would not ordinarily constitute an appropriate investment for institutional investors.”).

49. See Wood, *supra* note 47, at 8. Initial subordination by contract is typically seen in subordinated debenture issuances. See *id.* at 9. Subordination arrangements provided for in the indenture are therefore entered into between the corporate borrower and the purchasers of subordinated debt only, with third-party creditors being the intended beneficiaries. But initial subordination may also occur in the different context of an out-of-court workout of a financially-distressed firm whereby a bank agrees to extend credit to the firm on condition that the firm’s insiders simultaneously make loans, too, and that such loans be junior to the bank’s loan.

50. See *id.* at 8. Subsequent subordination often occurs in the context of workouts where a bank agrees to extend a new credit facility on condition that insiders (and suppliers) agree to subordinate their existing claims. See *id.* at 9. A loan agreement providing for subsequent subordination of outstanding debt thus requires consent from the corporate borrower, the lender seeking a senior claim, and the existing creditors whose claims are requested to become junior. When the going-concern value of the firm exceeds its liquidation value, a bank and the debtor’s insiders may strike a mutually advantageous bargain whereby the bank waives its default rights and provides new liquidity in exchange for some additional financial effort on the part of the firm’s insiders. To be sure, such effort may take the form of personal guarantees or capital contribution. See Douglas G. Baird & Thomas H. Jackson, *Bargaining after the Fall and the Contours of the Absolute Priority Rule*, 55 *UNIVERSITY OF CHICAGO LAW REVIEW* 738, 751-53 (1988). But as long as subordination arrangements are allowed and enforceable in the given jurisdiction, the bargaining chip a firm’s owners can put on the negotiating table is also subordination of their past and new debt funding. In so doing, a bank’s loan would be protected more than if the insiders provided equity or legally-subordinated debt, as in the latter cases the funds would go to the *pro-rata* advantage of non-bank creditors, too. See *infra* notes 52-55 and accompanying text.

51. See John Armour, *The Law and Economics Debate about Secured Lending: Lessons for European Lawmaking*, 5 *EUROPEAN COMPANY AND FINANCIAL LAW REVIEW* 3, 8 (2008) (“[C]ontractual priority arrangements...may be justified as bonds against wealth-reducing transactions.”).

claims have been satisfied, subordination credibly commits insiders to look after the interests of outside creditors and thereby avoid overly risky activity, because only by retaining enough asset value to pay off the outside debts entirely will the insiders be entitled to have their own debts repaid. When subordination is not provided for by the law and is therefore contracted for, acceptance by an insider of an arrangement subordinating its debt financing to that of another creditor also works as a signalling mechanism, as agreeing to a lower priority in bankruptcy shows faith in the ability of the firm to wholly meet its senior payment obligations.

Despite these similarities, a major difference exists between the legal and contractual modes of subordinating insiders' debt. While subordination by law ordinarily downgrades the priority status of an insider's debt relative to every other corporate debt of otherwise equal ranking, which therefore are all benefitted *pro rata*, subordination by contract usually entails that the bankruptcy dividend owed the insider be turned over to the outside creditor that is a party to the arrangement to no advantage for third-party creditors. As a result, the senior creditor obtains a "double dividend", *i.e.* both the share of asset value it is entitled to in its own right and the share of asset value the subordinated creditor would be entitled to, until the senior creditor's claim is paid in full.<sup>52</sup> If after full satisfaction of the senior creditor there still is residual value inuring to the junior creditor, such value is retained by the junior creditor on account of its own debt. None of this value will have to be shared with creditors alien to the arrangement.

Consider for sake of clarity a situation where there exist four unsecured creditors, of whom one is an insider ("Insider") and the other three are a bank ("Bank"), a trade creditor ("Trade Creditor") and a tort creditor ("Tort Creditor"). The amount of creditors' claims totals \$1000, with Insider being owed \$250, Bank \$500, Trade Creditor \$200 and Tort Creditor \$50. All of the creditors' claims are unsecured and enjoy the same ranking.<sup>53</sup> The bankrupt estate is worth \$200. As a consequence of the relative size of their debt claims in dollar value, the Insider is entitled to 25% of the assets available for creditors. The Bank, the Trade Creditor and the Tort Creditor are entitled to 50%, 20%

52. See Calligar, *supra* note 11, at 376-77 ("[F]rom the point of view of the bank (the senior creditor), subordinated debt is preferable to equity capital, since in the event of the debtor's bankruptcy the senior creditor will receive 'double dividends' out of the bankrupt's estate") (footnotes omitted); Richard E. Mendales, *The New Junkyard of Corporate Finance: The Treatment of Junk Bonds in Bankruptcy*, 69 WASHINGTON UNIVERSITY LAW QUARTERLY 1137, 1147-48 (1991) (criticizing the double dividend that senior lenders of a bankrupt junk bond issuer enjoy when junk bonds are contractually subordinated to the former's exclusive advantage).

53. In other words, there are no priority unsecured creditors among them.

and 5% of the estate, respectively. Table 1 below compares what all creditors would fetch under three different legal regimes. Under a first regime of no legal subordination prohibiting contractual subordination, each creditor obtains its *pro-rata* share of the estate. To put it in numbers, the Insider recovers \$50, whereas the Bank, the Trade Creditor and the Tort Creditor achieve \$100, \$40 and \$10, respectively. Under a regime of no legal subordination nonetheless allowing contractual subordination, to the extent the Insider has contractually subordinated its debt to the Bank's debt, the Insider gets \$0 to the advantage of the Bank, which benefits from the already-mentioned double dividend, *i.e.* its share of \$100 plus the subordinate Insider's share of \$50 for a total amount of \$150.<sup>54</sup> The Trade Creditor's and the Tort Creditor's shares remain unchanged at \$40 and \$10, respectively. Finally, under a regime of automatic subordination whereby the Insider's debt is by law subordinated to all other unsecured debts outstanding at the time of bankruptcy,<sup>55</sup> the Insider obtains \$0, while all the other three creditors proportionately benefit from the automatic release to their advantage of the Insider's share of the estate. As a result, if the Bank's share increases to \$133.32, the Trade Creditor's and Tort Creditor's shares proportionately rise to \$53.34 and \$13.34, respectively.

As Table 1 shows, by switching from a regime of automatic subordination to a regime allowing subordination by contract, the share of Bank in the 200-dollar estate (assuming a subordination agreement is entered into) would increase from 66.66% to 75%, or from 133.32 to 150 in dollar value, with a net benefit of \$ 16.68. In stark contrast to the windfall for Bank, the Trade Creditor's share in the estate would decrease from 26.67% to 20%, generating a net loss of \$ 13.34, while the Tort Creditor's share in the estate would similarly diminish from 6.67% to 5%, for a net loss of \$ 3.34. In other words, while banks seem to maximize their payoff under a regime allowing contractual subordination of inside debt on the plausible assumption that banks, in their capacity as the strongest creditors, succeed in achieving subordination arrangements whenever it is in their interest to have them, trade and tort creditors maximize their payoffs under a regime of automatic subordination.

54. Bank can appropriate the entire value otherwise pertaining to Insider because the original Bank's claim was worth \$500. If the Bank's claim face value were \$149 or less, Bank would get up to its claim's face value and would have to leave the remainder of Insider's share to Insider itself. If our numerical example were modified so that Bank is owed \$120, Insider is owed \$60, Trade Creditor is owed \$48 and Tort Creditor is owed \$12 out of claims totalling \$240 overall, once again assuming a bankrupt estate value of \$200 Bank would receive \$100 from the bankruptcy trustee and \$20 from Insider, with Insider keeping for itself the other \$30 it is owed (and Trade Creditor and Tort Creditor bringing home \$40 and \$10, respectively).

55. For details about the remedy of automatic subordination, see *infra* Part V, Section C.

Table 1. Distribution of the bankruptcy dividends under the no-subordination approach and the automatic subordination approach

| Regulatory Approach   | Unsecured Creditors |          |         |          |                |          |               |          |
|---|---------------------|----------|---------|----------|----------------|----------|---------------|----------|
|   | Insider             |          | Bank    |          | Trade Creditor |          | Tort Creditor |          |
|   | Claim %             | \$ Claim | Claim % | \$ Claim | Claim %        | \$ Claim | Claim %       | \$ Claim |
| No-subordination approach prohibiting contractual subordination | 25%                 | 50       | 50%     | 100      | 20%            | 40       | 5%            | 10       |
| No-subordination approach allowing contractual subordination    | 0%                  | 0        | 75%     | 150      | 20%            | 40       | 5%            | 10       |
| Automatic subordination approach                                | 0%                  | 0        | 66,66%  | 133,32   | 26,67%         | 53,34    | 6,67%         | 13,34    |

## G. Strategic Interests against Contractual Subordination of Inside Debt Financing

Despite the potential windfall for lenders arising from subordination of inside debt, the practice of inside debt financing in jurisdictions not providing for automatic subordination does not conclusively evidence a systematic presence of subordination arrangements in credit facilities, especially when the borrower firm is in good shape. Assuming risk-averse lenders, as banks seemingly are, this fact is puzzling. If converting unsubordinated insider loans into subordinated debt reduces the risk of loss for a bank, a risk-averse bank should aim for it in exchange for lowering the cost of debt for the firm. If asked to subordinate, the insider would in turn weigh the costs to it of having its debt subordinated to that of the bank and the benefits of a reduction in the loan interest rate charged the company. To the extent a mutually advantageous arrangement would be within the reach of the parties in most circumstances, the reason why insiders and risk-averse lenders do not come up with such an arrangement more often than they seem to do is not readily apparent. While hardly ever is a leveraged transaction for the purchase of expensive assets or the financing of capital-intensive projects structured without resorting to some form of subordination of inside debt, debt financing of firms by their controlling shareholders is less frequently subordinated than one would expect at first sight.<sup>56</sup>

56. To be sure, authors from different jurisdictions incidentally report that intragroup loans usually take the form of subordinated debt. See Stonehill & Stitzel, *supra* note 28, at 93 (“A [US] parent company loan [to a subsidiary] is usually subordinated to all other kinds of debt.”); Gopalan, Nanda & Seru, *supra* note 27, at 765-766 (“Indian business groups typically use subordinated intragroup loans as a means of intragroup transfer.”); Dewaelheyns & Van

A possible explanation lies in the cost of bargaining over the issue with all insiders making or willing to make advances to the company. A company can grant a bargaining creditor a senior status over that of other creditors without the need of such creditors' consent by allowing the former to lend on a secured basis. The assets pledged as a security for a creditor ensure that the secured creditor be entitled to seize and sell them should the borrower default on its payment obligations. But outside the domain of secured credit, a company and a bargaining creditor cannot establish priority of the latter's debt claims over third-party debt claims, including insiders' ones, by a contract solely entered into between the negotiating parties. Such a contract provision would be unenforceable against third-party creditors, including the insider creditors, unless such creditors specifically consent to the subordination of their claims. To the extent obtaining such consent from each and every insider entails some bargaining efforts, the higher the number of the insiders whose consent is needed, the higher the transaction costs. Nevertheless, with regard to the companies where the issue mostly is of relevance, that is, closely-held companies with a handful of management shareholders or subsidiary companies within a group of companies, the costs of bargaining with few insiders either directly involved in the management of the company or at the very least well informed of its affairs unlikely are prohibitive.<sup>57</sup> In light of this fact, the transaction cost hypothesis, which holds elsewhere,<sup>58</sup> has little merit as to explaining what

Hulle, *supra* note 36, at 366 (“[Intragroup] debt [in Belgium] usually is subordinated to bank financing.”). Yet, anecdotal empiricism seemingly indicates that lenders refrain from systematically prohibiting or otherwise limiting by contract the liberty of shareholders to extend new loans. See Clifford W. Smith, Jr. & Jerold B. Warner, *On financial contracting: An analysis of bond covenants*, 14 JOURNAL OF FINANCIAL ECONOMICS 117, 131 n.41 (1979) (borrowing by a subsidiary from its parent company is excluded from covenants restricting issuance of new debt on a consolidated basis); David A. Skeel & George Krause-Vilmar, *Recharacterization and the Nondraining of Creditors*, 7 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW 259, 284 (2006) (“[C]reditors do not seem to limit shareholder loans by contract.”).

57. Theory predicts that when equity is concentrated, debt tends to be closely-held, too. See Jan Mahrt-Smith, *The Interaction of Capital Structure and Ownership Structure*, 78 JOURNAL OF BUSINESS 787 (2005). The presence of a strong, controlling shareholder driving management to pursue its interests commands in equilibrium the presence of an equally strong creditor with the incentive and power to monitor and constrain an excessively controlling shareholder-oriented management. At the same time, the presence of a strong, concentrated creditor pushing for suboptimal low risk-taking finds its best response in a strong, concentrated equityholder reminding management to whom they owe their job and salary in the first place. Independently of the causes of this equilibrium, the existence of few inside equityholders and few concentrated debtholders make any negotiations between them less costly, with an increasing probability of a successful outcome.

58. A transaction cost hypothesis provides the foundations on which the general creditor priority rule, *i.e.* the priority of debt claims over equity claims, is built in respect of both widely-

might keep the parties from agreeing to a cost-effective, privately efficient subordination of insiders' claims by contract.<sup>59</sup>

Perhaps the lack of contractual subordination even where it seems advantageous to the outside lender is justified by the use of negative pledge covenants, which could be viewed as acting as a creditor protection device substituting for the former when prohibiting the company to incur further debt without approval from the outside lender.<sup>60</sup> To be sure, as long as the company is fully solvent, the threat of asset dilution, asset substitution as well as debt dilution can largely be kept in check by means of loan covenants,<sup>61</sup> which not only benefit adjusting creditors but also, albeit indirectly, protect nonadjusting ones.<sup>62</sup> Upon a firm's solvency, the insiders' commitment to the covenants

held and closely-held companies. More generally, the presence of transaction costs explains why priority rules meant to establish forms of asset partitioning as between multiple creditors are more efficiently supplied by law than by contract. See generally Hansmann & Kraakman, *supra* note 34, at 407-409.

59. Contrary to the view expressed above, Skeel & Krause-Vilmar, *supra* note 56, at 284-285, does not rule out transaction costs as an impediment to subordination arrangements being more frequently agreed to. Assuming positive transaction costs, one might wonder whether insiders and corporate creditors could pursue an *ex ante* costless charter arrangement as opposed to agreeing to an *ex post* costly loan contract provision. The answer to this question is in the negative as a subordination provision inserted in the charter would by its very nature operate to the advantage of all outside creditors. Conversely, the value of a subordination provision placed in a loan agreement with the company, with the insider creditors taking part in the deal in order to wave their priority rights, is captured solely by the outside lender who is a party to the agreement. Such a windfall is not meant to be shared with third-party creditors. Low-cost charter provisions could not be a substitute for high-cost loan contract provisions, if the latter were truly so.

60. It might be the case that the general negative pledge clauses contained in most lending arrangements in fact are sufficient to curtail shareholder loans in an optimal number of circumstances. See Skeel & Krause-Vilmar, *supra* note 56, at 285.

61. See Smith & Warner, *supra* note 56, at 123 (“[C]ovenants... take the current form and have survived because they represent a contractual solution which is efficient from the standpoint of the firm”). See also George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CALIFORNIA LAW REVIEW 1073, 1093 (1995) (“[Covenants] serve as trip wires for the lender’s right to accelerate and enforce or to intervene in the borrower’s decisions”). To this end, they are designed to be tripped long before the borrower becomes insolvent so as to give the lender time to figure what actions to take before value is irremediably lost. See *id.* at 1093. Hardly ever does the lender insist on an early repayment of the loan. More often the lender seizes the opportunity to exert greater control over the firm’s decision-making. See Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 UNIVERSITY OF PENNSYLVANIA LAW REVIEW 1219, 1228 (2006).

62. Debt covenants, in placing constraints on the extent to which management can subject corporate assets to the risk of loss, generate positive externalities for nonadjusting creditors, too. More generally, all creditors usually stand to benefit from negative pledge covenants obtained from the borrower by any one of them. See Lucian A. Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE LAW JOURNAL

agreed to by the company remains credible because a covenant breach would have detrimental consequences for them. Not only would an event of default pertaining to a loan agreement accelerate the reimbursement of the loan or have the effect of tightening the grip of the lender on the management of the borrower firm, but it would also possibly trigger cross-defaults, as is the case when an event of default agreed upon in a loan agreement becomes by reference an event of default for other loan agreements. The willingness to keep the company safe and sound and the ensuing necessity of any repeat corporate borrower to maintain a good reputation instrumental in having continuous access to the credit market ensures overall compliance with the obligations to the class of lending institutions. Nevertheless, allowing unlimited insider loans while subjecting them in whole or in part to complete,<sup>63</sup> or almost complete, subordination would be more beneficial to outside lenders than having insider loans restricted by financial covenants targeting debt issuance in general. A subordination provision in the lending agreement would cause no dilution of the lender's debt and could be crafted so as to limit cash disbursements without preventing the insider from extending as much credit as it deems fit for the firm.

Even if covenants might warrant some credit as potential substitute for contractual subordination in times of full solvency, troubles arise when the

857, 923 (1996). Still, while the *ex ante* benefits are apparent, there might exist negative *ex post* consequences for nonadjusting creditors. To the extent the breach of a covenant acts as a default event accelerating the maturity of a debt which compels the corporate borrower to reimburse it without delay, nonadjusting creditors will suffer from the ensuing reduction in asset value unless they can count on cross-default arrangements. But nonadjusting creditors cannot do so by definition. See Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 DUKE LAW JOURNAL 425, 438-39 (1997).

63. It is standard in the literature on debt subordination to present the agreement between an insider, usually a shareholder-manager of a closely-held company, and a bank to subordinate the advances made by the former to the credit extended by the latter as the archetypal example of a complete form of subordination. See Calligar, *supra* note 11, at 377; Asa S. Herzog & Joel B. Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 15 VANDERBILT LAW REVIEW 83, 90 (1961); Peter F. Coogan, Homer Kripke & Fredric Weiss, *The Outer Fringes of Article 9: Subordination Agreements, Security Interests in Money and Deposits, Negative Pledge Clauses, and Participation Agreements*, 79 HARVARD LAW REVIEW 229, 234 (1965); Philip R. Wood, *Subordination Agreements, Bankruptcy and the PPSA*, 49 CANADIAN BUSINESS LAW JOURNAL 66, 71 (2010). It is argued that external lenders might fear that the proceeds of their loan be used to repay already outstanding debts to the firm's insiders. Complete subordination provides that external lenders' claims be paid back in full before insiders' debt receives any payment. See Geoffrey Fuller, *CORPORATE BORROWING. LAW AND PRACTICE* 148 (5<sup>th</sup> ed. 2016). It also prevents insiders from seeking repayment prior to the event of default. See Wood, *supra* note 47, at 52. Furthermore, by subordinating insiders' debt completely, borrower's resources are safeguarded against the risk of being exhausted in meeting multiple payment demands simultaneously. See *id.* at 53.

company starts sliding into insolvency. For shareholders' appetite for risk-taking escalates and their incentives turn from being efficient<sup>64</sup> to being perverse,<sup>65</sup> the credibility of any commitment to creditors resulting from debt covenants entered into by the company may fall apart.<sup>66</sup> If a covenant breach by the promisor resulted in value destruction leading to bankruptcy, there would likely be no sufficient asset value against which the promisee could take remedial actions. Unlike debt covenants, the enforcement of which requires constant monitoring by the lenders and a prompt intervention as the finances of the borrower become distressed, contractual subordination offers a lower-cost protection as it becomes self-enforcing upon bankruptcy. To the extent debt covenants are not a perfect substitute for contractual subordination, the covenant hypothesis as a justification for the absence of systematic contractual subordination where it appears in the interest of risk-averse lenders rests on shaky foundations. There must be something else driving some creditors to not request subordination of debt advances from insiders.

The most plausible answer with regard to the lack of systematic subordination of inside debt may be found in an inter-creditor agency conflict. This conflict is readily apparent in a group of companies whenever a parent company issues debt and there is a chance, if not prevented or adequately constrained, that the subsidiaries do the same. Parent's debt claimants care about the overall amount of debt issued by the group as a whole because the solvency of the parent might well depend on the solvency of its subsidiaries. Besides, parent's creditors are structurally subordinated to subsidiaries' creditors in exerting claims against the subsidiary's assets. Therefore, debt covenants forced on parent usually limit the debt exposure of the whole group by restricting borrowing by parent and

64. When the company is solvent, the residual claimants are the shareholders. That is why it is the shareholders that are entitled to appoint management. They have the best incentives to seek out the best performing managers and monitor them so that they engage in the highest positive-NPV activities. See *infra* Part III, Section B.

65. Limited liability accords equityholders a statutory permission to privatize the gains and socialize the losses by enlisting the firm creditors to shoulder part of the burden. Thanks to the benefit of limited liability, equityholders of a levered firm may come to prefer lower NPV investments to higher NPV investments if the lower NPV investments promise a higher expected return for them. The higher the debt-to-equity ratio is, the more likely this scenario becomes. See *infra* Part III, Sections C and D.

66. See Scott, *supra* note 20, at 946 ("It is when the borrower is in financial straits that lenders believe the temptation to violate loan covenants arises."); Barry E. Adler & Marcel Kahan, *The Technology of Creditor Protection*, 161 UNIVERSITY OF PENNSYLVANIA LAW REVIEW 1773 (2013) (arguing that when breach of covenants is, as is often the case, associated with a debtor's insolvency, the contracted-for remedies for breach might prove ineffective as they require a debtor's solvency to be enforceable).

subsidiaries alike.<sup>67</sup> However, covenants fall short of restricting intragroup loans. Quite the opposite, the mechanism is conceived to shift most, if not all, external borrowing to the parent while letting this one to reloan the proceeds from its debt financing to its subsidiaries whenever needed.<sup>68</sup> Under this financing pattern, if the parent on-lends to a subsidiary and both the parent and the subsidiary default on their outside debt, rather than just having an equity interest in the bankrupt subsidiary<sup>69</sup> entirely subordinated to the claims held by subsidiary-level outside creditors, parent-level outside creditors obtain a claim against the bankrupt subsidiary's estate<sup>70</sup> which ranks *pari passu* with those of subsidiary-level outside creditors. By contrast, if the intragroup loan were subordinated to loans from subsidiary-level outside creditors, parent-level outside creditors would once again find themselves entirely subordinated to subsidiary-level outside creditors, with the former's chances of recovery not getting any better than when the parent finances the subsidiaries through capital contributions. The risk for parent-level lenders of being postponed to subsidiary-level creditors in a subsidiary's bankruptcy explains why it is in the strategic interest of parent-level lenders to allow intragroup loans, on the one hand, and to ensure that such loans not be subordinated, on the other hand.<sup>71</sup>

Outside of the context of corporate groups, lenders may instead be expected to renounce demands for subordination when they fear that the threat of subordination might deter later investing by the firm's owners and anticipate that later funding by the firm's owners might mostly be needed for their own safety as well. A day may come when the company urgently needs to tap each and every source of readily available funds for its own good and the good of its

67. Or by prohibiting borrowing by the subsidiaries altogether. See William W. Bratton, *Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process*, 7 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW 39, 52 (2006).

68. See *id.*

69. This equity interest would indirectly be held through post-bankruptcy ownership of the holding company's residual assets.

70. Again, the holding of this debt claim would indirectly be obtained by owning the bankrupt holding company's debt claim against the subsidiary.

71. It is not uncommon for intragroup dealings to stir intercreditor conflicts. As regards the US, see *In re Association Gas & Elec. Corp.*, 61 FEDERAL SUPPLEMENT 11, 28-29 (United States District Court for the Southern District of New York, 1943), affirmed, 149 FEDERAL REPORTER (SECOND SERIES) 996 (United States Court of Appeals for the 2<sup>nd</sup> Circuit, 1944) (trustee and debenture holders of a bankrupt parent filing action against trustee and debenture holders of a bankrupt subsidiary thereof claiming fraud as to the transfer of all parent's assets to the subsidiary in exchange for the subsidiary's stock through multiple transactions designed to escape a negative pledge covenant). Therefore, it is unsurprising that a parent's creditors put limitations on the freedom of a parent and its subsidiaries to transact among them and with third parties, and that they do so with carefully-drafted covenants.

current out-of-the-money creditors. Unsecured lenders dealing with a solvent firm may thus rationally anticipate that they are better off not discouraging *ex ante* any type of future financing, including debt financing, from a firm's owners, while leaving a request for a subsequent subordination of insiders' debt claims as a condition to a workout and the accompanying provision of additional external credit once insolvency looms large.<sup>72</sup> Precisely because external creditors expect covenants to cease to be protective when they would be mostly needed owing to final-period problems, early creditors may want to respond to expected covenant failure by keeping the door wide open to further funding from the equity owners, whatever the form the internal funding could possibly take, so that the owners' fresh money and increased exposure to losses might help get the former wholly or partially off the hook.<sup>73</sup>

To be sure, a lender could insist on extracting contractual subordination from a firm's insiders at the inception of the lending relationship and reserve the right to waive its debt priority in the future if additional inside debt financing were needed. But the mere existence of a subordination provision in an early loan agreement, in making later inside debt financing less likely, would have a deterrent effect against lending by those prospective unsecured creditors willing to leave debt financing from insiders unconstrained *ex ante*. Therefore, it might in some instances be in the individual and collective interest of institutional lenders not to request the subordination of corporate debt subsequently issued to insiders at the inception of their lending relationship with a fully solvent company. Far from having unequivocal explanatory power, this hypothesis could however explain why it seems that providers of unsecured credit occasionally do not seek to force contractual subordination on a firm's insiders as long as the firm is in good financial conditions, while reserving the right to demand subordination should they be asked to infuse additional money upon a deterioration of the firm's finances.

72. See Conrad B. Duberstein, *Out-of-Court Workouts*, 1 AMERICAN BANKRUPTCY INSTITUTE LAW REVIEW 347, 359 (1993) (“[In workout agreements] [i]t is also not unusual for creditors’ committees to further insist upon subordination of officers’ loans or loans by related companies under the principle of equitable subordination.”); George A. Nation III, *Circuity of Liens Arising from Subordination Agreements: Comforting Unanimity No More*, 83 BOSTON UNIVERSITY LAW REVIEW 591, 591 (2003) (“[I]n order to get additional funds for the debtor, the first priority creditor might be willing to subordinate all or part of its priority position to the new lender. This is especially true when the existing creditors are insiders.”) (footnotes omitted).

73. More generally, when negotiating debt covenants, lenders of healthy borrowers may find it in their interest to leave the window open to further debt incurrence to the extent, as pointed out in Bratton, *supra* note 67, at 52, “[a]dditional debt can provide the borrower with additional capital for good projects the returns on which make existing lenders more secure.”

PART III  
SHAREHOLDERS' INCENTIVES  
AND APPETITE FOR RISK

While in a world free of transaction costs a firm's capital structure does not bear on firm value,<sup>1</sup> in the real world it does and, as a consequence, it also matters for social welfare. It is not just about taxes and bankruptcy costs. It also is a matter of financial claimants' incentives and agency problems.<sup>2</sup> A firm's given capital structure shapes the incentives of the financial claimants differently from what a different capital structure of the same firm does. As incentives vary, so too does nature and size of the agency costs weighing on firm value. Corporate finance and agency theory insights help us ascertain when debt advances from a firm's insiders are more likely to be detrimental and when they are more likely to be beneficial from the perspective of economic efficiency.

One should first admit that any attempt to prove that insider loans are solely harmful or solely beneficial from a theoretical standpoint is misplaced. General, unambiguous statements on their welfare effects cannot be made, which fact explains why the literature is split between a sceptical view and a more benign one, with sceptical commentators advocating for a legal remedy of subordination of inside debt financing for the benefit of all outside creditors<sup>3</sup> and benevolent commentators cautioning against subordination of inside debt as being certainly or potentially inefficient and counterproductive.<sup>4</sup> The desirability of insider loans is ultimately an empirical question. Yet, analysing how insider loans shape insiders' and external creditors' incentives at different stages of a company's financial lifecycle may contribute to a better

1. See Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 *AMERICAN ECONOMIC REVIEW* 261 (1958).

2. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *JOURNAL OF FINANCIAL ECONOMICS* 305 (1976).

3. See *supra* Introduction, note 5.

4. See *supra* Introduction, notes 6-7.

understanding of the consequences of different legal arrangements in the allocation of priority rights in a firm's assets throughout its existence.

Before studying how debt advances made by a firm's insiders impact incentives and interests of owner-managers and creditors, it is worth recalling what incentive structure drives the shareholders with regard to risk-taking when the firm has incurred outside debt as opposed to when a firm is fully equity-financed. Section A deals with a fully equity-financed firm, while Section B deals with a levered, and yet fully solvent firm. Also, of concern is to show how the shareholders' incentive structure changes once a previously solvent company finds itself in the vicinity of insolvency or, even worse, slides into insolvency. Such task is taken up by Section C and Section D, respectively. Only by considering the evolving shareholders' incentives as their company moves from a condition of financial soundness to one of financial distress may one fully appreciate how inside debt financing may escalate the shareholders' appetite for risk and sow opportunistic behaviors.

## **A. Shareholders' Incentive Structure when a Firm Is Fully Equity-Financed**

Efficiency requires that a firm's managers maximize firm value, thereby enhancing social wealth. Firm value is maximized and economic efficiency is achieved when corporate managers undertake projects with the highest positive net present value ("NPV").<sup>5</sup> In doing so, managers create wealth for the firm, its

5. See, e.g., Richard A. Brealey, Stewart C. Myers & Franklin Allen, *PRINCIPLES OF CORPORATE FINANCE* 108 (13<sup>th</sup> ed. 2020); Remus D. Valsan & Moin A. Yahya, *Shareholders, Creditors, and Directors' Fiduciary Duties: A Law and Finance Approach*, 2 *VIRGINIA LAW & BUSINESS REVIEW* 1 (2007). Obviously, not all corporate decisions are investment decisions, much less decisions measurable in NPV terms. Therefore, the identification of the purpose of the business corporation and the ensuing scope of managerial fiduciary duties is a daunting and controversial task, which has had many academics, practitioners and business people shift their attention away from the mere balance-sheet or income effects of managerial decisions to, more broadly and vaguely, what interests of which classes of stakeholders such decisions should promote. Among the most recent contributions of a long-standing debate, see Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2017 *JOURNAL OF LAW, FINANCE, AND ACCOUNTING* 247 (2017) (sticking to shareholder primacy but proposing that weight be given to shareholder welfare rather than shareholder wealth); Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 *CORNELL LAW REVIEW* 91 (2020) (claiming that stakeholder protection should be advanced by external laws, regulations and policies rather than acting upon the corporate purpose or shifting directors' duties away from shareholder value creation, as the latter remedies would just broaden managerial discretion and unaccountability); Leo E. Strine, Jr., *Restoration: The Role Stakeholder Governance*

stakeholders and the society as a whole. Nevertheless, managers are relatively risk-averse in light of the firm-specific investments they make. In having their human capital inextricably tied to the fortunes of the company, they are incentivized to avoid taking risks that may endanger the financial soundness of the company even if such risks were optimal from the standpoint of the firm. In particular, managers are wary of bankruptcy and the ensuing proceedings that would possibly displace them from the firm, affect their reputation in the job market and weigh on their self-esteem.<sup>6</sup> The law counters the efficiency loss resulting from managerial risk aversion by, among other legal strategies, subjecting selection and appointment of the management team to the will of the residual claimants. Residual claimants are the claimholders that are entitled to take for themselves the free cash-flow generated by the company while ranking behind all other claimants in the repayment of the financial commitments made to the company. Put differently, residual claimants are those that win out if the company creates value and lose out first if the company performs poorly. When the company is solvent, the residual claimants are the shareholders. That is why it is the shareholders that are entitled to appoint management. They have the best incentives to seek out the best performing managers and monitor them so that the managers engage in the highest positive-NPV activities.

In an all-equity firm, that the individual shareholders are diversified or not does not affect the rational preference of any one shareholder for a higher positive-NPV investment over a lower positive-NPV investment even though the former should carry a greater risk of failure than does the latter. By the same token, no rational shareholder, whatever its appetite for risk, would prefer a lower positive-NPV project to a higher positive-NPV project even if the former had a greater upside potential.<sup>7</sup> What is more, no rational shareholder would ever opt for a negative-NPV project whatever its upside potential.<sup>8</sup>

*Must Play in Recreating a Fair and Sustainable American Economy: A Reply to Professor Rock*, 76 BUSINESS LAWYER 397 (2021) (looking favorably at “a mandatory, normative duty on directors to respect all stakeholders.”). For the purposes of the analysis carried out in this Section focusing on the NPV maximization rule is a proper approach as it shows that even under such a simple rule, which should be in the primary interest of the shareholders, there exist circumstances where it might be departed from by a firm’s management at the instance of the shareholders themselves. It is in these circumstances that inside debt financing might have a major impact.

6. See Susan Rose-Ackerman, *Risk Taking and Ruin: Bankruptcy and Investment Choice*, 20 JOURNAL OF LEGAL STUDIES 277, 278-79 (1991).

7. The choice between two equally positive-NPV projects, of which one has a greater upside and downside potential, would instead be driven by the *ex ante* appetite for risk of the company’s shareholders.

8. The same incentive structure that is found in an all-equity firm would be found in a levered firm under the assumption that despite the latter’s indebtedness such a firm would be

## B. Shareholders' Incentive Structure when a Levered Firm Is Fully Solvent

As the company incurs risky debt,<sup>9</sup> shareholders might have a distorted incentive to favor excessive risk-taking owing to their benefiting from limited liability for the company's debts.

From a financial perspective, loaning money to the company results in lenders underwriting a bond while according a default put option to the shareholders.<sup>10</sup> In other terms, shareholders are given the alternative between paying off the debts at maturity or causing the company to default and leaving it to the creditors while losing no more than the equity they invested. Such a default put is an option whose underlying asset is the company's assets and whose strike price is set equal to the face value of the debt. If at maturity, *i.e.* when liabilities fall due, the value of the corporate assets falls below the option exercise price, shareholders exercise the option, put the assets to the creditors, and walk away from the firm. Among the many variables which the value of the default put option depends on is the variance of the corporate assets' value. As such variance increases, so too does the value of the option held by the equityholders regardless of the expected return on corporate investment. The more the corporate assets' value falls because of unpaying risky decisions, the deeper in the money the option is.<sup>11</sup>

Whether we view the capital structure of a debt-financed company as a bond underwritten by the creditors coupled with a default put option awarded to the shareholders or, conversely, as a sale of the corporate assets to the creditors in exchange for the award of a call option on the very same assets to the shareholders,<sup>12</sup> the outcome does not change. Such a virtual call option still has

solvent forever, with everyone knowing that it would be solvent forever. See Alon Chaver & Jesse M. Fried, *Managers' Fiduciary Duty upon the Firm's Insolvency: Accounting for Performance Creditors*, 55 VANDERBILT LAW REVIEW 1813, 1820 (2002). The solvency-forever assumption would imply that no managerial decision could ever reduce outside debt value, with the benefits and costs of managerial decision-making being solely and entirely borne by the shareholder class. Under this assumption, shareholders would have no advantage to opt for negative-NPV projects or to prefer lower positive-NPV projects to higher positive-NPV projects.

9. That is, debt on which the company might default.

10. See Brealey, Myers & Allen, *supra* note 5, at 619-20.

11. The default put option works as an insurance coverage against the risk of default, with equity acting as an insurance deductible. In essence, creditors insure equityholders against any loss exceeding equity value. As insurance economics teaches, however, the protective features of the insurance contract invite moral hazard from insurance holders.

12. See Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 JOURNAL OF POLITICAL ECONOMY 637, 649-50 (1973).

a strike price equal to the face value of the debt while having as an underlying asset the left-hand side of the balance sheet.<sup>13</sup> This call option is exercised if and only if at maturity the underlying assets' value exceeds that of the liabilities.<sup>14</sup> As the company incurs debt and leverage soars, in light of the option feature that equity acquires, shareholders' incentive to take on greater risks in exchange for potentially greater value deepens at any given level of their *ex ante* appetite for risk. The higher is the standard deviation of the possible returns on the investments, the higher is the value of the call option.<sup>15</sup> Shareholders may thus be tempted to increase the riskiness of the corporate assets and together with it the value of the call option.<sup>16</sup> The bad news for creditors is that unlike most holders of financial options traded on derivative markets, inside equity owners retain control over the underlying corporate assets. Therefore, such threat is credible.

To be sure, at a time of full solvency, the incentive structure created by the priority scheme in the distribution of assets upon liquidation, together with the allocation of control rights among the corporate constituencies, maximizes efficiency even if the company has incurred debt. In spite of limited liability, the shareholders' class of a levered, yet fully solvent company has no interest in taking undeserving risks, as the equity value which is in their pocket may easily evaporate to their loss.<sup>17</sup> Nor does management have such an interest

13. See Jensen & Meckling, *supra* note 2, at 336.

14. If the opposite is true, the equityholders abandon the option and the creditors obtain the *de facto* ownership of the assets.

15. The greater the variance of investment outcomes, the greater the value of the call option shareholders hold.

16. The availability of this call option, whose value depends on the actions taken by the shareholders, on the one hand incentivizes shareholders to take value-enhancing actions but on the other hand may trigger excessive risk-taking by the shareholders to earn abnormal returns. That is why shareholders may want to substitute low-risk/low-return assets with high-risk/high-return assets.

17. Most numerical examples provided in the literature for the purpose of illustrating shareholders' distorted incentives pick up insolvent firms. In effect, it is balance-sheet insolvency that skews shareholder incentives toward overly risky investments more powerfully. Nevertheless, a potential distortion in shareholder incentives is latent at any given level of equity at any solvent firm. For instance, regardless of the amount of equity a firm has at any point in time, if the firm's shareholders are presented with two investment alternatives sharing the same probability of creating equity value and destroying equity value but differing from each other as to the equity value actually created in the good state of the world and the equity value actually destroyed in the bad state of the world, shareholders maximize their wealth by choosing the alternative delivering higher value in the good state whenever the difference in value created by the two alternatives in the good state of the world exceeds the difference in value destroyed by the two in the bad state of the world. But this outcome is dictated by the assumed investment alternatives. I suspect that in reality shareholders of a fully solvent firm

out of fear of losing jobs, compensation,<sup>18</sup> perks and reputation. In striving to preserve and increase equity value for the benefit of shareholders and themselves, managers simultaneously ensure that liabilities will be matched by sufficient assets. As a result, higher-ranking claimants, be they adjusting or nonadjusting creditors, turn out to be protected by the management's shareholder-oriented duties.

Taking a higher expected equity value decision as opposed to a lower expected equity value alternative might not be in the economic interest of a controlling shareholder of a closely-held firm, either. For instance, assuming two investments, of which one has higher expected equity value but contemplates a chance of wiping out all pre-investment equity and the other has a lower expected equity value but ensures with a 100% probability to keep pre-investment equity positive, the controlling shareholder may well choose the latter if a balance-sheet insolvency were to automatically trigger a bankruptcy proceeding. It is standard in the literature (and in the resulting numerical examples) to focus on shareholder wealth rather than on shareholder welfare.<sup>19</sup> This approach may be apt to elucidate the incentives of non-controlling shareholders, such as well-diversified investors in widely-held firms, whose utility from investing mainly comes in the form of share value maximization.<sup>20</sup> By contrast, controlling shareholders usually care about non-pecuniary private benefits of control, too. When they do, they might choose the course of action that minimizes the risk of bankruptcy and the ensuing loss of private benefits of control, even if it is not wealth-maximizing. Bankruptcy forces controlling shareholders to yield control to the creditors, thereby causing them to lose any nonmonetary private benefit arising from it. Once this further dimension of shareholder welfare is taken into consideration, it becomes apparent that a controlling shareholder may actually want to choose the investment alternative that maximizes the sum of the utilities from higher expected equity value and retention of private benefits of control, which may or may not coincide with the investment alternative delivering the higher expected equity value.

with long-term prospects care about downside scenarios and may well steer clear of investments that endanger the viability of the company regardless of their upside potential.

18. A company having its finances compromised would soon pay a lower fixed compensation. Likewise, destruction of share value could affect variable compensation by making stock options worthless and stock grants less remunerative.

19. See, e.g., Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VANDERBILT LAW REVIEW 1485, 1486-99 (1993); Chaver & Fried, *supra* note 8, at 1819-25; Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEORGETOWN LAW JOURNAL 247, 255-57 (2010).

20. But see *infra* note 22.

## C. Shareholders' Incentive Structure when a Levered Firm Is in the Vicinity of Insolvency

The shareholders' incentive structure in a levered firm might however evolve in the direction of a preference for excessive risk-taking. After all, the risk of personal losses is capped by their statutory limited liability. As a result, the downside of their management's impactful decisions is shared with the creditors. Thanks to the statutory permission to privatize the gains while socializing the losses by enlisting the firm creditors to shoulder part of the burden, equityholders of a levered firm may come to prefer lower positive-NPV investments to higher positive-NPV investments if the lower positive-NPV investments promise a higher expected return for them. The higher the debt-to-equity ratio is, the more likely this scenario becomes. More worryingly, regardless of the level which equity is at, shareholders may even prefer a negative-NPV business opportunity to a positive-NPV one, if the former has a higher upside potential and both contemplate losses beyond the existing equity value.<sup>21</sup> While the tipping point is surely reached when equity falls down to zero or turns negative, a reversal of the incentive structure may begin as soon as the debt-to-equity ratio reaches a high level and equity, while still being positive, enters a descending path. Once little equity is left over, little value risks being lost by the shareholders in opting for hazardous investments.<sup>22</sup>

21. In deciding which one to choose between two investment opportunities having two possible outcomes each and a different NPV, equityholders would take into consideration the highest value attainable in the best-case scenario and the residual equity value to be lost in the worst-case scenario. The lower the residual equity value on which equityholders can rely on the date of their decision, the more likely it is that equityholders will decide only by focusing on the upside for them of both investments regardless of the NPV for the firm on an expected basis. And if both options entail a loss beyond equity value in the worst-case scenario with equal probability, it will be rational for them to choose the project with the highest upside for them independently of its impact on firm value. See Bebchuk & Spamann, *supra* note 19, at 257.

22. Of course, the higher the pre-investment equity value, the less likely it is that any investment alternative realistically offered to the shareholders be susceptible to generate losses equal to or beyond such equity value. The less likely it is that the downside potential of the available investment alternatives reaches past equity value, the more likely it is that the positive or negative value resulting from them will only affect equity value. And the more likely it is that only equity value is impacted by shareholders' decisions, the more likely it also is that shareholders' decisions directed at maximizing equity value will maximize firm value as well. Besides, taking a higher expected equity value decision as opposed to a lower expected equity value alternative might not always be in the economic interest of shareholders, including diversified shareholders. For instance, assuming two investments, of which one has higher expected equity value but contemplates a chance of wiping out all pre-investment equity and the other has a lower expected equity value but ensures with a 100% probability to keep pre-investment equity positive, shareholders may well choose the latter if balance-sheet insolvency

In the zone of insolvency what the shareholders as a whole become interested in, and what determines the market value of the option they hold, is just the upside potential of any investment opportunity, *i.e.* the highest value in the best-case scenario. Like gamblers running out of money, equityholders may well be unconcerned with the downside risks because if the “gamble for resurrection” proves rewarding they reap all the benefits, whereas if a bad outcome materializes they lose no more than their little equity leftover. The exceeding destruction of asset value would just dent debt value. The increasing likelihood that the distorted incentive structure affecting shareholders at nearly-insolvent companies will induce attempts to expropriate debt value for their own good is in its own right capable to weigh on the market value of the outstanding debt. At this stage of a company’s lifecycle the risks of asset substitution alongside the risks of asset and debt dilution become too severe to be taken light-heartedly.<sup>23</sup>

#### **D. Shareholders’ Incentive Structure when a Levered Firm Is Insolvent**

The potentially perverse nature of shareholders’ incentives deepens further as the company’s financial distress turns into insolvency.

Prior to, and in light of, the upcoming commencement of a formal bankruptcy proceeding the class of shareholders may be all the more geared toward gambling the assets while prolonging the life of the company. Between the time at which the equity has been entirely wiped out and the date on which the insolvency proceeding formally commences, a mismatch in the allocation of residual claims and control rights, which usually are paired together, becomes apparent. While residual claims on the assets have now shifted to the

were to automatically trigger a bankruptcy proceeding and thereby deprive them of the residual option value. In other words, keeping the firm outside of bankruptcy and retaining option value is itself an economic value that numerical illustrations usually do not account for. This interest gives shareholders an incentive to stay away from decisions carrying a potential for a high return on equity but also a certain risk of insolvency when a safer alternative is available.

23. Nevertheless, evidence of overinvestment by financially-distressed firms is mixed. Compare Assaf Eisdorfer *Empirical Evidence of Risk Shifting in Financially Distressed Firms*, 63 JOURNAL OF FINANCE 609 (2008) (finding evidence of risk-shifting behavior in financially-distressed firms) and Keming Li, Jimmy Lockwood & Hong Miao, 44 JOURNAL OF CORPORATE FINANCE 275 (2017) (finding evidence that distressed firms tend to overinvest) with Erik P. Gilje, *Do Firms Engage in Risk-Shifting? Empirical Evidence*, 29 REVIEW OF FINANCIAL STUDIES 2925 (2016) (finding evidence that firms take on less risk as they become distressed).

creditors, the shareholders still formally retain control rights and option value. Regardless of how deep out of the money the call option shareholders hold is, the fact remains that they do still hold a call option on the corporate assets, whose value is sensitive both to the variance of the underlying asset values and the time to maturity. As a result, shareholders may strongly be tempted to increase their option value by wielding their control power to cause the firm to delve into share value-increasing, yet firm value-reducing operations while pushing back the start of the liquidation (or reorganization).<sup>24</sup> Consequently, the equity owners of a firm whose liabilities exceed its assets have an incentive to inefficiently reject immediate liquidation and continue operations even if the firm's liquidation value exceeds its going-concern value.<sup>25</sup>

In stark contrast to the above-mentioned extreme forms of value-destroying moral hazard, insiders may also be tempted by an unconditional surrender despite a battle for firm value is still worth fighting, itself a form of moral hazard. In fact, a shareholder-manager who had earlier invested in the equity of what has later become a financially-troubled company faces quite different incentives once it has to decide whether to make additional investments in the company to pursue a turnaround project or not. In light of the deteriorating financial conditions of the firm, the shareholder-manager knows that the odds may well be stacked against its company. When the equity swings around zero, the owner-manager might end up trading and taking gambles to resume profitability by deploying the remaining assets to a riskier use or moving in the opposite direction by turning off the company's engine prematurely, knowing that its restructuring efforts might only benefit holders of senior claims.<sup>26</sup>

24. In other words, the shareholders' option to put the assets to the creditors should the value of the assets fall below that of liabilities hedges the shareholders' risk of loss.

25. See Lin, *supra* note 19, at 1494-95.

26. This is not to say that all insiders of nearly-insolvent firms engage either in overinvestment or underinvestment. The contention is that they do have stronger incentives to overinvest or underinvest than they have when bankruptcy is off the table because they comfortably sit on a sufficiently large equity cushion.

PART IV

**DESIRABILITY OF INSIDE DEBT FINANCING  
UPON A FIRM'S SOLVENCY,  
PRE-INSOLVENCY AND INSOLVENCY**

The desirability of insider loans should be gauged in light of the changing incentives of a firm's owners as the company moves from a condition of solvency to one of insolvency. To the extent the incentive structure of a firm's owners in running the firm changes along the dimension of the firm's financial conditions,<sup>1</sup> the question becomes whether letting insiders avail themselves of debt financing ranking in bankruptcy on a par with outside debt financing might add to the risk that proper incentives turn perverse and already perverse incentives be further exacerbated. A question which the following Sections seek to answer. Section A studies what impact unsecured inside debt financing might have on the shape of a firm's capital structure, insider incentives and creditor interests when the firm is fully solvent. Section B focuses on the impact of unsecured inside debt financing on a firm's capital structure, insider incentives and creditor interests when the firm is in the vicinity of insolvency. Section C examines the same issue when the firm is insolvent. Finally, Section D discusses the likely impact that inside debt financing has on a firm's capital structure, insider incentives and creditor interests when the financing is provided on a secured basis.

**A. The Impact of Unsecured Inside Debt Financing on Capital Structure, Insider Incentives and Creditor Interests when a Firm Is Fully Solvent**

After the company has incurred outside debt or in the expectation that the company might incur outside debt, the owner-manager has an incentive to resort to inside debt rather than equity for any internal financing need so as

1. See *supra* Part III.

to better protect her personal wealth from insolvency risk without diluting her share of any upside resulting from successful corporate investment.<sup>2</sup> As debt provides a stronger protection to the owner-manager's personal wealth in the presence or expectation of corporate liabilities than does equity, holding more debt and less equity is a rewarding strategy for the insider. Because of the downside protection arising from holding debt, however, the owner-manager may now afford greater risks than she would have afforded with an all-equity funding pattern. The seeds of more than optimal appetite for managerial risk-taking are planted. The risk of asset substitution, which already is a by-product of shareholder limited liability,<sup>3</sup> is exacerbated.<sup>4</sup>

To be sure, the use of unsecured inside debt to finance small businesses is not necessarily outcome-determinative of the recovery rate in bankruptcy. After all, it is well known that general creditors of small firms typically receive little to nothing in bankruptcy.<sup>5</sup> Therefore, rational insiders extending unsecured credit should expect to perform no better than do other unsecured creditors despite choosing debt over equity. In light of this expectation, inside debt should not *ex ante* vary the quantity of risk that an insider of a small firm is prepared to run. Nevertheless, it is perfectly rational for insiders to make debt advances in addition, or as an alternative, to equity contributions. While the costs of infusing cash by inside debt or inside equity are comparable, debt becomes a (weakly) dominant strategy to the extent by holding debt an insider never does worse and possibly does better in bankruptcy than by holding equity.

2. See *supra* Part II, Section B, notes 6-7 and accompanying text.

3. One needs not take a stance against shareholder limited liability to see that, despite its overall net social benefit, it raises a problem of moral hazard in the share ownership base. See Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 UNIVERSITY OF CHICAGO LAW REVIEW 89, 104 (1985) (arguing that a moral hazard problem would exist under any rule other than limited liability and that limited liability incentivizes investments in socially beneficial, yet risky projects that otherwise would never see the light of day).

4. While it admittedly is limited liability that, by capping exposure to the risk of loss, governs the incentive structure of a firm's owners as to the taking of risks, debt advances may well compound the scale of the moral hazard problem. First, to the extent creating a debt claim in addition to holding an equity interest adds a layer of protection against the risk of loss, it rearranges the risk-sharing scheme between equityholders and pure creditors that is designed by corporate law with the provision of limited liability. Second, in extending credit to the firm, its owners provide the firm with resources to fund operations that the company might not have afforded without it. But funding a higher number of operations or operations of greater size and scope than it would have been possible without such financing may well result in greater damages to external constituencies than would otherwise have occurred.

5. See Douglas G. Baird, *The Reorganization of Closely Held Firms and the Opt Out Problem*, 72 WASHINGTON UNIVERSITY LAW QUARTERLY 913, 923 (1994).

Even the slightest chance to receive some value provides sufficient justification. In any event, even assuming that the outcome of corporate reorganizations and liquidations were conclusively to prove that unsecured debt receives in bankruptcy nothing more than does equity, evidence that insiders continue to turn to debt financing signals that they rightly or wrongly expect debt to be more advantageous to them than is equity. To the extent net of tax effects the only advantage of debt over equity is debt's higher priority in bankruptcy, a major reason why insiders choose debt must be a perceived reduction in financial risk. And if the expectation of a marginal decrease in financial risk is positive, whether it is well founded or not, such belief may well be sufficient to give a firm's insiders an incentive to take on risks in running the business that they would not accept if they financed the firm with equity only.

Although permission to provide unsubordinated debt would marginally increase incentives for the insiders to invest in the firm, it does not seem that such strengthening of insider incentives is socially needed at a time when the firm is solvent. When the firm is financially balanced, raising outside finance is easier and less costly.<sup>6</sup> And insiders themselves would unlikely forgo financing investment opportunities solely because they could only provide equity or subordinated debt financing. Social efficiency requires that incentives to investing be optimal rather than maximized at any cost.

At a time of full solvency, therefore, the regulatory issue is not so much coping with the problem of financial overleverage owing to excessive inside debt *per se* as it is preventing financing decisions by the insiders that, by according preference to unsubordinated inside debt, might spark moral hazard temptations within the ownership base, brace management for excessive risk-taking in the long run as well as incentivize asset and debt dilution activity. It is no valid objection to claim that in jurisdictions refraining from mandatorily subordinating debt claims arising from insider lending, the relegation of insiders' debt claims to an inferior status may equally be achieved by contract so that a mandatory subordination by law is useless. This objection is flawed based on both efficiency considerations and fairness grounds.

First, we learned that contractual subordination often takes place but takes place less often than expected.<sup>7</sup> Consequently, we must account for circumstances where insiders and their lenders refrain from seeking subordination or fail to

6. Klaus Gugler, Evgeni Peev & Esther Segalla, *The Internal Workings of Internal Capital Markets: Cross-Country Evidence*, 20 JOURNAL OF CORPORATE FINANCE 59 (2013), provides empirical evidence that the greater access a firm has to external capital markets, the less important the use of internal capital markets becomes.

7. See *supra* Part II, Section G.

agree on it. Second, the belief that in case of contractual subordination the risk of moral hazard would diminish as much as it would under a regime of legal subordination is misplaced. While insiders' moral hazard incentives would seemingly be weaker, the cost of credit provided by the subordinating creditor would not fully adjust to the overall riskiness of a firm's capital structure relying on inside debt as a source of financing. The lender who benefits from contractual subordination of inside debt is expected to fare better in bankruptcy than if the insider provided equity or inside debt subordinated for the benefit of all the creditors. Thanks to this targeted subordination of inside debt the lender escapes sharing the insider's bankruptcy dividend with its fellow creditors. As the credit risk diminishes for the lender, so do its monitoring costs. The lower the risk, the lesser the need to expend resources in monitoring. This fact causes efficiency losses in at least two respects.

If monitoring costs for a particular lender fall, so does the interest rate charged the borrower by that lender. As a result, the senior lender does not cause the insiders to fully internalize the costs of risky operations. But if adjusting creditors may anticipate this risk and adjust the terms of their contracts with the borrower company, the nonadjusting creditors are left hopeless. Even more worryingly, risk-taking by the insiders would not be as deterred as it would if the cost of credit fully reflected an enhanced enterprise risk. To the extent the borrowing cost is less sensitive to the variance of the firm's operations, the insiders may step up risk-taking without having to pay an extra compensation. This gives them an incentive to engage in comparatively riskier operations. Who subsidizes such suboptimal risk-taking is the class of nonadjusting creditors. By externalizing unnecessary financial and operational risks onto the nonadjusting creditors, social welfare is reduced.

Insofar as both a firm's insiders and its major lender are better off when internal funds are provided as loans rather than capital contributions, the combination of inside debt and the possibility of subordinating it to the debt held by the major lender invites undercapitalization. If the insiders face no penalty for making suboptimal inside debt financing, they have a stronger incentive to finance the company with little equity and a disproportionate amount of inside debt subordinated to the major lender's debt. This exacerbates the risk of loss for all creditors other than the subordinating creditor. In what becomes a vicious circle, companies which already are financially fragile, as are many closely-held companies, are lured into a capital structure that is ever more imbalanced. A structural financial fragility at the origin is deepened by a contractual arrangement that incentivizes the lending bank not only to monitor less *ex ante* but also to become more assertive *ex post*. For the bank is enabled to capture greater value in bankruptcy, it has a stronger incentive to file

a petition for bankruptcy to secure such value regardless of the other creditors' interests. While this fact is not necessarily negative for the creditors' class as a whole, the fate of the creditor constituency is made ever more dependent on the private cost-benefit analysis of one creditor, which is far from ideal.

Not only does contractual subordination subsidize external credit at a time when it is not needed for the survival of the firm, thereby unleashing undesirable financial structures and business conduct. To the extent it allows the strongest creditors to capture the insider creditor's share of the bankrupt estate to the exclusion of the weakest creditors with no countervailing benefit accruing to the latter, contractual subordination is also unfair. In light of the inefficiency and unfairness resulting from the use of inside debt to financing a fully-solvent firm, the law should consider to automatically subordinate inside debt for the benefit of all adjusting and nonadjusting creditors alike when inside debt is issued at the solvency stage of a firm's lifecycle. In doing so, the law would reshape the capital structure of closely-held firms, whether they are small and privately-owned or members of business groups, in a more socially desirable way without jeopardizing the viability of leveraged transactions which typically resort to contractually-subordinated debt.<sup>8</sup>

## **B. The Impact of Unsecured Inside Debt Financing on Capital Structure, Insider Incentives and Creditor Interests when a Firm Is in the Vicinity of Insolvency**

A firm's owners may be tempted solely by mild forms of moral hazard when insolvency is out of sight, knowing that they could face retaliation by the lenders for any behaviour aggravating their credit risk. But in the vicinity of insolvency, insider incentives may well become troubling. The seemingly plausible financing alternatives of a foundering firm which a shareholder-manager is likely to contemplate often come down to being either additional unsubordinated debt or nothing. Crossing out unsubordinated debt from the menu of the financing options may easily lead to no further funding from a firm's insider.

To be sure, cognitive biases such as unsubstantiated optimism and overconfidence in their own managerial capabilities may push some owner-

8. To the extent the leveraged transactions described *supra* in Part II, Section E, are accomplished by means of newly-created special purpose vehicles whose activity boils down to raising outside finance and deploying it in a single investment, number and size of the debt claims of external creditors other than the lenders that would benefit from the automatic subordination of inside debt would be limited.

managers to infuse equity and carry on. But an efficient law must confront the dark side of an incentive structure which may cause an owner-manager to invest no more of her own in the company's risk capital<sup>9</sup> and either engage in risk-shifting or exercise the option to abandon. Therefore, at this stage the issue turns on how to cabin extreme moral hazard by unwavering insiders, on the one hand, while simultaneously avoiding that chances of a prompt turnaround be foregone by hopeless insiders, on the other hand.

Allowing owner-managers to extend unsubordinated credit to a financially-distressed company may well prove the only viable alternative to no financing at all. Once the owner-manager has made additional unsubordinated debt investments out of her own pockets, she will have fewer incentives to increase risk-taking and opt for negative-NPV activities, for she would suffer from them just like any other creditor would. At the same time, the prospect of sharing in the estate on a parity with the general creditors should bankruptcy occur will give her an incentive to provide liquidity and refrain from exercising the default put option until after having made a further attempt to restructure the business or seize other business opportunities. As a result, premature and costly court-led insolvent liquidation or reorganization would be avoided or at least pushed back. Discouraging further investments in the firm from its insiders in the form of unsubordinated debt would aggravate rather than diminish the risk that current general creditors, whether adjusting or nonadjusting, face.

Despite the foregoing observations, two popular objections militate against the treatment of insider loans as unsubordinated debt when made on the verge of insolvency. The first objection is that the law should discourage that good money be thrown after bad money. The argument is premised on the assumption that who has brought the company to its knees is unlikely to resuscitate it in light of both the failing business model adopted until then and the impossibility or unwillingness to abruptly deviate from it.<sup>10</sup> Such an argument claims that allowing unsubordinated insider loans would

9. See Douglas G. Baird, *The Initiation Problem in Bankruptcy*, 11 INTERNATIONAL REVIEW OF LAW & ECONOMICS 223, 229 (1991) (arguing that it is not uncommon that managers of closely-held firms, in an attempt to keep a floundering business up and running, use funds set aside for employee withholding taxes despite knowledge that if the firm ultimately fails they will be held liable).

10. After having invested substantial time and efforts, the owner-manager might unsurprisingly develop an intimate affection for a failing business model and stick to it with a hope to see it pay off one day despite ongoing evidence to the contrary. See Barry E. Adler, *A Re-Examination of Near-Bankruptcy Investment Incentives*, 62 UNIVERSITY OF CHICAGO LAW REVIEW 575 (1995) (arguing that overinvestment is a comparatively bigger problem than underinvestment to the extent an insolvent firm is more likely to deserve liquidation than continuation).

but exacerbate the risk of artificially prolonging the life of a business fatally doomed to fail under incumbent management, thereby critically postponing bankruptcy and possibly deepening the firm's insolvency. The second objection contends that, to the extent fresh finance from insiders allows the company to continue its operations, current and prospective creditors may be misled into thinking that the business is still viable so that they may not be deterred enough from continuing to loan money and trade at a future loss for them. As a consequence, when insolvency ultimately sets on the company, the magnitude of the loss for the outside creditors would be larger more than it could otherwise have been if inside debt financing had been cut off earlier.

The first objection is flawed. The casual link between the treatment of loans and the decision to continue business operations or rather file for a preventive restructuring is too weak to make a reliable prediction of the impact of the former on the latter. To be sure, upon a firm's pre-insolvency insiders' interests diverge from outside unsecured creditors' interests, who unlike the former would benefit from an immediate liquidation or reorganization.<sup>11</sup> But forestalling unsubordinated insider lending at this stage would not necessarily ensure either outcome. Quite the opposite, it would likely induce the insiders to either overinvest the residual asset value or underinvest. A prohibition against unsubordinated insider lending would therefore alight the very same behaviors it was intended to prevent.

11. Secured creditors, thanks to the protection accorded to them by their security interests, are less worried about the conduct of their debtor in the vicinity of insolvency. But they are not fully indifferent to it. Secured creditors have a bias in favor of early liquidation so as to avoid that continuation of the business reduces the value of the collateral. See Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 UNIVERSITY OF CHICAGO LAW REVIEW 97 (1984). But the greatest concern to secured creditors is to avoid a Chapter 11 reorganization. Secured creditors can exercise their rights – chief among them the right to seize the collateral covered by the security – as long as the debtor is outside of bankruptcy. See Lucian A. Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE LAW JOURNAL 857, 861 (1996). In bankruptcy, the secured creditor is stayed from taking possession of the collateral backing the security interest. See United States Code, Tit. 11, §362(a). Although the stay on secured creditors' right to seize the collateral is counterbalanced by the obligation to provide a secured creditor with adequate protection according to §§361-364, secured creditors are advantaged by any attempt by the insiders to prevent or postpone bankruptcy. The reason is that despite the adequate protection mandate, in Chapter 11 reorganizations secured creditors fare worse than when the nearly-insolvent debtor continues operating at a loss to it. In a reorganization, the secured creditor is under a threat of receiving less than the pre-bankruptcy value of its collateral. See *id.* at 911-12. On the contrary, rescue attempts by a debtor's insiders, whether they succeed or not, buy secured creditors time to exercise their rights.

Consider a legal regime which provides for the automatic subordination of eve-of-bankruptcy insider loans. On the one hand, the threat of subordination may disincentivize the provision of new liquidity by the insiders insofar as holding subordinated debt would not spare them too low a ranking of their debt claims in bankruptcy. On the other hand, should they ultimately happen to not be deterred from extending subordinated credit, automatic subordination would give insider lenders one more incentive to refrain from a timely filing for a court-led corporate restructuring. After extending subordinated credit insiders would hold dual claims – equity and subordinated debt – similarly situated in bankruptcy. Both types of claims would be junior to all other competing claims against the firm's assets. The high probability, if not certainty, to lose on both the investments would advise the insiders to delay bankruptcy as much as possible. In light of such unpredictable effects on insiders' behavior, any generalization about concrete outcomes would be misguided. Truth is, a timely filing for a preventive restructuring seems to be incentivized either by the promise of a prize or by the threat of a penalty for late filing or no filing at all. Foreclosing unsubordinated loans by the insiders would be neither a prize nor a penalty. A timely filing is arguably more likely prompted by either a "stick" consisting of a wrongful trading rule targeting formal and *de facto* directors<sup>12</sup> or by a "carrot" consisting of the possibility for the insiders to share in the going concern value of the firm subject to restructuring.

Even assuming the argument on the unduly preservation of defunct companies in operation is tenable, still it proves too much. Freedom of enterprise in a market-oriented economy entitles those in charge of a company to do whatever they deem best for the company until they are left in control of it. Nobody would seriously question the legitimacy and efficiency of a model that allows shareholders to keep on making capital contributions to a failing firm despite the fact that the assets may stubbornly be mismanaged, the size of liabilities may be braced for a sharp increase, and on insolvency the damage to creditors may well outweigh the damage that would have occurred if the company had halted its operations earlier. It is therefore unclear why liquidity provided in the form of unsubordinated debt rather than equity should be looked at any different from this standpoint. On closer inspection, the problem of sticking with a failing business model indeed arises from a dysfunctional management rather than a would-be dysfunctional source of funding. And if the goal were precisely that of hastening the early displacement of a failing management, the policy of acting on the subordination of insider loans in the zone of insolvency would be weak at best, given that the absence

12. To the extent such a penalty can be avoided by the filing for a preventive restructuring.

of any restrictions to the prebankruptcy injection of equity and the rules on court-led corporate reorganizations do not discourage the survival of current management. Quite the opposite, such rules are meant to give current management a chance to remain in office.

The second objection raises a legitimate concern, but it would not be efficiently addressed by an indiscriminate subordination of eve-of-bankruptcy insider loans. An efficient remedy would look to charge eve-of-bankruptcy insider loans with a disclosure burden for them to escape subordination. Current and prospective consensual creditors, whether informed or misinformed about the economic prospects of the company, cannot rationally be expected to be misled into extending credit or continuing to trade if they could know that the debtor is kept up and running by means of debt financing furnished by the debtor's owners. Being rational players, they would anticipate that the insiders might make advances regardless of the creditworthiness of the company to advance their own private interests. Unlike the extension of credit by third-party lending institutions, which might be taken as a signal of a firm's viability,<sup>13</sup> insider loans if anything signal the lack of creditworthiness of the company<sup>14</sup> or the occurrence of hardships in raising outside funds. Rational outside observers should in fact wonder why insiders need to provide debt funding in the first place if outside, professional lenders could do so at a competitive price. Therefore, onlookers would likely infer that the borrower

13. It is on the allegedly misleading signal generated by banks lending in the zone of insolvency that attempts have been made in the US and elsewhere in the world to develop a doctrine of deepening insolvency and improvident lending. In light of the close lending relationship that banks entertain with corporate borrowers, they are expected by the market to have the proper incentives to step up monitoring and take an interventionist stance when a company's financial conditions turn precarious, to stop funding the company if chances of survival appear to be severely compromised and avoid other actions that might talk others into believing that the company's finances are healthy. Bank behavior is widely believed to be the only reliable proxy of what is going on at the firm. But, in the United States, aside from situations where banks harbor a conscious intent to aid and abet a fraud perpetrated by the borrower on its creditors or investors, lender liability for making loans that keep the borrower out of insolvency and help perpetuate its operations has mostly been ruled out despite bank's knowledge of the firm's precarious financial conditions and even despite bank's reckless behavior in lending. See *Metge v. Baehler*, 762 FEDERAL REPORTER (SECOND SERIES) 621 (United States Court of Appeals for the 8<sup>th</sup> Circuit, 1985); as regards Delaware, see *Tremwick America Litigation Trust v. Ernst & Young*, 906 ATLANTIC REPORTER (SECOND SERIES) 168 (Court of Chancery of Delaware, 2006).

14. See Leonard J. Long, *Automatic Subordination as Incentive for Insider Creditors' Prudential Investing*, 13 JOURNAL OF LAW & COMMERCE 97, 124 (1993) ("The fact that an insider is infusing new money as debt... may signal that the firm's financial situation is something less than optimal.").

either is not worth additional outside debt at all or at best faces escalating transaction costs which make inside financing cheaper than outside financing, either fact suggesting that financial or economic conditions have possibly been deteriorating. In fairness, the only message insider loans convey with some certainty is that insider lenders, on their part, have some faith in the solvency of the firm.<sup>15</sup> Put differently, a loan made by an insider is no false signalling device of the objective creditworthiness of the company, but rather is a signalling device of the belief of the lending insider itself on the viability of the firm, and no more than that. What matters is therefore that current and prospective creditors be put on notice that the company has been benefiting from loans from its insiders rather than from outside lenders. Once alerted to the imbalanced structure which the company's capital is morphing into as a consequence of a shift from external to internal sources of debt funding, those additional counterparties that end up lending and trading will not be the ones giving weight to a misleading signal of the company's creditworthiness but rather the ones giving credit to the insiders' belief about the viability of the company as a going concern.

To be sure, inasmuch as unsubordinated advances from the insiders allow an almost bankrupt firm, which would otherwise shut down owing to lack of outside funding, to continue to operate, they might indirectly contribute to aggravate the firm's indebtedness to already existing involuntary creditors, as would be the case with a tax authority claiming an escalating amount of unpaid taxes, and to produce new involuntary creditors, such as victims of corporate torts, who would not have existed with an earlier termination of the firm. The claims of these nonconsensual, nonadjusting creditors, if bankruptcy materializes, would be dealt a severe blow by additional, competing insiders' debt claims on the estate. While such a harmful externality might surface, the potential interests of hypothetical involuntary creditors however have to be traded off against the actual survival interests of the firm and its current stakeholders. Given this tradeoff, a policy discouraging inside debt financing in the vicinity of insolvency by lowering its degree of priority in bankruptcy is counterproductive. A more efficient approach is neither discouraging nor encouraging last-minute inside debt by simply ensuring its parity with outside debt in the order of bankruptcy priorities.

15. Still, it is a weak signal of faith, because if it were full faith the owners would make equity capital contributions, accept the risks associated with equity, and restore the financial balance of the company.

### C. The Impact of Unsecured Inside Debt Financing on Capital Structure, Insider Incentives and Creditor Interests when a Firm Is Insolvent

When a firm enters insolvency, rational choice and agency theories predict that the moral hazard problem becomes more extreme than already is upon a firm's pre-insolvency.

Awareness that equity value has turned negative might prompt the insiders, who now have lost all of their wealth invested in the firm, to rationally favor activities which promise whatever value for them with some positive probability despite their negative NPV. Therefore, the option value of equity coupled with control rights continues to give owner-managers an incentive to refrain from filing for bankruptcy. On the other hand, the insiders of a similarly situated firm might also have an incentive to forego profitable investment opportunities if the value created would go to the benefit of the creditor constituency only. Insider incentives upon insolvency are therefore skewed in the direction of either overinvestment or underinvestment more than are in the vicinity, and yet outside, of insolvency.

Provision of additional inside debt financing at this critical stage of a company's lifecycle may prove instrumental in mitigating these extreme forms of moral hazard. In committing additional wealth of their own to the cause, a firm's insiders would face a financial deterrent against reckless risk-taking or shirking. Far from exacerbating moral hazard temptations, an increased exposure to firm-specific risk would make the insiders more cautious. While insider lending should not be discouraged *per se* at this critical juncture as it offers a solution to a perverse incentive structure, permitting unsecured insider lending is also critical for preserving a lifeline for the insolvent firm at a time when no third-party lender would likely come to the rescue without a concurrent financial commitment on the part of the insiders.<sup>16</sup>

Upon insolvency, shareholders' and current unsecured creditors' interests converge. Whether adjusting or nonadjusting, current unsecured creditors are

16. It is rather ironical that one of the most common criteria used in case law to decide about the subordination (or recharacterization as equity) of inside debt financing looks into whether the financing was provided at a time when no third-party lender would have lent. To the extent third-party lenders are ready to lend, there is lesser need and likelihood of inside debt financing in the first place. It is when outside funds dry up that inside debt financing is most needed and likely. Claiming that inside debt should be unsubordinated when outside lenders would lend and should be deprived of its unsubordinated debt proprieties when outside lenders would refrain from lending amounts to negating the gap-filling role of inside debt. See also *infra* Part V, Section B, Paragraph 1, note 59 and accompanying text.

aware that they will not fare much better than the shareholders in bankruptcy. The junior ranking of their claims will likely deliver a very low bankruptcy dividend, if any, upon either a liquidation or a reorganization. While the insiders of an insolvent firm, by continuing business operations, gain or lose depending on the outcome of corporate investments and the cost of decision-making they incur, an insolvent firm's unsecured creditors are better off as a result of continued operations insofar as they have no more value to lose and expend no resources in decision-making. For a business to continue, though, additional funds are likely to be needed. For the alternative may lie in internal funding by the insiders in the form of unsubordinated debt or no funding at all, out-of-the-money unsecured creditors are better off if pre-petition inside debt financing is not discouraged, whether it provides a chance of a last-minute turnaround or not. From the current creditors' point of view, unsubordinated inside debt financing furnished in times of pre-insolvency and insolvency is useful because it further ties insider lenders' pockets to the fortunes of the company and likely acts as a self-imposed restraint on firm value-destroying behaviours, without necessarily jeopardizing a debt restructuring under court supervision and without prejudice to the filing duties of management, if applicable. Therefore, current unsecured creditors should not rise against pre-petition unsubordinated insider lending. They should be in favor of it.<sup>17</sup>

It is the prospective unsecured creditors that once again may lose out. But once again, with regard to prospective adjusting creditors, and prospective voluntary creditors in general, it is more of a problem of transparency than is a problem of source of funding. Even assuming it also is a problem related to the shape the funding takes, getting the insiders to put additional "skin in the game" just ensures that they think more thoroughly than they would otherwise do before recklessly gambling with what is left of asset value. As to the possible emergence of new involuntary creditors with unsatisfiable claims, who would not have existed if the firm had earlier halted its operations out of a lack of liquidity, the probability and magnitude of this potential risk must once again be traded off against the actual benefit of allowing insiders to commit further wealth to the rescue of the firm. Without necessarily taking side with either of the conflicting interests, a legal regime could easily settle on an agnostic policy that neither discourages nor encourages inside debt financing *per se* in times of

17. As should be the secured creditors, who are aware of the risk of loss posed to them by a reorganization. In the US, for instance, the risk of losing value associated with an insolvent debtor filing under Chapter 11 makes secured creditors predilect a Chapter 7 liquidation or an out-of-court turnaround, whether it ends up in a successful resurrection or a liquidation. See *supra* note 11.

insolvency. Allowing that unsubordinated inside debt financing be provided to an insolvent firm without lowering its priority in bankruptcy would achieve this simple policy goal.

#### **D. The Impact of Secured Inside Debt Financing on Capital Structure, Insider Incentives and Creditor Interests**

While it is controversial whether the benefits from unsecured insider lending outweigh the costs, lending by insiders on a secured basis is without doubt all the more critical from an efficiency perspective.

If arguments exist to make a case for repossessory and priority rights of secured credit outside of bankruptcy and for full priority thereof in bankruptcy when secured credit is provided by outside creditors,<sup>18</sup> no plausible argument may easily

18. See Clifford W. Smith, Jr., & Jerold B. Warner, *Bankruptcy, Secured Debt, and Optimal Capital Structure: Comment*, 34 JOURNAL OF FINANCE 247 (1979) (arguing that security provisions in debt contracts limit asset substitution); Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities among Creditors*, 88 YALE LAW JOURNAL 1143 (1979) (arguing that security interests reduce total monitoring costs when provided to less skilled creditors, to whom the cost of monitoring a debtor is comparatively higher than is to other, better-equipped creditors); Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE LAW JOURNAL 49 (1982) (arguing that secured debt remedies undermonitoring and overmonitoring as it is issued to more talented monitors as a reward for solving freeriding and duplication problems in the allocation of monitoring responsibilities); René M. Stulz & Herb Johnson, *An Analysis of Secured Debt*, 14 JOURNAL OF FINANCIAL ECONOMICS 501 (1985) (arguing that issuing debt with a higher priority helps solve the underinvestment problem); Homer Kripke, *Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact*, 133 UNIVERSITY OF PENNSYLVANIA LAW REVIEW 929 (1985) (arguing that a creditor's right to repossess the collateral reduces enforcement costs by avoiding costlier judicial process); George G. Triantis, *Secured Debt under Conditions of Imperfect Information*, 21 JOURNAL OF LEGAL STUDIES 225 (1992) (arguing that security interests strengthen incentives to comply with loan covenants by increasing the cost to the borrower of defaulting) and George G. Triantis, *Financial Slack Policy and the Laws of Secured Transactions*, 29 JOURNAL OF LEGAL STUDIES 35 (2000) (arguing that secured credit optimizes financial slack policy); Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 UNIVERSITY OF CHICAGO LAW REVIEW 645 (1992) (arguing that a rush to a financially-troubled firm's assets by unpaid unsecured creditors is prevented if such assets are encumbered); David Gray Carlson, *On the Efficiency of Secured Lending*, 80 VIRGINIA LAW REVIEW 2179 (1994) (arguing that collateralized debt reduces the risk of asset dilution) and David Gray Carlson, *Secured Lending as a Zero-Sum Game*, 19 CARDOZO LAW REVIEW 1635 (1998) (arguing that secured lending exists because it simply lowers the cost of lending and increases the amount of credit available to a firm); Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 DUKE LAW JOURNAL 425 (1997) (arguing that secured credit is mostly used to provide new liquidity to troubled firms so as to prevent

be raised to defend priority of secured insider lending in bankruptcy or outside of bankruptcy. While unsecured lending by insiders may be viewed as potentially raising problems of asset substitution, asset dilution and debt dilution,<sup>19</sup> secured lending by insiders certainly aggravates all of these problems without bringing to the table the benefits ordinarily identified in secured debt financing or adding anything to the benefits associated with inside debt financing.

Consider full bankruptcy priority first. By encumbering assets of a solvent firm to their benefit, insiders almost entirely reduce the risk of loss on their secured debt claims.<sup>20</sup> As a result, insiders' moral hazard incentives escalate exponentially.<sup>21</sup> Secured insider creditors are enabled to sustain undeserving business risks that they would avoid if they could not rely on security interests. Although the underinvestment problem is more easily be addressed by allowing insider lending on a secured basis than by disallowing it, the overinvestment problem resulting from secured insider lending is more than proportionately exacerbated.<sup>22</sup> On balance, the interplay of the two opposite effects on insiders'

bankruptcy); Claire A. Hill, *Is Secured Debt Efficient?*, 80 TEXAS LAW REVIEW 1117 (2002) (arguing that secured debt is key to lower-quality firms in their quest for outside debt while providing little opportunity for externalization of risks on unsecured creditors); Yair Listokin, *Is Secured Debt used to Redistribute Value from Tort Claimants in Bankruptcy? An Empirical Analysis*, 57 DUKE LAW JOURNAL 1037 (2008) (providing evidence that secured debt is not issued to redistribute value away from nonadjusting creditors).

19. See *supra* Part I, Section B.

20. Such risk may not be reduced down to zero even if the value of the collateral exceeds that of the claim. Secured creditors, including secured insider creditors, are stayed from exercising their repossessory right in a Chapter 11 reorganization while their priority right in the encumbered asset is replaced with an adequate protection mandate under which the secured creditor must receive cash payments or substitute liens with a view to paying it the full amount of its claim by the end of the proceeding. Despite the adequate protection directive, the secured creditor may fall short of receiving the full value of its claim. See *supra* note 11. In a reorganization, the secured creditor might be denied the loss of value of her claim resulting from the passage of time. See Baird & Jackson, *supra* note 11. Also, if the reorganization is converted into a liquidation, the collateral itself might meanwhile have lost market value. See Baird, *supra* note 5. However imperfect the satisfaction of secured claim might be in bankruptcy, the rate of recovery on secured claims is believed to be high enough for it to be sufficiently protective of secured creditors' interests, or else there would be no reason for a fierce, long-standing academic debate about the benefits and costs of secured credit's full priority in bankruptcy.

21. See David A. Skeel & George Krause-Vilmar, *Recharacterization and the Nonhindrance of Creditors*, 7 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW 259, 284 (2006) (arguing that lending by insiders on a secured basis aggravates the overinvestment problem); Andreas Cahn, *Equitable Subordination of Shareholder Loans?*, 7 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW 287, 298 (2006) (same).

22. The problem of underinvestment solved by secured insider lending would only involve positive-NPV investments having the effect of increasing the value of the assets up to, but not beyond, the size of debt. To the extent positive-NPV investments increasing asset value beyond

incentives appears to bring about a loss of efficiency. Second, in reducing the asset base against which unsecured outside creditors may assert their claims, secured insider lending more heavily dilutes outside creditors' rights.<sup>23</sup> All else equal, by extending secured credit an insider transfers greater value from unsecured outside debt to equity than when an insider extends unsecured credit.<sup>24</sup> Outstanding unsecured debt becomes ever riskier *ex post* without a reduced equity value having offset or compensated for such increased risk *ex ante*. As a result, equity receives a windfall. In light of such a windfall, collateralization incentivizes insiders to provide more debt than is optimal for a firm's capital structure.

Even outside of bankruptcy might secured credit cause efficiency losses. By taking a security in an asset of the firm, an insider creditor has a say on the disposition of the asset<sup>25</sup> and may subtly make sure to get its hands on it in critical circumstances.<sup>26</sup> To the extent the asset covered by the security may

the size of debt would make the shareholders better off, the shareholders would finance such investments even if the shareholders could not take a security interest. It is when the expected value goes to the advantage of the creditors only that an incentive is needed for the shareholders to take action. The certainty that no additional wealth would be wasted regardless of the outcome of the investments may provide such an incentive. Therefore, the range of investments which would be incentivized by secured insider lending would be limited to investments that are expected to bring asset value to the level of debt. On the contrary, the problem of overinvestment triggered by collateralizing insider loans would find no constraints, because the insurance against the risk of loss would in fact be established at a 100% level. As a result, any investment with whatever upside potential would have appeal for the secured insider regardless of their expected effect on firm value. The range of potential firm value-reducing investments triggered by secured insider debt financing would far outweigh the range of potential firm value-creating investments that would be incentivized.

23. It should also be noted that a secured insider loan unlikely is structured as a nonrecourse debt. Therefore, should the repossessed collateral prove insufficient to satisfy the insider's claim, the insider will be able to assert the unsatisfied portion of the claim against the remainder of the firm's assets on a par with the general creditors.

24. See Barry E. Adler & Vedran Capkun, *Debt-Equity Conflict and the Incidence of Secured Credit*, 62 JOURNAL OF LAW & ECONOMICS 551 (2019) (finding evidence of an escalating use of secured credit prior to bankruptcy filing in a sample of publicly-traded firms, which confirms that secured credit is used to transfer value from unsecured creditors to equityholders).

25. To the extent the priority right conferred on the secured creditor usually follows the collateral even if the collateral changes hands, the collateral is "virtually worthless" to any third party. See Bebchuk & Fried, *supra* note 11, at 876. In light of the stickiness of priority rights provided by security interests, secured creditors acquire leverage in the management of the collateral.

26. The insider creditor and a nearly-insolvent debtor company could always reach a secretive agreement whereby the debtor company does not pay off a debt secured on an asset of interest to the former so that the insider creditor can take possession of the asset. While an outright sale to an insider of an asset by a firm in the vicinity of insolvency might attract judicial review as a fraudulent conveyance, a comprehensive arrangement providing for extension of

be disposed of in the private interest of the secured insider lender, unsecured outside creditors are prejudiced twice, because not only are they barred from asserting their claims against the encumbered asset but they also face the increased risk that an asset valuable to the firm be subtracted from it to the detriment of the firm's overall business. As a result, far from decreasing overall monitoring costs incurred by creditors, secured inside debt financing increases them, since unsecured outside creditors must step up their monitoring effort, and the more important the asset at stake is to the viability of the debtor firm the closer the monitoring must be. In addition, every asset that is encumbered by an insider is one asset less to be available for use as a collateral for outside debt, which itself is another cause for an increase in the overall costs of monitoring to the outside creditor class.

Therefore, rather than efficiently reducing overinvestment, as does secured outside credit, secured inside credit inefficiently increases it. Rather than efficiently preventing outside debt dilution, secured inside credit inefficiently exacerbates it. Rather than efficiently reducing asset dilution, secured inside credit actually makes it easier.

While the agency costs of debt soar, no countervailing benefits customarily associated with secured debt justify that such costs be incurred. It is readily apparent why this is the case. Most advantages arising from secured debt financing essentially relate to the conferral on the secured creditor of the right to keep the encumbered asset in check.<sup>27</sup> The priority right arising out of a security offers a response to the unfettered managerial discretion in putting assets to use and the ensuing informational asymmetries and monitoring costs that an outside debt investor is confronted with. But insiders are not informationally disadvantaged, nor do they need a security interest to exert what admittedly already is an unconstrained control over the firm's assets. Informational privileges and full control rights are already allocated to them in their capacity as firm owners. Therefore, the granting of a security to an insider having a free hand in dictating the terms of the loan on the firm would not lower the interest rate on the loan but rather would just add to the contract terms benefitting the insider at the expense of the firm and its other constituencies.<sup>28</sup> Nor do insiders need to reduce

secured credit by an insider long before insolvency, failure to pay off the advance by the debtor company should it approach insolvency and seizure of the collateralized asset by the insider is less easily detectable as fraudulent.

27. See Douglas G. Baird, *Importance of Priority*, 82 CORNELL LAW REVIEW 1420, 1422 (1996) (highlighting that security interests allow their beneficiaries to constrain debtor's freedom to dispose of the encumbered assets and waste the proceeds).

28. If in an arm's length loan transaction one might expect that a debtor granting a security interest in its property would do so only if it could achieve a reduction in the interest rate

the cost of enforcing their debt, which seemingly is trivial due to spontaneous cooperation and compliance by the borrower firm. There is no advantage to be gained from making it easier for an insider to repossess the collateral outside of a judicial process or threatening the debtor company with seizure of a pledged asset to induce compliance with the loan agreement. Ultimately, a firm is unlikely to be better off receiving secured inside debt financing compared with unsecured inside debt financing.

Of concern should also be the incentives given lending institutions to collateralize their loans in the expectation that their borrower might one day issue secured debt to its insiders. Anticipating that assets might be used to provide collateral for loans by the insiders down the road, early lenders may well scramble to encumber assets more than is optimal. To be sure, one might argue that prior unsecured creditors should always worry that later creditors might obtain a security interest, regardless of the later creditors being internal or external to the firm. But evidence shows that outside creditors, or some of them at least, are wary of the costs associated with obtaining, monitoring and enforcing security interests and, to the extent possible, prefer negative pledge covenants to security interests.<sup>29</sup> Besides, a later pure creditor, before extending credit on a secured basis, would ordinarily demand full disclosure of prior negative pledge covenants restricting issuance of secured debt.<sup>30</sup> Although such a creditor would get to enjoy full priority in bankruptcy, it would not lightly extend credit which, by accelerating repayment of prior loans, could push the borrower into bankruptcy.<sup>31</sup> Therefore, it is not irrational for an early

charged by the secured creditor, in a conflicted loan transaction between a firm and one of its insiders it is less probable that a security interest would be traded for a reduction in the interest expense. Outside of the realm of publicly-traded companies, where related-party transactions are policed by a committee of independent directors, a more plausible assumption is that collateralization would be used to transfer wealth to the insider.

29. See Bebchuk & Fried, *supra* note 11, at 921-23 (arguing that the extent to which sophisticated creditors in the US resort to negative pledge covenants as a substitute for security interests proves that the use of the latter may not only be socially but also privately inefficient).

30. See Barry E. Adler & Marcel Kahan, *The Technology of Creditor Protection*, 161 UNIVERSITY OF PENNSYLVANIA LAW REVIEW 1773, 1801 (2013) (“New lenders routinely ask debtors for important documents and other information and attempt to verify whether the information they are provided is complete and accurate.”).

31. The cost of being embroiled in a likely insolvency proceeding in the aftermath of the extension of secured credit, the erosion of the secured credit full priority in bankruptcy and the potential liability arising from the role played in what would be a breach of contract would in most instances outweigh the expected benefits arising from the periodic payment of interests promised by a failing borrower. As a result, without a prior waiver from early creditors, later creditors would unlikely lend. The extent to which early lenders feel protected by negative pledge covenants may thus offer a plausible explanation as to why chances of issuance of secured

lender to lend unsecured despite the presence of unencumbered assets available to be pledged as collateral in the future. Early unsecured lenders armed with negative pledge covenants may well feel protected enough against attempts to dilute their claims.<sup>32</sup> In contrast to outside lenders, though, insiders are much less likely to be sensitive to the risks involved in encumbering assets in violation of negative pledge covenants.<sup>33</sup> Unlike pure creditors, they would weigh the risk of triggering an acceleration of reimbursement of outstanding debt against not only the benefit of future interest payments on their loan but also the far more attractive benefit of capturing value as equityholders should the financing be instrumental in creating share value. With the risk of seeing assets encumbered by the insiders in mind, early lenders would therefore have more of an incentive to demand security interests for their own good, even when the issuance of a security as opposed to a negative pledge covenant would be inefficient. A stronger demand of securities in a firm's assets early on would in turn fuel demands of securities in the remainder of the unencumbered assets later on not only by lenders who routinely lend secured but also by lenders who are normally ready to lend unsecured. To the extent the social benefits of secured lending enjoying full priority in bankruptcy are called into question, a framework that goes in the direction of increasing rather than decreasing lenders' incentives to lend on a secured basis should be regarded with caution.

debt to later lenders does not necessarily command early lenders to loan on a secured basis. But see Adler & Kahan, *supra* note 30, at 1810-12 (pointing to the shortcomings of the tortious interference doctrine in the US as a deterrent against extension of secured credit in violation of a pre-existing covenant); Adler & Capkun, *supra* note 24, at 568 (noticing that according to their empirical evidence not only do negative pledges fail to entirely prevent issuance of secured debt by financially-troubled firms but there also is a positive correlation, albeit likely resulting from a selection bias, between the presence of negative pledge covenants and the probability of issuing secured debt in violation thereof).

32. A rational lender would also anticipate the residual risk that despite the restrictive covenant the borrower might later issue secured debt to its detriment. It would therefore charge a higher interest reflecting this risk, thereby passing the cost of potential misbehavior onto the borrower. See Adler & Capkun, *supra* note 24, at 575-76 (arguing that, as a result of the risk premium to be paid to lenders, good-faith borrowers have an incentive to bond themselves against violation of restrictive covenants); Alan Schwartz, *Priority Contracts and Priority in Bankruptcy*, 82 CORNELL LAW REVIEW 1396, 1412 (1997) (suggesting that a borrower's inability to credibly commit to avoid debt dilution may cause the borrower to issue secured debt in lieu of antidilution covenants).

33. See Barry E. Adler, *An Equity-Agency Solution to the Bankruptcy-Priority Puzzle*, 22 JOURNAL OF LEGAL STUDIES 73, 80-81 (1993) (arguing that demand for securities by creditors of solvent firms finds justification in the risk that a firm's management issue secured debt when the firm begins approaching insolvency); Bebchuk & Fried, *supra* note 11, at 888 (arguing that owners-managers of a distressed firm have a strong incentive to help the firm stay afloat by borrowing from "family, friends, or business associates on a secured basis.").

The drawbacks of providing insiders with security interests as a protection for their debt claims would not be a cause of great concern from the standpoint of efficiency if the outside creditor class were made of adjusting creditors only. After all, in the presence or expectation of collateralization of a firm's assets for the benefit of a firm's insiders adjusting creditors could seek protection for the higher risk of being left unpaid by imposing compensatory contract terms. But given the actual or potential presence of nonadjusting creditors, allowing lending insiders to take security interests in their firm's assets means allowing them to externalize the insolvency risk onto the former to the largest extent without providing them any meaningful beneficial effects.<sup>34</sup> Arguably, a recipe for social efficiency losses of a magnitude much greater than that resulting from inside debt financing on an unsecured basis.

34. While nonadjusting creditors are equally worse off in bankruptcy whether debt has been secured for the benefit of insiders or outside creditors, they are better off *ex ante* if security interests are granted to outside creditors as opposed to insiders because they can benefit from the monitoring that outside creditors do.

PART V

REGULATORY APPROACHES  
TO INSIDE DEBT FINANCING

Law provisions and legal doctrines regulating the extent to which the debt raised from a firm's insiders ranks in parity with or below the debt raised from outsiders set out the terms of entry into an affiliation between insider creditors and outside creditors with regard to the contingent ownership of the firm. In establishing *ex ante* whether equityholders' debt claims shall rank equal or junior to pure creditors' claims, these rules allocate legal entitlements over the firm's assets in bankruptcy, whether a liquidation or a reorganization kicks off.

By contrast, avoidable preference rules, which are law provisions mandating *ex post* avoidance of transactions preferring a creditor to others, govern the conditions under which insider creditors may exercise their control rights in order to unilaterally terminate the joint entitlement with outside creditors of priority rights of same or different seniority over a bankrupt estate. Therefore, they set forth the terms for an early exiting from a prospective co-ownership of assets when the firm enters the zone of insolvency. While avoidable preference rules assume that insiders are entitled to make debt advances to the company, they are silent and remain indifferent as to the nature and ranking of insiders' priority rights *qua* creditors. Unlike the rules establishing the seniority of insiders' debt claims, preference rules work on an *ex-post* basis, *i.e.* after the formation of the affiliation between the inside dual-claim holders on the one side and the pure debtholders on the other side.

Rather than wanting to precisely describe and systematize the legal reality, the distinction between narrowly-defined rules on the seniority of insiders' debt claims and rules on preference avoidance, like similar others, serves the heuristic purpose to point to the different functions performed by the two sets of rules and alert to the different legal implications that may derive from their adoption. The general consensus can be summarized as viewing the rules mandating subordination of insider loans as a tool for alleviating asset substitution and debt dilution problems and considering avoidable preference

rules as a tool for remedying an asset dilution problem. But while the efficacy of preference rules may survive the absence of a subordination remedy, the efficacy of a subordination remedy would severely be impaired by the absence of preference rules. Preference rules are strongly needed to reinforce the effectiveness of subordination rules whenever the latter are in place. As a result, a regime under which insider loans were only dealt with by means of preference rules would be conceivable. A regime under which insider loans were dealt with solely by means of subordination rules would be flawed. This explains why, although the set of rules on subordination and the set of rules on preference avoidance may one live an independent life from the other, there hardly exist jurisdictions around the world pursuing subordination of insider loans without coupling such remedy with avoidable preference rules specifically targeting insiders. On the contrary, there exist significant jurisdictions that provide for special rules on avoidance of preferential payments to a firm's insiders without adding to them rules on subordination of inside debt financing.

This division of labor and asymmetrical interdependence between rules on subordination of credit extended by insiders and rules on avoidance of eve-of-bankruptcy transactions preferring insider creditors to other creditors is also reflected in the policy recommendations made by international organizations of the likes of UNCITRAL and the World Bank. While such organizations are unanimous in advocating that preferential transfers made at a time when the company was insolvent or themselves triggering the insolvency of the company be avoidable and that the suspect period be longer when the person benefitting from the transfer is related to the company,<sup>1</sup> they fall short of being unanimous when it comes to recommending that loans made by a firm's insiders be stripped of their unsubordinated nature.<sup>2</sup> Moreover, even when they do make such a recommendation, they do so with caution.<sup>3</sup>

The next Sections provide an overview of the existing regulatory approaches to inside debt financing. Sections from A through to C are devoted to the

1. See United Nations Commission on International Trade Law [UNCITRAL], *Legislative Guide on Insolvency Law, Recommendations 87-99*, at 152-55 (2005); The World Bank, *Principles of Effective Insolvency and Creditor/Debtor Regimes, Principle C11.3*, at 24 (2016).

2. The World Bank makes no recommendation in this regard except that it clarifies that the *pari passu* distribution of the bankrupt's estate should be subject to «equitable subordination of a creditors claim» when «appropriate». See The World Bank, *supra* note 1, *Principle C12.3*, endnote 10.

3. UNCITRAL suggests that «The insolvency law should specify that claims by related persons should be subject to scrutiny and, where justified,... [t]he claim may be subordinated» as an alternative to restricting the voting rights of the related person or reducing the amount of the claim. See United Nations Commission on International Trade Law [UNCITRAL], *supra* note 1, *Recommendation 184*, at 266.

three main regulatory approaches to inside debt financing that are embraced in some prominent European countries, the US and other world jurisdictions. In more detail, Section V illustrates the no-subordination approach. Section B describes the doctrine of equitable subordination. Section C focuses on the remedy of automatic subordination. Section D is concerned with the avoidable preference rules targeting insiders.

## A. The No-Subordination Regulatory Approach

The next two Paragraphs analyze the no no-subordination approach, that is, an approach that refrains from subordinating insider loans. Paragraph 1 examines the main characteristics of this regulatory approach. In support of this analysis, Paragraph 1 briefly describes the jurisdictions of the UK, France, the Netherlands and Australia, all of which share the choice to leave the insiders free to advance debt ranking in parity with outside debt. Paragraph 2 discusses the advantages and disadvantages of such an approach.

### 1. Core Features of the No-Subordination Approach

By no-subordination approach I mean a jurisdiction's choice of providing for no specific rules, whether statutory or judge-made, mandating subordination of the debt owed a company's insiders to the debt owed other creditors. The no-subordination approach is premised on the idea that indebtedness to an insider should be of no concern as such. All that matters is how the funds loaned to the company by any one of its insiders are used by management and on what terms and conditions such funds are loaned by, and returned to, the insider lenders.

The rationale behind this approach is that any rules hindering debt funding advanced by a firm's insiders solely based on their holding ownership interests or executive offices would have a deterrent effect against insiders' lending *ex ante* without regard to its *ex post* potential beneficial effects. In penalizing a source of financing for firms as such, efficient rescue attempts in circumstances of severe informational asymmetries might be forestalled without any guarantee that value-destroying rescue attempts would be better prevented.<sup>4</sup> The no-

4. See Martin Gelter, *The Subordination of Shareholder Loans in Bankruptcy*, 26 INTERNATIONAL REVIEW OF LAW & ECONOMICS 478, 500 (2006); Peter O. Mülberr, *A Synthetic View of Different Concepts of Creditor Protection, or: A High-Level Framework for Corporate Creditor Protection*, 7 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW 357, 397-99 (2006).

subordination approach relies on the full and sole responsibility of those on whom the firm management is bestowed, *i.e.* the directors, to gauge terms and conditions of any financing, including inside debt financing, in their capacity as guardians of the corporate bastions. Directors have discretionary authority on whether to raise funds from a firm's owners in the form of equity or debt and on how to use owners' money. As a result of this authority, the point becomes making management accountable for any *ex post* improper use of the available funds rather than limiting the financing options for the insiders *ex ante*.<sup>5</sup>

This approach figures prominently in the UK. Under British law, creditor protection is notably sought by focusing on management's conduct only.<sup>6</sup> Statutory law and case law are concerned with the duties which directors must fulfil as the company approaches insolvency, with no serious consideration ever being given to a remedy of the likes of subordination of insiders' debt to pure creditors' debt.<sup>7</sup> The statutory baseline is provided for in §§214 (liquidation) and 246ZB (administration) of the Insolvency Act 1986, known as the wrongful trading rules. When a company has gone into insolvent liquidation or administration,<sup>8</sup> a director (including shadow directors)<sup>9</sup> may be found liable to make such contribution to the company's assets as the court thinks proper if at some time before the commencement of the winding up or administration of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation or administration. However, exemption from

5. See Andreas Cahn, *Equitable Subordination of Shareholder Loans?*, 7 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW 287, 297 (2006); Horst Eidenmüller, *Comparative Corporate Insolvency Law*, in THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 1003, 1024 (Jeffrey N. Gordon & Wolf-Georg Ringe eds. 2018); Kristin van Zwieten, *Related Party Transactions in Insolvency*, in THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS 260, 274-75 (Luca Enriques & Tobias H. Tröger eds. 2019).

6. See Paul Davies, *Directors' Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency*, 7 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW 301, 316-27 (2006) (discussing British provisions on wrongful and fraudulent trading).

7. See Interdisciplinary Group on Capital Maintenance, REFORMING CAPITAL. REPORT (Jonathan Rickford ed., 2004), 15 EUROPEAN BUSINESS LAW REVIEW 919, 985 (2004) (dismissing the suitability of subordination of inside debt in the British context as a potent disincentive against insider loan financing and a "major interference with vested rights").

8. Insolvency is formally established according to a balance-sheet test, *i.e.* when the firm's liabilities exceed its assets. But according to case law, as long as the company is cash-flow solvent, it is viewed as still having a reasonable prospect of avoiding insolvent liquidation. Therefore, §214 duties are triggered when the company becomes unable to pay off its debts as they become due. See Davies, *supra* note 6, at 318-20.

9. A shadow director is "a person in accordance with whose directions or instructions the directors of the company are accustomed to act". See Insolvency Act 1986, §251(1).

liability is granted if the director having such actual or constructive knowledge of lack of favourable prospects took every step with a view to minimizing the potential loss to the company's creditors. These and other rules<sup>10</sup> are construed as shifting the orientation of directors' duties in insolvency and in its vicinity to the benefit of the creditors and away from shareholder wealth maximization.<sup>11</sup> Albeit targeting directors, the objective pursued by them is widely seen as countering overinvestment resulting from an increasing appetite for risky ventures in the shareholders' class as the company is bordering on insolvency.<sup>12</sup> In making shadow directors equally liable, the provision goes as far as punishing all corporate decision-makers, be they directors or shareholders involved in management, that played a role in the demise.<sup>13</sup> A similar no-subordination approach relying on fiduciary duties and managerial liability

10. See §15A of the Company Directors Disqualification Act 1986, inserted therein by the Small Business, Enterprise and Employment Act 2015, according to which a company's directors may be subject to a compensation order by the court on the application of the Secretary of State if they get to be disqualified as a result of a conduct which caused losses to one or more creditors of an insolvent company.

11. At common law, directors have always had to exercise their powers in the best interests of the company, with such interests having occasionally come to include the interests of the creditors in addition to those of the shareholders. See D.D. Prentice, *Creditor's Interests and Director's Duties*, 10 OXFORD JOURNAL OF LEGAL STUDIES 265, 273 (1990). Therefore, rather than creating a new duty, wrongful trading rules are deemed to merely shift the focus of the ordinary duties of care and loyalty owed the company so as to have proper regard for the interests of creditors as the new residual claimants. See Kristin van Zwieten, *Director Liability in Insolvency and Its Vicinity*, 38 OXFORD JOURNAL OF LEGAL STUDIES 382, 382-83 (2018).

12. See Rizwaan J. Mokal, *An Agency Cost Analysis of the Wrongful Trading Provisions: Redistribution, Perverse Incentives and the Creditor's Bargain*, 59 CAMBRIDGE LAW JOURNAL 335, 353-54 (2000) (arguing that §214 of the Insolvency Act 1986 is more effective and litigated in the context of closely-held firms because shareholder-managers of a financially-distressed closely-held firm have a stronger incentive to continue trading despite losses than have managers of a financially-troubled widely-held company).

13. The same rationale underlying the wrongful trading rules has been found in the seminal case *West Mercia Safetywear v. Dodd*, [1988] BUTTERWORTHS COMPANY LAW CASES 250 (Court of Appeal). The case was about a finding of breach of duties to an insolvent subsidiary by a director for having made a preferential reimbursement of a debt owed to the subsidiary's insolvent parent, of which too he was a director and whose indebtedness to a bank he had personally guaranteed. In spite of the traditional view that *West Mercia* is about unlawful trading in insolvency, more recent cases have more specifically used it as a precedent for dealing with preferential transactions with a view to holding a bankrupt's directors and the beneficiary of the transaction liable for damages. See van Zwieten, *supra* note 11, at 391-405. Unlike the wrongful trading rule, the *West Mercia* rule does not require that the company be ultimately placed in insolvent liquidation, although it turns out that *West Mercia* duties are usually not litigated until after the commencement of an insolvency proceeding. See *id.* at 383 n.10.

rather than on capital structure rules is adopted in France,<sup>14</sup> the Netherlands<sup>15</sup>

14. France, too, focuses on directors' duties without considering whether the equityholders paid in an adequate amount of equity capital to finance business operations or funded them by extending credit. First, pursuant to Code de commerce [Commercial Code], artt. 631-4 and 640-4, directors must file for a judicial reorganisation or a judicial liquidation proceeding within forty-five days from the date on which the company became unable to pay off its debts. Second, French law imposes a negligence-based director liability ("*responsabilité pour insuffisance d'actif*") on regular and *de facto* directors when a company enters an insolvent liquidation proceeding as a result of asset value falling below liabilities. If such a balance-sheet insolvency is ascribed to management's fault, the court may rule that that the difference in value be paid, in whole or in part, by all or some of the directors who are found guilty of mismanagement, provided that they acted with gross negligence. See Code de commerce, art. 651-2. Third, similar to the British director disqualification, French law empowers courts to prohibit a bankrupt company's directors from holding managerial offices in the future. See Code de commerce, art. 653-8. Additionally, criminal penalties up to a 5-year imprisonment are also levied against directors who fraudulently increase the size of liabilities or undertake other opportunistic transactions in the vicinity of insolvency. See Code de commerce, artt. 654-1 to 654-3. French law does however deal with shareholder loans for tax purposes.

15. In the Netherlands, subordination of insiders' debt claims to those of outside lenders, where needed, is usually achieved by contract. In cases where intragroup loans are at stake, courts insist that under Dutch law all loans, including those given by parent companies, enjoy the same status, unless the loan agreement provides otherwise. As a result, a parent company's claim arising from an advance to an insolvent subsidiary is braced for ranking *pari passu* with all other outstanding unsecured claims. But the Dutch regime as construed by courts exemplifies a tension between the willingness to abide by the formal principle of equal treatment of all creditors, including insider creditors, and fairness considerations. Occasionally, courts did recharacterize a loan of a parent to an insolvent subsidiary as equity. See Rechtbank Amsterdam 26 juli 2005, unpublished, confirmed by Gerechtshof Amsterdam 5 november 2005, JURISPRUDENTIE ONDERNEMING & RECHT 2007/51, annotated by Steef M. Bartman (Carrier 1) (holding that a shareholder loan can be subject to subordination when it is to be regarded as an informal capital contribution, which fact occurs when the shareholder loan was granted at a time and under conditions that no third party would have accepted); Rechtbank Breda 7 juli 2010, JURISPRUDENTIE ONDERNEMING & RECHT 2010/293, annotated by A.J. Tekstra (Oude Grote Bevelsberg q.q./Louwerier q.q.) (stating that subordination can be ordered by the court only if the loan is both recharacterized as informal capital and was granted by a controlling shareholder). Or they contended that despite the absence of a statutory remedy of subordination, if facts and circumstances so require, an outcome similar to that of subordination may be achieved through other legal means. Compare Gerechtshof Arnhem-Leeuwarden 10 maart 2015, JURISPRUDENTIE ONDERNEMING & RECHT 2015/160, annotated by Jaap Barneveld (P&O Partner B.V./curatoren) (affirming that an action may be brought against the lending parent based on tort law or invoking the general principles of reasonableness and fairness to mitigate the effects of statutory law), with Rechtbank Amsterdam 17 december 2008, JURISPRUDENTIE ONDERNEMING & RECHT 2009/171 (One. Tel/Bink q.q.) (ruling out subordination on grounds of reasonableness and fairness standards). The Dutch regime as construed by local courts is thus illustrative of the difficulty in categorizing jurisdictions as belonging to wholly

and Australia,<sup>16</sup> which explicitly allows contractual subordination of corporate debts.<sup>17</sup>

## 2. *Advantages and Disadvantages of the No-Subordination Approach*

The no-subordination approach can generally be understood as allocating insiders a property-rule protection over the priority status of their debt claims, itself resulting in a property-rule protection over their preferred choice of a

distinct groups based on the type of subordination remedy in place. General principles of reasonableness and fairness, for instance, may be invoked under a variety of doctrines by most civil law courts on par with their common law counterparts when such courts feel that proper consideration must be afforded to interests or particular circumstances otherwise neglected by statutory law. They are part of the weaponry almost any civil law courts can count on to correct failures or unintended consequences stemming from a blind application of statutory law. As a result, dividing lines between no-subordination and subordination jurisdictions are inevitably blurred.

16. While pursuant to Corporations Act 2001, §563A, the debt claims held by shareholders *qua* shareholders are automatically subordinated without exception, as with the United Kingdom a deterrent against opportunistic insider loans, that is, funds advanced by a firm's controllers with a view to letting the company continue to trade despite its irremediable insolvency, comes in the form of the insolvent trading rule enshrined in §588G. By virtue of this provision, a director, including *de facto* and shadow directors, attracts civil liability if she incurs a debt at a time when the company is insolvent or becomes insolvent as a result of incurring that debt or at a time when there are reasonable grounds to believe that the company is insolvent or would become insolvent. See Corporations Act 2001, §588G(1)(2). This violation qualifies as a criminal offence if the director's failure to prevent the company from incurring the debt was dishonest. See §588G(3). Though a safe harbour is available, the threshold is set as high as requiring the director to show that the debt was incurred directly or indirectly in connection with a course or courses of action that were reasonably likely to lead to a better outcome for the company. See §588GA(1). For purposes of this assessment, regard may be had to whether the person properly informed herself of the company's financial position; or took appropriate steps to prevent any misconduct by officers or employees of the company that could adversely affect the company's ability to pay all its debts; or took appropriate steps to ensure that the company was keeping appropriate financial records consistent with the size and nature of the company; or obtained advice from an appropriately qualified entity who was given sufficient information to give appropriate advice; or developed or implemented a plan for restructuring the company to improve its financial position. See §588GA(2). For a comparison between the British wrongful trading rule and the Australian insolvent trading rule, see Andrew Keay & Michael Murray, *Making Company Directors Liable: A Comparative Analysis of Wrongful Trading in the United Kingdom and Insolvent Trading in Australia*, 14 INTERNATIONAL INSOLVENCY REVIEW 27 (2005).

17. Under Corporations Act 2001, §563C, a debt subordination by a creditor of a company is not *per se* unlawful or unenforceable, except so far as the debt subordination would disadvantage any creditor of the company who was not a party to, or otherwise concerned in, the debt subordination.

company's capital structure.<sup>18</sup> To the extent equityholders and other insiders are allowed to lend to the firm and be treated as holders of debt claims just like any other outside creditor is, they are permitted to acquire legal entitlements over the firm assets on an equal footing with the outside creditors. When unsubordinated inside debt financing is provided to the firm, outside creditors' priority rights in bankruptcy get diluted in percentage terms to make room for insider creditors' rights. And all this may occur at the initiative of the insider creditors without the need of the outside creditors' consent.

Of all possible legal approaches to insiders' debt advances, there is no doubt this one is the most favourable to the insiders. A law endorsing the no-subordination approach leaves them free to choose the capital structure they deem best for their company without penalties. Nominal undercapitalization accompanied by inside debt is not disfavoured as such. By offering insiders the unrestricted entitlement to put in place a capital structure under which they can share in the estate assets with pure creditors in the event of bankruptcy, the law allows them to obtain an insurance, albeit a partial one, against the risk of loss on their investments. The rationale is that where insider loans figure in large part, *i.e.* closely-held firms, equityholders likely have most of their wealth dependent on the fortunes of the one firm they have invested in. Although they, unlike external financiers, have control rights which allow them to have the firm take precautions to minimize the risk of loss *ex ante*, the concentration of their wealth in the firm and the difficulty in diversifying such a risk away by other means might make them less efficient risk-bearers than are outside creditors, regardless of the latter's information and coordination costs. And because a firm's concentrated ownership, especially where it is coupled with small size, may limit or impair access to external capital markets as an alternative to bank financing, the policy is not to stifle entrepreneurship by curbing a potentially valuable source of funding from the firm's owners.

As a matter of fact, this approach ensures that insiders be better off making debt advances than capital contributions. Yet, institutional lenders such as

18. The notion of property rules as opposed to that of liability rules and inalienability rules is famously discussed in Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARVARD LAW REVIEW 1089 (1972). The use of Calabresi and Melamed's analytical framework for a better understanding of corporate law is obviously not unheard of. See, *e.g.*, Michael J. Whincop, *Painting the Corporate Cathedral: The Protection of Entitlements in Corporate Law*, 19 OXFORD JOURNAL OF LEGAL STUDIES 19 (1999). The same theoretical framework is fruitfully applicable to bankruptcy law, too. To the best of my knowledge, this work is the first that employs Calabresi and Melamed's framework to make a positive and normative assessment of various regulatory approaches to inside debt financing.

banks anticipate that the dominant strategy for unconstrained management shareholders of closely-held firms is to extend credit rather than risk capital. Banks know, or ought to know, that after loaning money to the firm, the controllers will have an incentive to dilute the former's debt claims should the company need additional funds. Out of this belief, lending institutions may want to condition *ex ante* the provision of loans on the contractual subordination of all advances to be made as from the date of the loan agreement, and possibly of the advances already made, by the firm's owners. If the law so allows and the parties so wish, the original allocation to the insiders of the entitlement to claim back a percentage of priority rights over a firm's assets can easily be renegotiated to the advantage of all contract parties.<sup>19</sup> When the no-subordination approach is associated with the permission of contractual subordination of the owners' debt claims, Coasean bargaining<sup>20</sup> is favoured to the extent few transactional obstacles likely stand in the way of a privately efficient, bargained-for reallocation of the entitlement between a firm's owners and the bargaining creditors.

From an efficiency perspective, legal entitlements should be allocated to whom values them more. The party who values the entitlement more would likely have gotten it if bargaining over the issue had been possible *ex ante*. Who values a legal entitlement more, and a how hypothetical bargaining between the parties would have allocated it, may however be unclear. In this context, one might argue that higher-value users are the insiders, while others might argue that higher-value users are the creditors. It may well be possible that in some companies they are the former, while in some other companies they are the latter.

Allocation of entitlements would not matter to efficiency if bargaining were costless. But bargaining might be costly. Under conditions of uncertainty, it is therefore efficient to allocate the entitlement to the party who is more likely to separate from it if it were mutually advantageous to do so, thereby undoing the allocation of the entitlement made by the law. To make such an assessment, one should look at the transaction costs that the parties face, and if such costs are symmetrical or not. When dealing with priority rights, transaction costs do not appear to be symmetrical. The costs to creditors of obtaining contractual subordination of inside debt from insiders are seemingly lower than the costs to insiders of obtaining lack of subordination of their debt from creditors. To

19. Although bargaining to this outcome might in practice not take place for the reasons discussed *supra* in Part II, Section G.

20. See Ronald J. Coase, *The Problem of Social Cost*, 3 JOURNAL OF LAW & ECONOMICS 1 (1960).

put it another way, obtaining subordination of insider claims by contract is overall less costly than depriving creditor claims of their priority status vis-à-vis insider claims.

Why this is the case can be easily appreciated. The most severe of all bargaining problems potentially surfacing in negotiations between insiders and outside creditors, *i.e.* the holdout problem, is comparatively lower than would be if the entitlement were originally allocated to the external creditors. Insiders of a closely-held company are usually fewer and far more homogenous than are outside creditors. None of them, if asked to give up on the priority rights in bankruptcy conferred on them by their debt investments, is likely to hold out for an unreasonable private benefit undermining the collective efficiency of a potentially mutually-beneficial exchange with the external creditors. Insiders can be expected to come together in light of a shared view of their common interest resulting from a family, fiduciary or close business relationship. On the contrary, the potential heterogeneity and self-interestedness of outside creditors would render comparatively less certain that priority rights shift from outside creditors to a firm's owners through frictionless bargaining when a reallocation would be efficient. One or more creditors could easily drag their feet for a higher price than is reasonable. We should therefore expect that the parties would agree to give the entitlement to the insiders as a value-maximizing course of action. In effect, the no-subordination approach does dovetail with the permissibility of contractual subordination in all the jurisdictions where it is employed. This combination makes sure that where the entitlement of priority rights in bankruptcy proves misallocated, it can be corrected through low-cost, mutually-advantageous bargaining between inside dual-claim holders and outside lenders.

Insofar as constraints only arise out of loan contracts, the no-subordination approach in its pure form vows to make insiders free to put in place the company's capital structure they wish to have. In deferring to insider choice independently of whether the company is fully solvent or in financial dire straits, the approach at stake incentivizes insiders to provide debt financing as opposed to equity financing throughout the corporate lifecycle. In particular, the financing of a rescue attempt at a faltering company by issuing debt to the insiders is not discouraged as such. As a result, a firm, including an ailing one, is more likely to receive advances from its ownership or management base than it would be if the insiders had to bargain to achieving equal ranking for their debt. Supply of inside debt capital is thus allowed to fill the gaps of a firm's capital structure unconstrained.

The drawback, however, is that an unfettered liberty may lead to a company's capital structure exacerbating moral hazard temptations by the owners already

at the early stages of the company's existence. Despite the presence of loan covenants, the only counterweight to the deployment of a firm's assets to risky ventures once a firm's finances begin to deteriorate would be provided by the threat of director liability and its corollaries. Besides, any mutually-beneficial subordination agreement between the insiders and the outside lenders would leave the nonadjusting creditors no better off. Rather, subordination agreements would make them worse off.<sup>21</sup> The potential availability of subordinated inside debt would encourage banks to actively seek, and insiders to grant, subordination, with the effect of promoting inside debt financing relative to inside equity financing. As a result, greater wealth would be moved away from nonadjusting creditors for the benefit of the coalition of subordinated insiders and subordinating lenders.

## **B. The Equitable Subordination Regulatory Approach**

The next two Paragraphs target the equitable subordination approach, that is, an approach that subordinates insider lending when equitable considerations so require. Paragraph 1 illustrates the main characteristics of this regulatory approach. This Paragraph groups together all those jurisdictions, ranging from the US to Italy, that despite regulatory differences share the view that an insider's debt advance should not be subordinated unless the insider has engaged in some wrong. Paragraph 2 highlights the advantages and disadvantages of such an approach.

### *1. Core Features of the Equitable Subordination Approach*

The equitable subordination of advances to companies made by their insiders is a remedy by which inside debt claims are moved down in the order of payment out of the assets in the bankruptcy estate in application of principles of equity and fairness to outside creditors.<sup>22</sup> In the words of one US court, the purpose is "to reprioritize the order of allowed claims based on the equities of the case".<sup>23</sup>

21. See *supra* Part II, Section F, notes 52-55 and accompanying text.

22. See *In re Lifschultz Fast Freight*, 132 FEDERAL REPORTER (THIRD SERIES) 339 (United States Court of Appeals for the 7<sup>th</sup> Circuit, 1997).

23. *In re County of Orange*, 219 BANKRUPTCY REPORTER 543 (United States Bankruptcy Court for the Central District of California, 1997). Subordination of a claim must be distinguished from disallowance of a claim. When disallowed, the claim is rejected as invalid. Although different from one another, in practice subordination of a claim leads to the same

The remedy of equitable subordination is without prejudice to the rules on director misconduct and liability of the type mentioned *supra* in Section A, Paragraph 1, which apply nonetheless. It actually complements the latter insofar as remedies for breach of directors' duties expand the pool of assets on which the outside creditors may seek satisfaction, while equitable subordination reduces the overall number of claims that can be exerted against such assets.<sup>24</sup> The added value that subordination, to the extent there exist claims to be subordinated, brings to the recovery chances of the body of creditors is that unlike director liability, it swiftly provides a readily available surplus which creditors may take advantage of. While a damage award arising from breach of directors' duties calls for collection efforts, which might be successful or not, the equitable subordination remedy is just about downgrading the legal nature of a claim upon a court order.

Depending on the jurisdiction, the remedy of equitable subordination has wider or more limited application. This is the reason why it perhaps is more precise to speak of as many equitable subordination approaches as the number of jurisdictions using equitable considerations as a justification for a subordination remedy. Nevertheless, despite variations across national legal regimes as to the requirements for its application, all regulatory approaches share a common general framework according to which the application is triggered by either a finding of undercapitalization alone or, alongside undercapitalization, a showing of malfeasance by the lender resulting in injury to creditors.

When the approach looks only to a company's capital structure to establish whether to relegate debt claims to an inferior status, it presents the firm's controllers with the sharp alternative between adequately capitalizing the company or facing the penalty of claim relegation. Therefore, in its most rigorous form, the remedy is premised on the idea that, no matter the controller's good faith and best efforts to safeguard the interests of creditors, if a company plummets into insolvency and was undercapitalized, the controllers are to be blamed for having wrongly shaped the company's capital structure and failed to provide a capital cushion for creditor protection. As a result of this *ex post* finding, controllers who are also creditors must compensate the

consequences for the holder thereof than does disallowance of a claim. See Bernard A. Riemer, *Claims Against Bankrupt Corporations Based on Advances by Controlling Stockholders or Parent Corporations*, 73 COMMERCIAL LAW JOURNAL 273, 274 (1968) (“[S]ubordination may be, and usually is, tantamount to disallowance, since the assets of a bankrupt estate are usually insufficient to pay in full the claims of all creditors.”).

24. See Robert C. Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 HARVARD LAW REVIEW 505, 518 (1977).

other general unsecured creditors for their negligence by giving way to the latter's claims. Under this view, the inequitable conduct solely and sufficiently lies in the defective design of the company's capital structure, which insiders are made responsible for.<sup>25</sup> Conversely, when the regulatory approach looks to both a company's capital structure and a separate, unfair behavior by its controllers, the remedy is premised on the idea that thin capitalization is a legitimate entrepreneurial choice *per se* regardless of its impact on the company's solvency, unless it is associated with further actions or operations intentionally and fraudulently meant to advantage the owners at the injury of one or more creditors.<sup>26</sup>

Moreover, equitable subordination may alternatively work for the benefit of all general unsecured creditors or just a number of them. Albeit varying in the way they sort the beneficiaries, equitable subordination approaches exhibit a consistent relationship between the facts and circumstances chosen as triggers and the pool of beneficiaries. When equitable subordination is built upon an imbalanced capital structure alone, the interplay of thin capitalization, shareholder limited liability and insiders' strategic holding of debt claims is un rebuttably presumed to pose a threat to the interests of all general creditors alike. In light of this, all outside creditors, whether they were informed or uninformed of the undercapitalization and adjusted their claim to the risk of default or not, ought to be taken care of in bankruptcy without distinction. In contrast, when equitable subordination requires a fraud or misrepresentation on top of undercapitalization, the assumption is that it is the fraud or misrepresentation to have possibly misled one or more creditors into underestimating the risk of default and foregoing an *ex ante* demand for adequate compensation. Therefore, equity commands that only those creditors who were actually defrauded or from whom information was instrumentally concealed should be allowed to benefit from subordination of insiders' claims. It follows that while the remedy of equitable subordination based on undercapitalization alone invariably benefits both the adjusting creditors and the nonadjusting creditors, regardless of whether the former creditors could have demanded and did in fact demand *ex ante* compensation, the remedy of equitable subordination based on insiders' misconduct practically goes to advantage of the adjusting creditors only, despite the fact that it might well be the nonadjusting creditors those in greater need to be protected.

25. Italy provides an example of this first approach. See *infra* notes 67-71 and accompanying text.

26. This approach is commonly employed throughout the US. See *infra* notes 27-45 and accompanying text.

The US provides the most prominent example of the form of equitable subordination approach of claims in bankruptcy requiring both undercapitalization and a wrong by the insider lender for the subordination of inside debt to kick in.<sup>27</sup> Codified in §510(c)(1) of the Bankruptcy Code of 1978,<sup>28</sup> the judicially-created doctrine of equitable subordination developed by bankruptcy courts sitting as courts of equity<sup>29</sup> is meant to correct the liquidation results that would follow from a blind application of the principle of equality of distribution set forth in bankruptcy law.<sup>30</sup> Such doctrine, embraced early on in a trilogy of cases decided by the Supreme Court<sup>31</sup> and left in the hands of the courts even after its statutory recognition,<sup>32</sup> has evolved

27. The remedy of equitable subordination neither prevents nor dictates its terms on contractual subordination, which is allowed pursuant to §510(a) of the Bankruptcy Code and lives an independent life. See *In re Credit Industrial Corp.*, 366 FEDERAL REPORTER (SECOND SERIES) 402, 409 (United States Court of Appeals for the 2<sup>nd</sup> Circuit, 1966) (“The doctrine of equitable estoppel is clearly irrelevant to a determination of whether a lawful subordination agreement is enforceable in bankruptcy proceedings”). Nevertheless, equitable subordination and contractual subordination might interfere with one another if a bankruptcy trustee seeks judicial subordination to harmed creditors of a claim that was previously subordinated by contract to a specified creditor. In such a case, it has been argued that equitable subordination should take precedence over contractual subordination. See James L. Lopes, *Contractual Subordinations and Bankruptcy*, 97 BANKING LAW JOURNAL 204, 231-33 (1980).

28. According to which, “under principles of equitable subordination”, the court may “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 an allowed interest”.

29. See *Pepper v. Litton*, 308 UNITED STATES REPORTS 295, 305 (United States Supreme Court, 1939) (justifying equitable powers “to the end that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done”).

30. See Asa S. Herzog & Joel B. Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 15 VANDERBILT LAW REVIEW 83, 83 (1961) (noticing that since “certain claims possess an intrinsic ethical superiority to others”, there is “a compelling reason for overriding the principle of equality”).

31. See *Taylor v. Standard Gas & Electric Co.*, 306 UNITED STATES REPORTS 307 (United States Supreme Court, 1939) (subordinating the parent’s claims to those of the preferred stockholders based on gross mismanagement and undercapitalization of the subsidiary); *Pepper v. Litton*, *supra* note 29, at 295 (disallowing the controlling stockholder’s debt claim in light of the fraud perpetrated against a creditor); *Comstock v. Group of Institutional Investors*, 335 UNITED STATES REPORTS 211 (United States Supreme Court, 1948) (allowing the parent’s claim without subordination on grounds of good faith efforts by the parent to run the subsidiary in the latter’s interest).

32. The legislative history of the United States Code, Tit. 11, §510(c)(1) unequivocally points in the direction of Congress’s willingness “to follow existing case law and leave to the courts development of this principle”. See Rafael Ignacio Pardo, *Beyond the Limits of Equity Jurisprudence: No-Fault Equitable Subordination*, 75 NEW YORK UNIVERSITY LAW REVIEW

in a three-prong test<sup>33</sup> focusing on the following requirements: 1) whether the claimant has engaged in fraud or other inequitable conduct;<sup>34</sup> 2) whether the claimant's conduct has resulted in harm to the other creditors or in an unfair advantage to the claimant;<sup>35</sup> 3) whether the subordination of the claim does not run counter to the tenets of bankruptcy law.<sup>36</sup>

When all these requirements are met, the bankruptcy court can utilize its equitable powers to avert injustice by preventing the claimant from sharing on

1489, 1506 (2000), quoting the statement of Representative Edwards in 124 CONGRESSIONAL RECORD 32, 398 (1978). Although the bill initially presented by the Commission on the Bankruptcy Laws of the United States provided for a *per se* subordination of all claims, whether secured or unsecured, of any principal officer, director, or affiliate of a debtor, that proposal was rejected. See James M. Wilton & William A. McGee, *The Past and Future of Debt Recharacterization*, 74 BUSINESS LAWYER 91, 93 n.7 (2019).

33. See *Benjamin v. Diamond (In re Mobile Steel Co.)*, 563 FEDERAL REPORTER (SECOND SERIES) 692, 700 (United States Court of Appeals for the 5<sup>th</sup> Circuit, 1977).

34. Inequitable conduct means, in the words of one court, a "conduct which may be lawful, yet shocks one's good conscience. It means, inter alia, a secret or open fraud; lack of faith or guardianship by a fiduciary; an unjust enrichment, not enrichment by bon chance, astuteness, or business acumen, but enrichment through another's loss brought about by one's own unconscionable, unjust, unfair, close, or double-dealing or foul conduct". *In re Harvest Milling Co.*, 221 FEDERAL SUPPLEMENT 836, 838 (United States District Court for the District of Oregon, 1963). All but few rulings have so far required a finding of inequitable conduct by the creditor. Among those that have not, one case (*In re V. Loewer's Gambrinus Brewery Company*, 167 FEDERAL REPORTER (SECOND SERIES) 318 (United States Court of Appeals for the 2<sup>nd</sup> Circuit, 1948)) is a very early one; another one (*Matter of Stirling Homex Corp.*, 579 FEDERAL REPORTER (SECOND SERIES) 206 (United States Court of Appeals for the 2<sup>nd</sup> Circuit, 1978), certiorari denied, 439 UNITED STATES REPORTS 1074 (United States Supreme Court, 1979)) is viewed as having been misinterpreted; the few others have mostly dealt with pre-petition tax penalty claims. Case law advocating no-fault subordination has been heavily criticized in the literature as contrary to the legislative history of §510(c) and congressional intent. See Scott M. Browning, *No Fault Equitable Subordination: Reassuring Investors That Only Government Penalty Claims Are at Risk*, 34 WILLIAM & MARY LAW REVIEW 487 (1993); Pardo, *supra* note 32.

35. The doctrine is remedial in nature, *i.e.* it is intended to offset the harm inflicted on creditors and solely to the benefit of those creditors actually damaged. See Andrew DeNatale & Prudence B. Abram, *The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors*, 40 BUSINESS LAWYER 417, 423 (1985). The goal is not that of punishing the offending creditor for its misconduct. As a consequence, if the improper conduct harmed the entire creditor body, the offending creditor's claim shall be subordinated to all other creditors' claims. But if harm was done to some specific creditors only, the offending creditor's claim shall solely be subordinated to the claims of those creditors actually injured. See *id.* at 426.

36. Subverting the statutory scheme is forbidden. The court is not free to adjust a legally valid claim asserted by a good-faith party on grounds that an inequitable result would ensue. See DeNatale & Abram, *supra* note 35, at 427-28.

a parity with other claimants of equal status,<sup>37</sup> irrespective of the ordering of claims provided for in state law.<sup>38</sup>

While according to the cardinal principles of equity jurisprudence all creditors' claims may be subjected to subordination, a less severe conduct is required to be shown and a more exacting judicial scrutiny is carried out in respect of insiders' claims as opposed to outsiders' claims.<sup>39</sup>

37. To the extent a debt claim cannot be subordinated to a proprietary interest, the subordination of a creditor's claim can only benefit other creditors, and not the equityholders of the debtor. See DeNatale & Abram, *supra* note 35, at 421-22. That being said, the subordination may be ordered as between equity interests, too. Satisfaction of the equity interest of a stockholder guilty of misconduct may be postponed to satisfaction of all other equity interests. See *In re Automatic Washer Co.*, 226 FEDERAL SUPPLEMENT 834, 836 (United States District Court for the Southern District of Iowa, 1964), affirmed, 338 FEDERAL REPORTER (SECOND SERIES) 1006 (United States Court of Appeals for the 8<sup>th</sup> Circuit, 1964).

38. This "disregard of nonbankruptcy law" has been questioned on grounds that allowing bankruptcy law to subvert the ordering scheme resulting from state law incentivizes a strategic use of the bankruptcy forum for the pursuit of private interests at the expense of the collective interest of the creditors as a whole. See Thomas H. Jackson, *Translating Assets and Liabilities to the Bankruptcy Forum*, 14 JOURNAL OF LEGAL STUDIES 73, 87 n.38 (1985).

39. See Lawrence Ponoroff, *Whither Recharacterization*, 68 RUTGERS UNIVERSITY LAW REVIEW 1217, 1288 (2016). Courts generally agree that the insider status invites closer scrutiny, lowers the level of misconduct required to meet the threshold and shifts the burden of proof. As regards scrutiny, see *Schubert v. Lucent Technologies, Inc. (In re Winstar Communications, Inc.)*, 554 FEDERAL REPORTER (THIRD SERIES) 382, 412 (United States Court of Appeals for the 3<sup>rd</sup> Circuit, 2009) ("Dealings between [the] debtor and an insider [are] to be rigorously scrutinized") (quoting *Fabricators, Inc. v. Technical Fabricators, Inc. (In re Fabricators, Inc.)*, 926 FEDERAL REPORTER (SECOND SERIES) 1458, 1465 (United States Court of Appeals for the 5<sup>th</sup> Circuit, 1991)); *Wilson v. Huffman (In re Missionary Baptist Foundation of America, Inc.)*, 712 FEDERAL REPORTER (SECOND SERIES) 206, 211-12 (United States Court of Appeals for the 5<sup>th</sup> Circuit, 1983) ("insider connection with the debtor compels close examination of [the] claim"). As regards the required severity of conduct, see *In re Fabricators, Inc.*, cited *supra* in this note, at 1465 (maintaining that the degree of inequitable conduct required of insiders varies between non-insiders and insiders); *In re Mid-American Waste Systems, Inc.*, 284 BANKRUPTCY REPORTER 53, 70 (United States Bankruptcy Court for the District of Delaware, 2002) ("[T]he standard for finding inequitable conduct is much lower [for insiders]"); *Redmond v. Jenkins (In re Alternate Fuels, Inc.)*, 789 FEDERAL REPORTER (THIRD SERIES) 1139, 1158 (United States Court of Appeals for the 10<sup>th</sup> Circuit, 2015) (affirming that "evidence of less egregious conduct" is required for purposes of equitably subordinating an insider debt claim); *Virginia Broadband, LLC v. Manuel*, 538 BANKRUPTCY REPORTER 253, 264 (United States District Court for the Western District of Virginia, 2015) (pointing out that the standard for inequitable conduct is not as high when the creditor is an insider). As regards burden-of-proof shifting, see *In re Pacific Express, Inc.*, 69 BANKRUPTCY REPORTER 112, 116 (United States Bankruptcy Appellate Panel of the 9<sup>th</sup> Circuit, 1986) ("If the objectant comes forward with sufficient substantiations of misconduct on the part of the insider claimant, the burden will shift to the insider to establish that each of his challenged transactions with the debtor had all the earmarks of an arm's length bargain.") (quoting *Matter of Teltronics Services, Inc.*, 29 BANKRUPTCY REPORTER 139, 169

Instances of inequitable conduct emerging from case law are mismanagement, fraud, breach of fiduciary duty, domination of the subsidiary up to making it a mere instrumentality or *alter ego* of the parent, impermissible control, improper claim acquisition.<sup>40</sup> Importantly, the improper conduct needs not be related to the acquisition or assertion of the claim for debt.<sup>41</sup> Any unfair act on the part of the claimant compromising bankruptcy results to other creditors may warrant subordination irrespective of whether the conduct bears no relation to the claim.<sup>42</sup>

With regard to what facts meet the threshold for inequitable conduct, it is noteworthy that advancing a loan to an undercapitalized company is seldom deemed to constitute inequitable conduct in and of itself for the purpose of the test.<sup>43</sup> The better view is that undercapitalization must be accompanied by some aggravating conduct such as fraud or mismanagement.<sup>44</sup> The arguments usually

(United States Bankruptcy Court for the Eastern District of New York, 1983)); *CapMark Financial Group Inc. v. Goldman Sachs Credit Partners L.P.*, 491 BANKRUPTCY REPORTER 335, 345 (United States District Court for the Southern District of New York, 2013) (holding that once the plaintiff has made a *prima facie* showing of inequitable conduct, the burden shifts to the insider claimant to prove good faith and the inherent fairness of the transaction).

40. See Pardo, *supra* note 32, at 1491.

41. Of course, it could be. For instance, it has been maintained that the doctrine of equitable subordination could even be used to subordinate the debt claims of the selling shareholders of an overindebted company acquired through a leveraged buyout when the selling shareholders have received in exchange for their stock buyers' notes endorsed and secured by the target company itself. See Emily L. Sherwin, *Creditors' Rights against Participants in a Leveraged Buyout*, 72 MINNESOTA LAW REVIEW 449, 455-60 (1988).

42. See *In re Mobile Steel Co.*, *supra* note 33, at 700 (citing *Bostian v. Schapiro (In re Kansas City Journal-Post Co.)*, 144 FEDERAL REPORTER (SECOND SERIES) 791, 803-04 (United States Court of Appeals for the 8<sup>th</sup> Circuit, 1944)).

43. Likewise, insufficient capitalization usually does not provide a self-standing justification for veil-piercing decisions. See Jonathan Macey & Joshua Mitts, *Finding Order in The Morass: The Three Real Justifications for Piercing the Corporate Veil*, 100 CORNELL LAW REVIEW 99, 123-30 (2014). Undercapitalization alone was deemed a sufficient ground to subordinate the claim of a shareholder-director mostly in early cases such as *Costello v. Fazio*, 256 FEDERAL REPORTER (SECOND SERIES) 903 (United States Court of Appeals for the 9<sup>th</sup> Circuit, 1958). For an exceptionally more recent one, see *In re Fett Roofing & Sheet Metal Co.*, 438 FEDERAL SUPPLEMENT 726 (United States District Court for the Eastern District of Virginia, 1977), affirmed, 605 FEDERAL REPORTER (SECOND SERIES) 1201 (United States Court of Appeals for the 4<sup>th</sup> Circuit, 1979).

44. In examining the precedent of the subordination of the parent's claims ordered in *Taylor v. Standard Gas & Electric Co.*, *supra* note 31, the Supreme Court in *Pepper v. Litton*, *supra* note 29, at 308 highlighted "a history of spoliation, mismanagement and faithless stewardship of the affairs of the subsidiary by Standard to the detriment of public investors." It was the fact of the mismanagement rather than that of the undercapitalization to constitute the predominant factor in the decision of the case. See Riemer, *supra* note 23, at 282.

levied in support of the latter position are at least three. Outside creditors have actual or constructive knowledge of a company's capital structure and can adjust their credit terms *ex ante* to compensate for the riskiness thereof or refrain from transacting altogether. Subordination would chill the raising of funds from a company's owners, thereby undermining corporate investments. The concept of undercapitalization is just too vague to give firm guidance in the application of the doctrine.<sup>45</sup>

Although the requirement of inequitable conduct as construed by most courts makes it unlikely that an imbalanced capital structure, when coupled with good faith on the part of the insider, would trigger subordination,<sup>46</sup> in the US the doctrine of equitable subordination must also be viewed in connection with the doctrine of recharacterization of debt as equity, which supplements the former and arguably has the potential to pose an even greater threat to the chances for an insider creditor to recover in bankruptcy.<sup>47</sup> Loans from stockholders, directors and managers have long been the preferential target of bankruptcy trustees' and courts' determination that a debt claim should be recast as an equity investment based on the circumstances of the case.<sup>48</sup> Inclination by courts to recharacterize inside debt on the ground it is

45. See Kathleen Kinney, *Equitable Subordination of Shareholder Debt to Trade Creditors: A Reexamination*, 61 BOSTON UNIVERSITY LAW REVIEW 433 (1981) (arguing that subordination is warranted for the protection of trade creditors, who by customary trade credit practices are in no position to get hold of a company's financial condition in a timely and accurate fashion and negotiate contract protections).

46. Clark, *supra* note 24, argues that the doctrine of equitable subordination originated as a functional substitute for, and a complement to, fraudulent conveyance law and the doctrine of piercing the corporate veil. Compared with fraudulent conveyance, equitable subordination has the advantage of not requiring that the court separately look into each of the many transactions between a company and its controlling shareholder that usually precede the demise and also covering situations where there are no transfers to attack. Compared with veil-piercing, equitable subordination has the advantage of increasing chances of recovery by creditors without the need to reach the controlling shareholder's personal assets. It therefore constitutes a cost-effective alternative to both of them. David Gray Carlson, *The Logical Structure of Fraudulent Transfers and Equitable Subordination*, 45 WILLIAM & MARY LAW REVIEW 157, 167 (2003), goes as far as to contend that "the equitable subordination remedy is a fraudulent transfer remedy" (emphasis in original).

47. See Wilton & McGee, *supra* note 32, at 93 (noticing that debt recharacterization has "displace[d] equitable subordination as a favored cause of action for bankruptcy trustees and creditors' committees" in bankruptcy proceedings).

48. See Hilary A. Goehausen, *You Said You Were Going to Do What to My Loan – The Inequitable Doctrine of Recharacterization*, 4 DEPAUL BUSINESS & COMMERCIAL LAW JOURNAL 117, 129 (2005) ("A claim for recharacterization is most often raised by creditors' committees or a trustee in bankruptcy in cases where a lender is a corporate insider, such as a shareholder, manager, or director.").

camouflaged equity has steadily increased overtime and shows no signs of abatement.<sup>49</sup>

Once more grounded on bankruptcy courts' equitable powers and §§105(a) and 502(b) of the Bankruptcy Code,<sup>50</sup> the doctrine of debt recharacterization claims that bankruptcy courts have the authority to recharacterize an insider's debt claim as an equity interest when necessary to ensure that the economic substance of the transaction not give way to the form thereof. A minority of US federal courts have ordered debt recharacterization simply when either the company was found undercapitalized from the onset or the "the loans were made when no other disinterested lender would have extended credit"<sup>51</sup> (hereinafter referred to as the "*N&D Properties* Test"). On the contrary, a large majority of federal courts have embraced more articulated, multi-factor tests deriving from tax cases which have dealt with the tax treatment of insider loans to solvent corporations.<sup>52</sup> Of these multi-factor tests, the most cited is an eleven-factor test (hereinafter referred to as the "*Roth Steel* Test")<sup>53</sup> which among its determinative factors lists the following: the names given to the instruments, if any, evidencing the indebtedness; the presence or absence of a fixed maturity date and schedule of payments; the presence or absence of a fixed interest rate and interest payments; the source of repayments; the adequacy or inadequacy of capitalization; the identity of interests between the creditor and the stockholder; the security, if any, for the advances; the corporation's ability to obtain financing from outside

49. See Cameron J. Schlager, *Bankruptcy, Debt Recharacterization, and the Constitution – An Erie Relationship*, 93 AMERICAN BANKRUPTCY LAW JOURNAL 1, 3 (2019) (“[T]he use of the recharacterization doctrine in bankruptcy is on the rise.”).

50. While the power to recharacterize is generally recognized by circuit courts having addressed the issue, all of which have resolved in the affirmative the question of whether bankruptcy courts are entitled to reframe a suspect loan transaction as an equity contribution, a few bankruptcy courts still object to judicial recharacterization based on the lack of any statutory basis. See Rebecca S. McMahon, *Codification and Clarity: Debt Recharacterization*, 34 EMORY BANKRUPTCY DEVELOPMENTS JOURNAL 603, 615-18 (2018). Of the circuits which do find sufficient authority to recharacterize in the Bankruptcy Code, most tie such authority to the general equitable powers afforded to a bankruptcy court in §105(a), whereas a minority hold that the power to recharacterize lies in the claim allowance and disallowance provision of §502(b). See *id.* at 618-22.

51. See *Estes v. N&D Properties, Inc. (In re N&D Properties, Inc.)*, 799 FEDERAL REPORTER (SECOND SERIES) 726, 733 (United States Court of Appeals for the 11<sup>th</sup> Circuit, 1986) (arguably the case originating this doctrine).

52. The purpose of the tax cases is that of ascertaining whether interest expenses are deductible from taxable income or not.

53. Spelled out firstly in *Roth Steel Tube Co. v. Commissioner of Internal Revenue*, 800 FEDERAL REPORTER (SECOND SERIES) 625, 630 (United States Court of Appeals for the 6<sup>th</sup> Circuit, 1986), certiorari denied, 481 UNITED STATES REPORTS 1014 (United States Supreme Court, 1987), it has since been followed by federal courts of most other circuits.

lending institutions; the extent to which the advances were subordinated to the claims of outside creditors; the extent to which the advances were used to acquire capital assets; and the presence or absence of a sinking fund to provide repayments. The *Roth Steel Test* entails an “open-ended inquiry” where no one factor is controlling and the weight given to each factor may vary from case to case.<sup>54</sup> A creditor’s status as an insider and the undercapitalization of the borrower alone are usually deemed insufficient grounds to trigger debt recharacterization.<sup>55</sup> The judicial scrutiny looks into the context in which the loan was made and its terms.<sup>56</sup> The focus is on the intent of the lender and the borrower rather than on any improper conduct of the former.<sup>57</sup> Creditor behaviour purportedly matters only to establish whether at the time of the advance the parties wanted it to be debt or equity.<sup>58</sup> This is being done in an openly declared attempt to distinguish debt recharacterization from equitable subordination and have the inquiry under the former doctrine precede the one under the latter.

Both the *N&D Properties Test* and *Roth Steel Test* have been heavily criticized. The *N&D Properties Test* is being blamed for making initial undercapitalization alone a determinative factor, since undercapitalization *per se* says nothing about the intent of a lender as to the nature of its later advances to the company. Even more troubling is the use of the disinterested outside lender as the paradigm against which to evaluate whether the funding from an insider can credibly qualify as a debt as opposed to equity. Insofar as a company may need inside rescue financing precisely because, and at a time when, it finds it hard or impossible at all to get an outsider to lend on reasonable terms, such a standard would systematically impair if not *de facto* preclude inside credit as a source of eve-of-bankruptcy financing.<sup>59</sup> The *Roth Steel Test*, in turn, has first

54. See Wilton & McGee, *supra* note 32, at 96.

55. See *id.*

56. See *id.*

57. See *id.*

58. See *id.*

59. See *id.* at 94-95. Besides, the impropriety of using an arm’s length lender standard in this context becomes all the more apparent as one considers debtor-in-possession (DIP) financing rules. See *id.* at 104. According to United States Code, Tit. 11, §364(c), a DIP may be authorized by the bankruptcy court to obtain credit benefitting from superpriority over both pre-petition debt and §364(a) and §364(b) priority administrative expenses only if the trustee is unable to obtain unsecured credit pursuant to either §364(a) or §364(b). Inside credit is allowable as DIP financing. See *In re Medical Software Solutions*, 286 BANKRUPTCY REPORTER 431, 437 (United States Bankruptcy Court for the District of Utah, 2002) (recognizing that DIP financing from an insider was instrumental to ensuring that the debtor could continue its operations). It is therefore legally sanctioned that in times of financial distress inside debt financing should operate, and can be relied upon, as a substitute for unavailable outside debt. Recharacterizing pre-petition inside debt as equity when and because no other external lender

been dismissed by tax authorities themselves as a source of “inconsistent and unpredictable results” for tax purposes.<sup>60</sup> *A fortiori* it is being viewed by many observers as simply inadequate to detect capital contributions to insolvent companies disguised as loan advances to the extent its multiple factors are either too vague, out of context, or utterly inapplicable to the financing of companies in or near insolvency.<sup>61</sup>

Aside from the vagaries of courts in applying the doctrine of recharacterization of debt as equity,<sup>62</sup> the shared rationale may easily be found in the willingness to circumvent the limits of the doctrine of inequitable subordination. By negating the requirement of inequitable conduct by the insider, courts have created a separate cause of action to the advantage of bankruptcy trustees, who can more easily recover purportedly loaned money for the benefit of the unaffiliated creditors. Yet, on closer inspection it turns out that most of those very same courts still end up explicitly or implicitly demanding for evidence of some impropriety in the creditor behaviour. In their attempt to prevent unfair results, courts do not forget about the negative fallouts from too easily forcing debt recharacterization upon good-faith lending shareholders. In light of this, the two doctrines taken together confirm and strengthen the requirement of some inequity in the insider creditor behaviour for its claim to be disallowed or postponed to those of general unsecured creditors. Considering that subordinating a debt claim is much akin to recharacterizing it as equity as to the economic consequences for the lender,<sup>63</sup> the two doctrines, albeit formally distinct in their premises and their effects, substantively overlap to a large extent.<sup>64</sup>

would have lent is inconsistent with the eligibility of inside debt as a post-petition funding source when and to the extent no other external lender would lend.

60. See Department of the Treasury, Internal Revenue Service, *Treatment of Certain Interests in Corporations as Stock or Indebtedness*, 81 FEDERAL REGISTER 72858, 72861 (Oct. 21, 2016).

61. The erratic judicial outcomes stemming from the application of this test and other multi-factor tests have been pointed out by many commentators. See Wilton & McGee, *supra* note 32, at 106 (concluding that inconsistency and unpredictability in courtrooms “discourage out-of-court workouts and reorganizations of insolvent businesses.”).

62. See Jules S. Cohen, *Shareholder Advances: Capital or Loans*, 52 AMERICAN BANKRUPTCY LAW JOURNAL 259 (1978) (struggling to find consistent criteria in court rulings to unequivocally distinguish shareholder advances as equity from shareholder advances as debt).

63. See Ponoroff, *supra* note 39, at 1246 “[W]hether the purported claim is subordinated or disallowed, the economic impact on the claimant (and other creditors) is identical.” Obviously, while a debt claim may be equitably subordinated in whole or only in part, a debt claim that is recharacterized as an equity interest must face this destiny in its entirety. See Goehausen, *supra* note 48, at 138.

64. See Ponoroff, *supra* note 39, at 1282-88 (arguing that the doctrine of debt recharacterization should itself be recharacterized and merged into an expanded doctrine of no-fault equitable subordination).

A similar approach to insider loans based on fashioning an equitable remedy meant to curtail improper conduct has recently been adopted in Japan<sup>65</sup> and Russia.<sup>66</sup>

65. While Japanese statutory law is silent on subordination of insider loans, Japanese courts are split on the issue. On the one hand, the two most recent cases on record, which originated from the demise of the US investment bank Lehman Brothers, ruled that the making of loans by shareholders to their affiliates belongs to the realm of the ordinary economic activities taking place within corporate groups and that the status of such loans in bankruptcy cannot be affected by instances of mismanagement by the controlling shareholder alone. Besides, if the financing practice of a corporate group consists of intragroup cash transfers giving rise to intragroup debt claims and the outside creditors know or ought to know of such financing practice or implicitly rely on it, there are no grounds for them to demand subordination of debt held by the corporate affiliates of the bankrupt. See Tōkyō Kōtō Saibansho [Tōkyō High Ct.] June 30, 2010, 1372 HANREI TAIMUZU [HANTA] 228, and Tōkyō Kōtō Saibansho [Tōkyō High Ct.] July 4, 2011, 1372 HANTA 228, both discussed in Tomoki Masuda, *Subordination of Shareholder Loans in Japan*, University of Toyama Faculty of Economics Working Paper No. 319 (June 2018), 4, [researchmap.jp/tomokimasuda/misc/18267432/attachment\\_file.pdf](http://researchmap.jp/tomokimasuda/misc/18267432/attachment_file.pdf). In contrast, a few older cases maintained that in the presence of a controlling shareholder who mismanaged the company up to triggering the bankruptcy thereof, it is within the powers of the court to rule in favor of the subordination of the debt claims inuring to said controlling shareholder. Settled principles such as equity and good faith are sufficient ground to enable the bankruptcy court to downgrade shareholder-creditors' debt claims for the protection of outside creditors. See *id.* at 4-5. Japanese commentators, too, are divided among the many advocating for subordination of shareholder loans in bankruptcy under the range of circumstances and based on the concerns usually referred to in US case law and American and German legal literature and those claiming the uselessness or, worse, the counterproductive effects of the remedy of subordination in light of its potential to chilling efficient insider loans. See *id.* at 18-21 (concluding against the adoption of the subordination remedy in Japan). Although Japanese law, unlike US law, does not explicitly uphold subordination of creditor claims in bankruptcy, it turns out that Japanese courts believe to have the discretionary authority to employ it where the equities of the case so require, just as US courts do. Still, the small numbers of cases available does not make clear under what conditions equity and good faith in effect invite subordination. Sure enough, the abovementioned cases show the existence of a wedge between the courts' claim of holding the power to order equitable subordination and their willingness to extensively follow up on such claim in practice.

66. In the absence of a statutory provision on shareholder loans, the relationship between lending shareholders and borrowing companies had always been dealt with according to ordinary contract law principles. But a recent ruling handed down by the Russian Supreme Court seems to have changed the rules of the game. Under the doctrine of corporate claims employed by Russian courts, shareholders cannot assert claims against the estate of the bankrupt company based on debt arising from the corporate relationship. For instance, they cannot claim unpaid, yet declared dividends. Nor can they claim the value of shares put back to the issuing company. But it was not until 2017 that the doctrine of corporate claims was applied to inside debt financing. See Ilya Kokorin, *Risks for Insider-Financed Restructurings in Russia*, Inside Story (September 2017), [www.insol-europe.org/news/inside-stories](http://www.insol-europe.org/news/inside-stories). In a case involving a bankrupt company whose controlling shareholder had appropriated corporate resources by means of large dividend payments, caused the company to suffer from a liquidity shortage, and

In contrast, Italy brings to the fore an example of the first approach, that is, undercapitalization alone being sufficient to trigger subordination of insider claims. The law of limited liability companies and of corporate groups provides that the repayment of debt advances made by a company's equityholders is subordinated to that of all other debt claims if the advance was made at a time when the company was overleveraged or when its financial conditions were such as to require a capital contribution.<sup>67</sup> The rigor of the Italian approach is twofold. First, according to the Supreme Court the downgrading must hit the advances made by all equityholders, including nonmanagement and minority ones.<sup>68</sup> The fact alone of being the holder of a dual claim is assumed to be all that matters, for the ownership interest regardless of its size grants the dual-claim holder information rights that a pure creditor does not have. The potential informational asymmetry between dual-claim holders and pure creditors is sufficient ground to command subordination of the former's debt claims independent of any effective exercise of corporate control or improper conduct. Second, as construed by the Supreme Court, subordination of equityholder loans is complete, meaning that it operates independently of the commencement of an insolvency proceeding.<sup>69</sup> The "original sin" of having provided debt at a time when a capital contribution was the "right" financing decision to take forecloses the reimbursement of the equityholder's debt until all other debts have been paid off in full. Moreover, although by statute this form of equitable subordination only applies to debts held by equityholders

then used the same money to make advances to the controlled company, the Russian Federation Supreme Court made use of the doctrine of corporate claims to recharacterize those advances as capital contributions. See Verkhovnyĭ Sud Rossiĭskoi, Opredeĭeniye ot 6 Iyulya 2017 r. N 308-ĖC17-1556(2) [Ruling of the Russian Federation Supreme Court of July 6, 2017, Sviridov v. Neftegazmash-Technologies]. To be sure, according to the decision not all the advances from shareholders warrant recharacterization or subordination. What tips the balance in favour of an insider's claim disallowance are its conduct prior to insolvency, the context in which as well as the terms on which credit was extended, and broad fairness considerations. Consistent with abovementioned ruling, the guidelines issued by the Presidium of the Russian Supreme Court in January 2020, after clarifying the under Russian law debt claims held by equityholders are not automatically subordinated *per se*, instruct lower courts to consider subordinating advances when made by controlling shareholders and/or their affiliates at the start-up of the company, unless there was a proper business purpose to choose debt rather than equity, as well as at a time in which the company must file for bankruptcy. Although much more must be said before this new doctrine settles down and the doubts it now carries with it are dispelled, Russian legal system seems to be moving in the direction of a full-blown equitable subordination approach.

67. See Codice civile (C. civ.) [Civil Code], artt. 2467 and 2497-*quinquies*.

68. See Cass., 31 gennaio 2019, n. 3017, SOCIETÀ 2019, 803. By contrast, debt claims held by non-equityholder insiders are inconsistently exempt from subordination.

69. See Cass., 15 maggio 2019, n. 12994, FORO IT. 2019, I, 2315.

in limited liability companies and by parent companies controlling and managing their subsidiaries (*i.e.* debts arising from intragroup transactions), whether such subsidiaries are limited liability companies or corporations, case law has extended its application by analogy to debts issued by closely-held corporations to any influential shareholders, even where the latter do not qualify as a dominating parent company.<sup>70</sup> The Italian approach, by stripping equityholders' debt of its priority right, results in the placing on lending equity owners of something akin to an "affirmative duty of cooperation with creditors".<sup>71</sup>

Italy is by no means the only European jurisdiction taking this approach. A similar solution is in place in other European legal regimes, although the details thereof may differ in some respect.<sup>72</sup>

## *2. Advantages and Disadvantages of the Equitable Subordination Approach*

The equitable subordination approach, regardless of how it is fashioned, vests a modifiable property rule in the insiders, *i.e.* a property rule which is made contingent and subject to reversal.

More specifically, insiders are permitted to take back a percentage of creditors' priority rights over the firm assets without the latter's consent on condition that they behave fairly, whatever behaving fairly means in the

70. See Cass., 20 giugno 2018, n. 16291, FORO IT. 2018, I, 2750. To recapitulate, insiders who are targeted by the remedy of equitable subordination are: All equityholder-creditors of a limited liability company; large, influential shareholder-creditors of a closely-held corporation, whether it is listed or unlisted; the lending parent company, provided that it exerts dominance over a limited liability subsidiary company or a subsidiary corporation, whether it is listed or unlisted.

71. For this phrase and the controversial existence of such duty in US case law, see Clark, *supra* note 24, at 547.

72. For instance, under Austrian law (see *Eigenkapitalersatz-Gesetz* (EKEG) [Act on Equity Substitution]), for a loan to be subordinated to all other secured and unsecured claims it must have been made by a shareholder possessing at least 25% of the share capital or by any other person who can be deemed in control of the company. Besides, the debt must have been issued by the company when it was in financial distress, which notion is defined as comprising situations of cash-flow insolvency, balance-sheet insolvency, or thin capitalization, which occurs when the equity-to-debt ratio falls below 8% and the duration of the company's indebtedness calculated for this purpose exceeds 15 years, unless a reorganization of the company is not required under the law. Loans made and not terminated before the start of the financial distress are exempt from subordination, as is credit extended to a financially-distressed company by a person simultaneously purchasing a qualifying equity position, provided that the financing falls within the framework of a corporate reorganization. Exemption from subordination is also granted to short-term cash advances.

various jurisdictions. By contrast, if insiders act improperly, they face a penalty. The penalty may range from a recharacterization of their debt as equity or a subordination of their debt to pure creditors' debt. This penalty is but a reversal in the allocation of the background entitlements. In case of insider opportunism, the property-rule protection therefore shifts to creditors. And it is the court the external authority that is delegated the power to correct the resulting misallocation by reallocating the initial entitlement away from inefficient insiders to efficient outside creditors based on the *ex post* court's observation of the outside debt value-reducing actions taken by the insider creditor. The adoption of a modifiable, state-contingent property rule, whereby the entitlement to act free of interference is reallocated *ex post* in light of the observable behaviour of the opposing parties, is yet another example of a remedy developed in equity to counter the opportunism of the agents for the benefit of the principals.

The strength of the equitable subordination approach, whatever its contours, lies in its flexibility. As with standards of behaviour in general, it vests the courts with the authority to adjust its application to changing needs and circumstances. Its being context-specific and adjustable contributes to avoid the shortcomings of the one-size-fits-all approach typical of mandatory rules. Besides, though modifiable *ex post*, the *ex ante* property-rule protection afforded insiders diminishes the risk of strategic behaviour in negotiations for a reallocation of the entitlement. Insofar as equityholders and other insiders have more homogenous preferences than have pure debtholders, allocating the entitlement to claim back a percentage of priority rights over the firm assets to the former rather than according the latter the entitlement to veto the dilution of their rights ensures that an efficient reallocation of the entitlement not be strategically held out in furtherance of a private interest contrary to the joint one. In doing so, this approach resembles the no-subordination approach.

As a result of this initial allocation of the entitlement, insiders have a greater incentive to provide rescue financing to ailing firms. As long as they act with good faith, they are allowed to provide the necessary liquidity to revamp the business in the form of debt without fear of a later downgrading of their claim. In resting assured that the status of their debt claim will not change in response to an adjudication of their company as bankrupt except for wrongdoing attributable to them, insiders may channel funds into the company precisely when they are more needed, *i.e.* when no other outsider would trust to extend further credit, while partially insuring themselves against downside risks.

The equitable subordination approach is however complex to the extent it entails a comprehensive review of the inside creditor conduct in search for some inequity. As with all standards conceived to curb opportunism, the court

must establish whether the insider has behaved strategically and the strategic behaviour has crossed the threshold of permissibility. The subjectivity involved in this type of review may well produce divergent applications of the standard across the judiciary, thereby undermining legal certainty. This uncertainty and ensuing unpredictability are what many observers blame on equitable subordination and debt recharacterization as they have so far been applied across the US. What is more, the uncertainty is compounded by the principle according to which unfair conduct untied to origination or acquisition of the claim nonetheless weighs in favor of subordination or recharacterization. Brought to its extreme, this holding entails that any insider's threshold misbehavior, regardless of its timing and relevance to the asserted claim, may be used to invoke a modification of the entitlement to the insider's detriment. The extent to which courts are empowered to modify *ex post* even *ex ante* legitimate debt entitlements strengthens the incentives for belated creditors to litigate insiders' claims, with the effect of rendering the status of insiders' claims in bankruptcy more volatile than they would otherwise be. At the same time, to the extent some form of malfeasance by the insiders is needed for subordination or recharacterization to apply, the law fails to prevent that thin capitalization coupled with indebtedness to insiders become the capital structure of choice for too many financially fragile firms. Whether it is bad faith or good faith that accompanies a firm's owners in opting for an imbalanced capital structure, the fact is that the more the inside debt-to-inside equity ratio increases, the more the insiders are incentivized to push the firm in the territory of excessive risk-taking and overinvestment. Therefore, the equitable subordination approach based on insiders' wrongdoing, while sowing doubts in good-faith insider lenders fearing to be penalized by judicial errors, does not do much to diminish the incentives for opportunistic insiders to engage in inefficient lending and risk-taking.

### **C. The Automatic Subordination Regulatory Approach**

The next two Paragraphs are devoted to the automatic subordination approach, that is, an approach which subordinates insider lending *per se*. Paragraph 1 studies the main characteristics of this regulatory approach. In doing so, Paragraph 1 briefly describes some of the most prominent jurisdictions featuring this regulatory option, including, among others, Germany, Spain and Brazil. Paragraph 2 highlights the advantages and disadvantages of such an approach.

## 1. Core Features of the Automatic Subordination Approach

The automatic subordination approach is characterized by the compulsory subordination of loans made by a firm's insiders in the event of insolvency of the borrower firm, regardless of the conduct of the insider lenders, the financial conditions of the firm at the time of the loan and the timing of the loan itself. Loans from the insiders are subordinated to all other corporate debts merely based on the nature of the lender and the later advent of bankruptcy.

Automatic subordination of inside debt financing adds to the rules on director misconduct and liability. Albeit operating on a different level, as subordination of insider creditors' claims is made independent of any finding of liability on the part of directors and shareholders in managing the firm, it actually aims at complementing director liability rules in that it calls for insider creditors to commit their claims to reduce the loss for outside creditors if insolvency materializes.

Automatic subordination of insider loans is usually inchoate and triggered by the commencement of a bankruptcy proceeding. Its goal is to rewrite the ranking of priorities in bankruptcy so that the bankruptcy trustee be instructed to distribute the estate according to an order of payments different from the one that would apply in the context of a solvent liquidation. The automatic subordination remedy does not apply outside of a formal insolvency proceeding. The rationale is that if the company is not adjudicated as insolvent, there is no immediate or cognizable threat to the interests of creditors arising from the repayment of an insider loan. In the absence of an actual prejudice, a generalized prohibition to reimburse inside debt as such would inefficiently place too heavy a burden on debt financing from the insiders, who would be discouraged from providing their entity with valuable financial resources in the form of debt.<sup>73</sup>

73. The automatic subordination approach *de facto* turns the debt held by insiders into a form of contingent convertible debt characterized by a mandatory conversion feature and a trigger consisting of the commencement of an insolvency proceeding. Although the claim is formally subordinated rather than converted into equity, the approach still provides for a loss-absorbing mechanism that is similar to that of a debt-to-equity conversion in that losses spread over to outside creditors only after holders of subordinated debt have been wiped out. To be sure, unlike contingent convertible debt issued by banks, which aims to provide an emergency buffer to replenish the equity capital long before insolvency thereby performing a bail-in function (see Charles W. Calomiris & Richard J. Herring, *How to Design a Contingent Convertible Debt Requirement That Helps Solve Our Too-Big-to-Fail Problem*, 25 JOURNAL OF APPLIED CORPORATE FINANCE 39, 44 (2013)), the form of contingent convertible debt herein discussed does not purport to prevent bankruptcy generated by capital losses. The contingency triggering subordination is in fact the bankruptcy itself. But, as with banking

Germany has adopted this approach since the 2008 reforms of its law of limited liability companies and insolvency law.<sup>74</sup> Until 2008 case law and statutory law had put in place a regime by which equityholders holding managerial positions and equityholders having more than 10% of a limited liability company's equity capital or more than 25% of a corporation's share capital might have had their loans to the company subordinated to the claims of the general unsecured creditors in the distribution of the bankrupt estate. Subordination would affect only those loans that were deemed to have been provided as a substitute for equity capital. The conclusion that a loan was a substitute for equity capital was reached with regard to both loans provided to a company at a time when it was in financial distress and loans provided to a solvent company if not terminated before the company fell into financial distress. The approach recalled that of equitable subordination insofar as not all loans by the shareholders *per se* were automatically subordinated, but only those that were made in circumstances where a reasonably prudent shareholder would have made a capital contribution. Nonetheless, given the wide latitude of the notion of a company's financial distress,<sup>75</sup> as a matter of fact most if not all loans still outstanding at the time of the insolvency would be subject to subordination.<sup>76</sup>

Since the 2008 reforms German law has dismissed the ambiguous notion of loans substituting for equity capital and subjected to subordination all shareholders' loans *per se* if a few further requirements are met. Moreover, German law has unified the legal treatment of shareholder loans whether they are made to limited liability companies or corporations. Under current

contingent convertible debt, whose issuance poses a credible threat to the existing shareholders that their equity interests will severely be diluted in the event of conversion, the automatic subordination of shareholder loans sets incentives for the insiders to steer the company clear of adverse states of the world to avoid the deepening of their financial suffering. As a result, the automatic subordination approach similarly acts as a disciplinary device on shareholder-appointed management.

74. See Dirk A. Verse, *Shareholder Loans in Corporate Insolvency – A New Approach to an Old Problem*, 9 GERMAN LAW JOURNAL 1109 (2008).

75. A company was deemed to be in financial distress for purposes of subordination of shareholder loans when the company was insolvent or near insolvency if it had not been for the liquidity provided by means of the loan; the company had an excessive indebtedness; and the company lost its creditworthiness, *i.e.* no outside creditor would have extended credit to it on reasonable market terms.

76. To the extent the conditions of financial distress always precede the formal adjudication of a company as a bankrupt, loans that had not yet been repaid before the formal commencement of the insolvency proceeding were inevitably viewed as loans not terminated before the beginning of the company's financial distress. As such, they were captured by the subordination remedy.

German law, inside debt financing claims rank below all other debt claims when the company is placed into an insolvency proceeding.<sup>77</sup> As a consequence of subordination, the payment of insiders' claims is made conditional on the prior full satisfaction of outside creditors' claims. Insiders are deemed to be shareholders who either serve as directors or hold more than 10% of a company's equity capital.<sup>78</sup> Nevertheless, a loan from a 10%-plus shareholder is exempt from subordination if it was provided by an investor who, in connection with the provision of a credit facility to an insolvent or overindebted company, acquired shares in excess of 10% with a view to restoring the financial soundness of the firm. The exemption lasts until such financial soundness is achieved.<sup>79</sup>

In adopting an automatic subordination rule, Germany seemingly followed Spain, which has provided for inchoate subordination since regulating shareholder loans in 2003.<sup>80</sup> Other European jurisdictions strike a similar, although not necessarily identical, note on the theme of insider loans.<sup>81</sup>

Brazilian law, in turn, goes even further than all of the above-mentioned

77. See *Insolvenzordnung* (InsO) [Insolvency Act], §39, para. 1, no. 5.

78. See InsO, §39, para. 5.

79. See InsO, §39, para. 4.

80. Spanish insolvency law (Ley Concursal, as was consolidated by Real Decreto Legislativo 1/2020, de 5 de mayo), too, distinguishes between outside and inside lenders and automatically commands subordination of the latter's loans once an insolvency proceeding commences. See art. 281, para. 1, no. 5. Insiders for the purposes of subordination of their debt claims are the stockholders owning either directly or indirectly at least 5% of the share capital of a bankrupt publicly-traded corporation and at least 10% of the share capital of a bankrupt nonpublicly-traded company. See art. 283, para. 1. (If the relevant threshold is crossed by an already-existing shareholder only after the credit advancement, the rule does not apply). Insiders are also the following: the formally-appointed and *de facto* directors of the bankrupt company, including those having held such positions anytime in the two years prior to the insolvency; the companies belonging to the same group to which the bankrupt company belongs; the 10% or 5% shareholders of companies of the same group to which the bankrupt company belongs to. See art. 283, para. 2, 3 and 4, respectively.

81. Differently from German and Spanish laws, Portuguese law expressly subordinates solely shareholder loans made to limited liability companies in the event of the insolvency or dissolution of the company, but it does so independently of the size of the equity interest held by the lender and the timing of the loan. See *Código das Sociedades Comerciais* [Business Associations Code], art. 245, para. 3. Another example of automatic subordination comes from Greece's law of limited liability companies, and it comes with an interesting twist. While Spanish- and German-style subordinations spring into effect at the time when an insolvency proceeding commences, Greek subordination does just the opposite, as it becomes effective upon dissolution of the company for any reason except for, at least statutorily, a judicial liquidation. See *Nómos 3190/1955 Perí Etaireión Periorisménis Eftýnis* [law of limited liability companies], art. 32, para. 3. Unlike most other European jurisdictions, Greek law further singles itself out by expressly stating that the granting of a security upon the company's assets in favor of a lending shareholder is barred. See art. 32, para. 1. In case of illegitimate

European laws insofar as it automatically subordinates all debt claims held by whichever shareholder or director in all types of companies without distinction.<sup>82</sup> According to this wide-ranging, far-reaching subordination remedy, not only is the debt owed shareholders resulting from advances subordinated to the debt owed outside creditors but also the debt related to the compensation owed directors falls within the scope of such automatic subordination.<sup>83</sup>

## 2. *Advantages and Disadvantages of the Automatic Subordination Approach*

The automatic subordination approach grants outside creditors a property rule for the strongest protection of their priority rights. Insiders cannot change the order of priorities in the distribution of a bankrupt firm's assets without the creditors' consent. Put differently, outside creditors' entitlements are not exposed to the risk of dilution as a consequence of an insider willing to claim back a percentage of priority rights on the assets in its capacity as a creditor. The automatism implied in this remedy, which is obtained by means of a *per se* rule,<sup>84</sup> renders the approach far more straightforward than the equitable subordination approach in that it is smoother to apply and less prone to *ex post* litigation.<sup>85</sup>

Automatic subordination of inside debt finds its rationale in the more severe shareholder-creditor agency problems that closely-held firms experience. As share ownership becomes more concentrated, managers become more accountable to shareholders.<sup>86</sup> Where a controlling shareholder or coalition of shareholders emerge, managers' incentives to pursue shareholders' interests are more pronounced. When the closely-held firm is small, shareholders and managers often coincide in whole or in part, and when this happens managers and shareholders' incentives are aligned by definition.<sup>87</sup> But even

provision of collateral for the security of the debt, what is voided is the security alone, with the debt remaining effective as unsecured and subordinated.

82. See Lei No. 11.101, 9 fevereiro de 2005, art. 83, para. VIII.

83. See Francisco Satiro de Souza, Júnior, *Article 83*, in *COMENTÁRIOS À LEI DE RECUPERAÇÃO DE EMPRESAS E FALÊNCIA: LEI 11.101/2005* 358, 369 (Francisco Satiro de Souza, Jr. & Antônio Sérgio A. de Moraes Pitombo eds. 2007).

84. See Leonard J. Long, *Automatic Subordination as Incentive for Insider Creditors' Prudential Investing*, 13 *JOURNAL OF LAW & COMMERCE* 97, 134 (1993).

85. Such a rule draws a line which is "bright, clear and hard". See Long *supra* note 84, at 142.

86. See Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 *UNIVERSITY OF PENNSYLVANIA LAW REVIEW* 1907 (2012).

87. Empirical evidence confirms that creditors give weight to the wedge between control rights and cash-flow rights. The greater the wedge, the higher the cost of debt to the firm. Besides, the effect on bank loan spreads are amplified when the closely-held firm's family-

if the firm is large and managers do not hold substantial equity stakes, they face a greater chance to be dismissed or rewarded less when failing to cater to dominant shareholders' expectations. These implicit threats give managers an incentive to direct their efforts at creating shareholder value, possibly at the expense of creditor interests. To be sure, in response to soaring levels of share concentration outside debt might become more concentrated, too.<sup>88</sup> And when outside debt is more concentrated, monitoring efforts are stepped up so as to offset the increasing shareholder-creditor agency problems. Still, insiders are better informed about the prospects of the firm than are creditors and have control of the company to the exclusion of creditors.<sup>89</sup> Besides, when the borrower is a subsidiary in a group of companies and the lender is the parent company or another subsidiary of the group, the ownership concentration does not necessarily prevent the parent from bearing risk more efficiently than do outside creditors. Quite the opposite, the multi-member and multinational structure of the group could make the internal lender a more efficient risk bearer than is an external lender.<sup>90</sup> Therefore, vesting a property-rule protection in the creditors' class may be viewed as a sound regulatory policy to the extent it may balance the one-sided shareholder control over the firm's capital structure. Whenever the creditors' class is wholly or partially filled with nonadjusting creditors, this rationale grows even stronger.

Firstly, in protecting creditors by means of a property rule, automatic subordination of insiders' debt advances accords voluntary creditors a bargaining advantage and reduces the costs of creditor protection by saving in transaction costs involved in agreeing to and drafting subordination clauses. Secondly, automatic

owned, with the CEO being part of the controlling family, and when it is small. See Chen Lin, Yue Ma, Paul Malatesta & Yuhai Xuan, *Ownership structure and the cost of corporate borrowing*, 100 JOURNAL OF FINANCIAL ECONOMICS 1 (2011).

88. The presence of a strong, controlling shareholder driving management to pursue its interests commands in equilibrium the presence of an equally strong creditor with the incentive and power to monitor and constrain an excessively controlling shareholder-oriented management. See *supra* Part II, Section G, note 57.

89. Automatic subordination of shareholder-creditors' claims to all other debt claims fits the more general pattern according to which better informed and more skillful monitoring creditors should rank low in the order of priorities and less informed and less skilled creditors should rank high so as to shift the burden of monitoring, and the ensuing incentive, to those creditors that can sustain such burden at lower cost for the benefit of the whole creditor class. See Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities among Creditors*, 88 YALE LAW JOURNAL 1143, 1154-56 (1979).

90. Groups of companies rely on internal capital markets as a complement to, or substitute for, external capital markets to fund their projects. All else being equal, external funds are more costly to obtain and allocate than are internally-generated funds due to information asymmetries and agency costs. See *supra* Part II, Section D.

subordination of inside debt financing operates as a screening mechanism. This remedy filters out insiders that are not prepared to run a higher risk of loss because of the lower priority of their claims in bankruptcy. This should help to populate the market with insiders that have greater commitment to avoid bankruptcy and greater faith in their ability to do so. Lastly, by increasing the recovery chances of all unsecured creditors in bankruptcy, including those of nonadjusting ones, it simultaneously prevents that opportunistic insider loans cause harmful externalities to the detriment of tort and trade creditors. Prevention of negative externalities to the injury of a class of defenseless debt claimants brings about efficiency gains and provides a response to fairness concerns.

Nevertheless, all this is obtained at the cost of marginally discouraging pre-insolvency insider financing even when the latter is strongly needed to counter both overinvestment and underinvestment. In reducing the likelihood that the controllers will extend credit at the doorstep of their company's critical financial conditions, the automatic subordination of inside debt financing may go in the direction opposite to that of curbing extreme moral hazard attitudes of firm owners typical of pre-insolvency situations. Once the company nears insolvency, unsecured creditors, whether they are protected by loan covenants or not, are faced with an endgame problem.<sup>91</sup> While the firm owners have an incentive to engage in value appropriation by assuming excessive risks, creditors have no means to credibly threaten retaliation. If the continuing lending relationship were abruptly brought to a halt by the ultimate demise of the firm, there would be nothing left to retaliate against.<sup>92</sup> Therefore, assuming that incentives toward risk-shifting at creditors' expense can be diminished by inducing equity owners to have further skin in the game,<sup>93</sup> disincentivizing such investments in the form of debt results in aggravating rather than ameliorating this agency problem. Besides, without a concrete chance to share with the creditors the potential value created by additional financial and managerial efforts, the insiders' possibility and willingness to outmaneuver the debt overhang, which makes unlikely for them to ever see a profit in the near future, is severely compromised. Furthermore, even if an agreement to contract around the rule is conceivable that maximizes the joint payoffs of the classes of shareholders and creditors, the mandatory feature of the subordination rule, to the extent it provides each outside creditor with a veto right over any *ex post* renegotiation

91. See *supra* Part II, Section G, notes 64-66 and accompanying text.

92. This is the reason why default clauses in loan agreements are designed to be triggered long before an irremediable insolvency occurs. See *supra* Part II, Section G, note 61.

93. Getting the insiders to put additional money of their own at risk of loss makes sure that they think more thoroughly than they would otherwise do before recklessly gambling with what is left of asset value.

of their individual claims' priority, might unduly constrain if not undermine pre-insolvency refinancing efforts and out-of-court workouts even when a rescue attempt is socially desirable. The more fragmented and heterogenous the creditors as a class are, the more severe this holdout problem may become.

Automatic subordination might also be blamed for increasing external borrowing costs for fully-solvent firms. In a world where lenders may take advantage of the lack of a generalized subordination remedy by demanding a contractual subordination of insiders' claims to their exclusive advantage, it may be argued that by precluding this bargaining possibility the cost of external credit would tick upwards.

To sum up, the existence of net efficiency gains from the automatic subordination approach is questionable much like it is with regard to both the no-subordination approach and the equitable subordination one. And while this remedy is overall fairer than the others, it certainly is the least flexible whenever the lack of statutory exceptions, carveouts or safe harbors makes it insensitive to insider-specific or firm-specific circumstances that may occasionally justify a more lenient treatment of debt financing from the insider base.<sup>94</sup>

94. It is noteworthy that no jurisdiction I am aware of utilizes a liability rule protection. A conventional liability rule protection granted to the outside creditors would mean that insiders could loan and gain equal ranking in exchange for a statutory or court-determined price. A reverse liability rule would be theoretically possible, too. Under such a rule, outside creditors could obtain superior ranking by paying a statutory or court-determined "bribe" to the insiders. On reflection, though, it becomes apparent why no jurisdiction has so far ventured in the domain of a conventional liability rule, let alone a reverse liability rule, for the allocation of the entitlements at hand. Setting the damages for outside creditors under a conventional liability rule or the bribe to be paid to insiders under a reverse liability rule with a view to having the taker internalize the cost to the counterparty of the involuntary exchange would be exceedingly difficult for any rulemaking authority. To be sure, a conventional liability rule could provide for acceleration of the outside debt, an increase of the interest rate on the loan, the provision of interest payments on an otherwise interest-free debt, or other similar solutions aimed at compensating the outside creditor for an increase in the probability of not being paid back. But the task of establishing a proper remedy and the correct amount in order to neither undercompensate nor overcompensate outside creditors seems daunting. While the damage arising from inside debt should be set equal to the reduction in value of the outside debt, where the outside debt is not publicly traded such a value reduction would be difficult to ascertain. Additionally, new outside debt could arise only after the company has incurred inside debt. In such an event, one should carry out a hypothetical analysis as to how much the outside debt would have been worth if inside debt had not existed. Furthermore, judgment-proof problems affecting the borrower company, *i.e.* debtor's inability to pay back owing to insufficient or illiquid assets, could render the remedy unenforceable. Not surprisingly, the superiority of property rules over liability rules when damages are too difficult to assess by an external authority and judgment-proof problems exist is widely accepted in the literature. See Louis Kaplow & Steven Shavell, *Property Rules Versus Liability Rules: An Economic Analysis*, 109 HARVARD LAW REVIEW 713 (1996).

## D. The Avoidable Preference Rules

Generally, preference avoidance provisions set aside payments made by an insolvent debtor to any of its creditors within a certain timeframe before the advent of an insolvency proceeding on grounds that the payment is presumed to have advantaged the recipient at the expense of all other unpaid creditors.

To be sure, a preference, unlike a fraudulent conveyance, does not actually damage the debtor or necessarily implies an intent to defraud creditors, since the payment is due. A preference does however damage all creditors other than the transacting creditor to the extent it sorts the beneficiary from a pool of creditors whose chance to be paid back solely depends on the distribution of the bankrupt estate, itself diminished by the early, full payment of the preferred creditor. Therefore, a readily apparent rationale behind preference avoidance provisions is ensuring equality of treatment among the creditors.

In addition to the equal treatment of creditors, there exist powerful efficiency considerations recommending the use of preference avoidance, too. First, knowing that under conditions of financial distress full repayment of one debt may reduce the chances of reimbursement of other debts, each creditor of a nearly-insolvent firm would scramble to seek the payment of their claims as early as possible at whatever cost to the firm. But a race to appropriate a firm's assets would dent its viability as a going concern. Preference rules are therefore deployed to prevent an early dismemberment of the debtor.<sup>95</sup> Second, preference rules mitigate the risk of overinvestment<sup>96</sup> and debt dilution. They impede transactions whereby financially-distressed debtors, which would be efficient to liquidate, might still attempt to obtain fresh finance from some of their stronger lenders at the expense of the creditor body as a whole.<sup>97</sup>

95. In doing so, they complement the rules on the automatic stay of collection activity by creditors after a firm has filed for bankruptcy. See Thomas H. Jackson, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 125 (1986). Actually, the automatic stay on its own further strengthens the incentive to collect before bankruptcy. Because of the stay of their collection efforts after bankruptcy, creditors know they have no chance to collect on an individual basis once the bankruptcy proceeding commences. As a result, they are incentivized to circumvent the stay by seeking a repayment of their debt before bankruptcy. Therefore, the harsher the stay is for creditors, the more it needs to be backed up by avoidance of preferential transactions taking place when the intervention of the stay is perceived by the creditors' class as imminent.

96. See Barry E. Adler, *A Re-Examination of Near-Bankruptcy Investment Incentives*, 62 *UNIVERSITY OF CHICAGO LAW REVIEW* 575 (1995).

97. For instance, if it were not for avoidable preference rules, a nearly-bankrupt borrower willing to continue its operations could offer a lender the reimbursement of its unsecured debt on condition that the latter extend additional credit. The lender, in turn, might well agree if such additional credit could be extended on a secured basis. But the threat of seeing reimbursement of

In light of the foregoing considerations, it becomes apparent that the rules on preference avoidance and the rules on subordination of debt claims operate on a different level, the former disciplining the conditions to the exit from the debtor-creditor relationship and the latter regulating the conditions to the entry into the relationship.<sup>98</sup> But they also have a different mode of operation. On the one hand, preference rules aim for a fair and efficient treatment of outside creditors against preferential payments to insider creditors by extending the “look-back” period, *i.e.* the period prior to bankruptcy in which the payment of a debt is treated as a preference. In doing so, they want to make sure that insider creditors cannot easily get around the impediment to an early repayment that should exist for all creditors alike. Hence, the purpose of rules on preference avoidance targeting insiders is to *equalize* insider creditors and outside creditors in light of their different possibility to game the system. On the other hand, the remedy of subordination of inside debt aims for a fair and efficient treatment of outside creditors against opportunistic insider financing by distinguishing the ranking of debt priority in bankruptcy. Hence, the purpose of rules on subordination of inside debt financing is to *differentiate* insider creditors from outside creditors despite the same contractual nature of their respective debt advances to the firm.

In their attempt to level the playing field between inside and outside debtholders, rules subjecting the reimbursement of inside debt to stricter conditions than those applicable to the reimbursement of outside debt are unsurprisingly less controversial than rules on subordination of inside debt to the benefit of outside debt.<sup>99</sup> This fact may explain why jurisdictions that provide for a remedy of subordination of inside debt do not usually fail to set forth preference avoidance provisions specifically addressing repayment of debts for the benefit of insiders, while jurisdictions that refrain from providing for a specific remedy of subordination of inside debt do not shy away from adopting specific rules on avoidance of preferences benefitting insiders.

the earlier debt avoided *ex post* as a preference reduces the incentive for a lender to make additional pre-bankruptcy advances even when such advances could be provided on a secured basis.

98. Which fact does not mean that the law of debt subordination and the law of bankruptcy preferences cannot one interfere with the other. The risk of reciprocal interference is real if the two laws are not designed consistently. See Jay L. Koh, *Equity Unbound: A Meaningful Test for Equitable Subordination*, 16 YALE LAW & POLICY REVIEW 467, 485-88 (1998) (claiming that the judicial formalistic interpretation of the notion of creditor misconduct as a prerequisite to equitable subordination does not comport well with exceptions to preference avoidance).

99. Yet, while some commentators believe that rules on repayment would suffice to deter opportunistic behaviors by insiders (see Verse, *supra* note 74, at 1115), others doubt that voidable preference rules in and of themselves exert any deterrent effect against pre-bankruptcy debt collection attempts (see Adler, *supra* note 96).

The US, Italy, Germany and Greece, among others, have specific rules for the avoidance of transactions for the benefit of insider creditors. Under §547(b) of the US Bankruptcy Code, the trustee may avoid any transaction transferring value from an insolvent debtor to or for the benefit of a creditor being an insider at the time of the transfer, including loan repayments and transfer of security interests, which would accord the creditor more than it would receive in the liquidation of the corporation if such transaction took place within a year before the date of the filing of the petition.<sup>100</sup> Along the same lines, German law provides for the avoidance of the repayment of loans made by inside equityholders if the loan was paid back in the year leading up to the filing for bankruptcy.<sup>101</sup> Besides, the German regime extends the preference period to 10 years with regard to the grant to the inside equityholder of a security for its debt.<sup>102</sup> Italian law states that the reimbursement of a debt advance made to a company by whichever shareholder, whether it is a majority or minority one, or by a non-shareholder company that nonetheless controls and manages the debtor company (for instance, by means of a contract between the two) is automatically avoided if it occurred within a year before the date of filing of the petition.<sup>103</sup> But this provision, which applies to debt advances regardless of their falling due before or after the commencement of the insolvency proceeding, only deals with debt advances made at a time when the company was overleveraged or when its financial conditions were such as to require a capital contribution. All other debt advances from a company's insiders are subject to avoidance according to ordinary preference rules, which avoid the repayment of debts falling due after the start of the bankruptcy proceeding if the payment took place within 2 years prior to the filing of the petition<sup>104</sup> as well as the repayment of debts already fallen due at the time of the payment

100. By contrast, under §547(b)(4)(A), if the beneficiary is not an insider, the transaction may be avoided only if it took place within 90 days before the date of the filing of the petition. But see also §8(f)(3) of the Uniform Voidable Transactions Act, which, unlike the Bankruptcy Code, exempts preferential transfers to insiders from avoidance "if made pursuant to a good-faith effort to rehabilitate the debtor and the transfer secured present value given for that purpose as well as an antecedent debt of the debtor". In the Official Comment, at 33, it is explicitly argued that an insider who had made an advance to a now insolvent debtor should not be dissuaded from pursuing a good-faith effort to stave off bankruptcy. Provided that the insider furnishes new value critical for the rehabilitation of the debtor, it should be allowed to extend credit in exchange for collateral securing the old and new debt.

101. See InsO, §135, para. 1, no. 2.

102. See InsO, §135, para. 1, no. 1.

103. See Codice della crisi e dell'insolvenza [Crisis and insolvency code], art. 164, para. 2 and 3.

104. See Codice della crisi e dell'insolvenza, art. 164, para. 1.

if the payment took place within 6 months prior to the filing of the petition, in the latter case provided that bankruptcy trustee is able to prove that the creditor knew of the debtor's insolvency.<sup>105</sup> A further example of related-party transaction avoidance comes from Greece's law of limited liability companies, which provides that repayment of a shareholder loan is set aside if it prejudices the satisfaction of already-outstanding third parties' claims regardless of how long before the opening of the insolvency proceeding the reimbursement was made.<sup>106</sup>

Interestingly, among the jurisdictions detailing rules on subordination of insiders' debt Spain proves an exception to the extent it does not specifically provide for the avoidance of early repayments of insider loans. Spanish law solely resorts to a general rule according to which transactions detrimental to the bankrupt estate which took place within 2 years prior to the commencement of the insolvency proceeding may be avoided without need of a finding of a fraudulent intent.<sup>107</sup> Opposite to Spain, the UK does have a specific remedy for the avoidance of preference benefitting insiders despite the absence of a specific subordination remedy. According to §§239 and 240 of the Insolvency Act 1986, whatever transaction has the effect of putting a person connected with the company into a position which, in the event of the company going into insolvent liquidation, is better than the position it would have been in if that thing had not been done is deemed a preference<sup>108</sup> and, as such, is avoidable if undertaken in the period of 2 years prior to the onset of insolvency. Among the jurisdictions embracing a no-subordination approach for inside debt, Australia goes even further than the UK by listing a number of voidable transactions the provision of which could be utilized to avoid the making and reimbursement of a shareholder loan. In particular, the law subjects to avoidance the giving of an unfair preference to a creditor,<sup>109</sup> uncommercial transactions,<sup>110</sup> the

105. See Codice della crisi e dell'insolvenza, art. 166, para. 2.

106. See Nómois 3190/1955 Perí EtaireiÓN Periorisménis Efhýnis, art. 32, para. 2.

107. See Ley Concursal, art. 226.

108. The requirement that in giving the preference the company was influenced by a desire to accord the recipient a benefit is presumed, unless the contrary is shown, when the recipient is a person connected with the company.

109. The transaction gives rise to an unfair preference «if it results in the creditor receiving from the company, in respect of an unsecured debt that the company owes to the creditor, more than the creditor would receive from the company in respect of the debt if the transaction were set aside and the creditor were to prove for the debt in a winding up of the company». See Corporations Act 2001, §588FA.

110. An uncommercial transaction occurs «if, and only if, it may be expected that a reasonable person in the company's circumstances would not have entered into the transaction, having regard to: (a) the benefits (if any) to the company of entering into the transaction; and

making and payoff of an unfair loan to the company<sup>111</sup> as well as unreasonable director-related transactions.<sup>112</sup> While the look-back period for an insolvent transaction<sup>113</sup> is ordinarily established in 6 months before the commencement of the insolvency proceeding, with regard to insolvent transactions for the benefit of related parties and unreasonable director-related transactions such period is extended to 4 years. As to unfair loans, they may be avoided regardless of the date on which they were made.<sup>114</sup>

Finally, French law confirms its indifference to the issue of insider loans by not specifically pursuing avoidance of transactions with insiders when undertaken on the brink of insolvency. The general rule is that repayment of a debt made after the date on which the debtor ceased to fulfil its obligations can be avoided if the third party who dealt with the debtor had knowledge of the debtor's insolvency,<sup>115</sup> but there are no specific provisions regarding the insiders as to the length of the preference period or presumption of knowledge of the firm's insolvency on their part.

A pattern according to which the remedy of subordination of inside debt financing, whether it consists of equitable subordination or automatic

(b) the detriment to the company of entering into the transaction; and (c) the respective benefits to other parties to the transaction of entering into it; and (d) any other relevant matter.». See Corporations Act 2001, § 588FB.

111. A loan to a company may be set aside as unfair «if, and only if: (a) the interest on the loan was extortionate when the loan was made, or has since become extortionate because of a variation; or (b) the charges in relation to the loan were extortionate when the loan was made, or have since become extortionate because of a variation; even if the interest is, or the charges are, no longer extortionate.». The initial or subsequent extortionate nature of the loan is assessed having regard to factors such as «the risk to which the lender was exposed»; «the value of any security in respect of the loan»; «the term of the loan»; «the schedule for payments of interest and charges and for repayments of principal»; «the amount of the loan»; «any other relevant matter.». See Corporations Act 2001, §588FD.

112. Among the unreasonable director-related transactions of the company the law considers a payment made by the company or the incurring by the company of an obligation to make such a payment for the benefit of a director when «it may be expected that a reasonable person in the company's circumstances would not have entered into the transaction, having regard to: (i) the benefits (if any) to the company of entering into the transaction; and (ii) the detriment to the company of entering into the transaction; and (iii) the respective benefits to other parties to the transaction of entering into it; and (iv) any other relevant matter.». See Corporations Act 2001, §588FDA.

113. A transaction is deemed an insolvent transaction when it consists of an unfair preference or an uncommercial transaction entered into when the company was insolvent or an unfair preference or uncommercial transactions the effectuation of which caused the company to become insolvent. See Corporations Act 2001, §588FC.

114. See Corporations Act 2001, §588FE.

115. See Code de commerce, art. 632-2.

subordination, is coupled with a specific avoidable preference rule has a compelling rationale. The latter is needed to back up the former. Without preference rules, insider claimants would likely exert pressure on management to make payments in the expectation of the upcoming insolvency and easily get around the penalty of subordination. The control power over the firm affairs together with the informational advantage they possess also justifies the provision of an extended look-back period to capture as many suspect transactions as it is feasible in light of the countervailing necessity of not unduly undermining transactional certainty. The insider nature of the recipient of a payment unavoidably raises the suspicion that it knew or could have known of the impending crisis long before anybody else could, and therefore that it strived to obtain an early or timely payment while the satisfaction of other creditors' claims was pushed back. Although the preference period is usually rather short to avoid *ex post* disruption of otherwise legitimate transactions, when it comes to insiders it reasonably gets doubled or stretched even further.

Likewise, jurisdictions targeting preferential payments to a firm's insiders usually drop the requirement that inside debt, the payment of which was made before the start of the insolvency proceeding, fall due thereafter. Therefore, even the payment of a debt owed an insider that became due before the commencement of the insolvency proceeding is dealt with as a preference. It could not be otherwise. Bear in mind that the very essence of a cash-flow insolvency is the failure to pay debts when they come due. If bankruptcy has ultimately occurred it must be because, alongside claims which were timely satisfied there were claims which simultaneously fell due and yet were left unpaid. In light of this, exempting from avoidance the payment of an already due debt made when the opening of an insolvency proceeding was only few weeks or months away would run counter to the logic of preventing discrimination among the creditors and a race to the debtor's assets. The slightest difference between debts' maturity dates would lead to opposite outcomes as regards the probability of repayment. Besides, when among the creditors there exist insiders, if such an exemption were introduced, not only would there be room for discrimination depending on even slightly different debt maturity dates, but insiders would also have an incentive to artificially shorten the maturity date of their claims by manipulating the loan documentation, thereby lowering chances of recovery for outside creditors even further.

To conclude, the effectiveness of rules on subordination of debt claims held by insiders would severely be impaired without accompanying preference rules curbing opportunistic reimbursement attempts.

PART VI

DETERMINANTS OF AN EFFICIENT  
AND FAIR REGULATORY INTERVENTION  
ON INSIDE DEBT FINANCING

A regulatory intervention in search for an optimal seniority of inside debt in bankruptcy must confront the fact that in a world of information asymmetries “there are no seniority rules which are capable of reducing under-investment incentives without exacerbating over-investment”.<sup>1</sup> In other words, when considering optimal priority rules the benefit of discouraging underinvestment must be balanced against the cost of encouraging overinvestment and vice versa.

Nonetheless, no-subordination, equitable subordination and automatic subordination of insiders’ debt advances, in offering a different mix of private and social benefits and costs, allow us to make choices in the pursuit of economic efficiency and distributional fairness. Choosing from among these competing remedies may be done based on the distributional concern to ensuring a fair allocation of the bankrupt’s estate among multiple, disparate claimants. In effect, these remedies vary in their distributional effects. And fairness considerations may justify preference for one approach over the others. But these remedies can be ranked along an efficiency dimension, too. And both efficiency and fairness considerations point in the same direction for regulatory purposes, although the direction changes according to the changing financial conditions of the firm.

Section A explores what efficiency and fairness objectives a desirable regulation of inside debt financing should advance. Section B focuses on unsecured insider lending and argues that while insider loans made at a point in time distant from bankruptcy should be mandatorily subordinated, insider loans made in the zone of insolvency should be exempt from subordination if properly disclosed. This solution mitigates both overinvestment at fully-

1. See Elazar Berkovitch & E. Han Kim, *Financial Contracting and Leverage Induced Over- and Under-Investment Incentives*, 45 *JOURNAL OF FINANCE* 765, 767 (1990).

solvent firms and underinvestment at nearly-insolvent firms. Section C argues that collateralization of a firm's assets to secure insider lending should be disallowed, since it incentivizes overinvestment more than it alleviates underinvestment. Section D reflects on the consistency of the subordination and no-subordination remedies with the absolute priority rule. Section E does the same exercise in respect of the relative priority rule. Section F discusses the relationship between the subordination and no-subordination remedies, on the one hand, and the rules on debtor-in-possession financing, on the other hand. Section G reasons over the importance of having avoidable preference rules guarding against attempts by insiders to dilute the asset base when insolvency looms large. Section H investigates what notion of insider should be used for the purposes of a legal remedy that is intended to subordinate insiders' debt claims.

## A. Efficiency and Fairness Objectives

At its core, an optimal regulatory action in the field of inside debt financing should pursue multiple goals simultaneously: helping a financially helpless company to take on insiders' debt whenever insiders believe in a turnaround and are ready to bet more money on the cause; reducing the probability of a firm's falling into a state of financial helplessness *ex ante* by curbing insiders' moral hazard temptations; avoiding an increase in external borrowing costs for firms; ensuring that the potential dividend owed insider creditors out of the bankrupt estate not be always and entirely captured by some inside and outside creditors to the exclusion of some other outside creditors.

To the extent subordination of inside debt to outside debt and recharacterization of inside debt as equity might lead to similar results, *i.e.* the relegation of an insider creditor's claim to a status in which the probability of obtaining a *pro-rata* distribution of the estate is close to zero, one should also wonder whether a socially desirable regulatory approach should address both doctrines in order to avoid inconsistency. In effect, the remedies of subordination and debt recharacterization might conflict with one another or exacerbate their respective effects beyond the optimum. Therefore, fashioning a proper subordination remedy would be of little use if it were not accompanied by a consistent application of the doctrine of debt recharacterization. But while gauging the desirability of a subordination (or no-subordination) remedy is challenging, evaluating the appropriateness of the doctrine of debt recharacterization is much less so. The doctrine of recharacterization of debt as equity *per se* can hardly be called into question on efficiency grounds.

Just as efficiency requires that substance not give way to form, such doctrine seeks to avoid that a money advance intended as equity *ex ante* be disguised as a loan *ex post* just because the parties later find it advantageous to pretend the advance to be debt. Without a threat of undergoing recharacterization, insiders would have an incentive to attach the formalities typical of a loan to advances intended to increase the equity capital. Doing so would give insiders a better chance to participate in the distribution of the estate in the event of bankruptcy while still leaving them free to treat their contributions as equity as long as the firm is outside of bankruptcy. A regulatory response along the lines of debt recharacterization is thus unquestionably needed to remedy a strategic behavior of this sort on the part of a firm's insiders.<sup>2</sup> Rather, the issue is how to apply the recharacterization remedy in such a way as to ensure predictability and reasonableness. But an inquiry into the proprieties of a well-functioning doctrine of debt recharacterization is beyond the scope of this work.<sup>3</sup>

## **B. Optimal Rules on Unsecured Inside Debt Financing**

In the next Paragraphs, the analysis aims to establish if and under what conditions one of the regulatory approaches examined in Part V proves superior to the other two. Paragraph 1 illustrates the superiority of the automatic subordination approach to the no-subordination and equitable subordination approaches upon a firm's solvency. By contrast, Paragraphs 2 and 3 weigh up the superiority of the no-subordination approach to the automatic and equitable subordination approaches in times of financial distress and insolvency, respectively.

2. Nevertheless, to the extent the doctrine of debt recharacterization is conceived as remedial rather than penal in nature, it has little deterrent effect. Insiders face no penalty for attempting to camouflage their equity contributions other than the risk of recharacterization itself. Besides, the burden of proof usually lies on the objecting party. As a consequence, this type of insider misconduct is not effectively disincentivized.

3. At a minimum, insiders should be given clear guidance regarding what facts would trigger a recharacterization. Besides, mere undercapitalization or the inability to procure external financing should not provide a justification for recharacterization as they have nothing to do with the intrinsic nature of the transaction. See Matthew Nozemack, *Making Sense Out of Bankruptcy Courts' Recharacterization of Claims: Why Not Use § 510(c) Equitable Subordination?*, 56 WASHINGTON & LEE LAW REVIEW 689, 720 (1999). Good-faith, well-documented advances bearing the earmarks of an arm's length loan should be exempt from recharacterization. See Jules S. Cohen, *Shareholder Advances: Capital or Loans*, 52 AMERICAN BANKRUPTCY LAW JOURNAL 259, 275 (1978).

### *1. Superiority of Automatic Subordination to both No-Subordination and Equitable Subordination when Inside Debt Financing Is Provided to a Fully Solvent Firm*

With regard to unsecured insiders' loans made while the company is solvent and not terminated before bankruptcy, the automatic subordination remedy appears to be preferable to both the no-subordination remedy and the equitable subordination remedy. In these circumstances, to the extent automatic subordination provides the whole creditors' class with a full-blown property-rule protection, it prevails over the other two on both efficiency and fairness grounds.

Automatic subordination, by depriving the insider creditor of any chance to share in the estate *pari passu* with the outside creditors should the company go bankrupt, mitigates moral hazard incentives existing in corporate controllers, which arise after controllers' credit has been extended to the firm, and prevents outside debt dilution, as no value would be transferred from the earlier outside debt to the equity. In doing so, automatic subordination reduces the credit risk borne by outside lenders and the resulting interest rate they charge the company. When such borrowing costs are reduced, allocative efficiency stands to benefit unless the gain from the reduction in the cost of borrowing from outsiders is more than offset by an increase in the cost of insider financing. But automatic subordination of inside debt claims arising while the company is solvent unlikely deters debt financing from the insiders or make it more costly to the firm. If the company needs funds to finance growth and expansion and is fully viable, it should have ready access to the outside credit market on reasonable terms. There should be no need to borrow from insiders in the first place. Even assuming the tightening of credit conditions resulting from credit rationing, the inability of management to signal the good quality of the projects to be financed, the nature of the firm's assets or business, the nature of the transaction to be financed, or some other positive transaction costs prevent access to credit markets on reasonable terms, to the extent management believes the project is worth financing and equityholders have funds available for that purpose, there is no obvious reason why they should not advance debt just because their claims shall be subordinated in the event of bankruptcy. Their incentive to finance a project that appears profitable in their subjective estimation likely overcomes any disincentive from the risk of subordination. If they were not thinking that way, they would not have invested in the firm's equity at all in the first place. Their condition as shareholders in a fully solvent company, when faced with the expectation of a positive-net present value ("NPV") project and able to pursue it with

own funds, ensures that they provide the needed funds whether in the form of equity, quasi-equity or debt.

Automatic subordination is also superior inasmuch as it sets proper monitoring incentives for the creditors' class. It is well known that debt priorities, whether provided for by the law or agreed to by contract, may be justified on the basis of informational asymmetries, monitoring skills, and risk-bearing capacity. According lower priority to creditors having superior information, greater ability to monitor the debtor and capacity to bear the risk of a debtor's default at lower cost while affording higher priority to creditors trailing the former in knowledge of the debtor, ability to monitor it and capacity to sustain the risk of debtor's failure ensure that better-equipped creditors exercise an optimal amount of monitoring for the benefit of the creditors' class as a whole, thereby reducing agency costs and social waste. Insofar as contractual subordination of inside debt in the context of a regulatory framework of no-subordination makes some lenders better off than they would be under automatic subordination by increasing their expected recovery rate, it reduces their incentives to monitor the borrower, thereby forcing worse-positioned creditors to monitor at a higher cost and exposing nonadjusting creditors to a greater risk of loss.

Not only does automatic subordination of debts owed insiders reduce insiders' moral hazard and dilution of outside lenders' claims, not prevent investing by the insiders when the company is viable, and allocate debt priorities optimally, thereby maximizing social efficiency, but it also is more protective of the creditors as a whole. To be sure, automatic subordination is mostly beneficial to nonadjusting creditors. Without a chance to obtain an extra compensation for the risk being run or to protect their claim by means of covenants, their expectation to be satisfied hinges on the debtor's capital structure as is shaped by the equityholders and their management. Knowing that such creditors have their hands tied behind their back, equityholders may opportunistically opt for debt rather than equity financing in order to claim back a percentage share of the formers' prospective ownership rights over a firm's assets upon the firm's demise. The choice of debt rather than equity at this stage is a social cost, for it creates negative externalities to the detriment of defenceless third parties outside any mutually advantageous market transactions. In the absence of avenues to ensure that the insiders internalize such costs, curbing this form of redistributive strategic behaviour is not only fair to nonadjusting creditors but also key to pursuing social efficiency.<sup>4</sup> Any private benefit obtained by the

4. There is large support in the literature for the belief that legal and private arrangements reducing chances for tort claimants to get compensated for the harm inflicted on them entail

insiders in terms of eventual participation in the estate assets on a parity with the nonadjusting creditors is likely outweighed by the sum of the *ex ante* social cost of greater incentives toward moral hazard and the *ex post* social cost of strategic expropriation of nonadjusting creditors.<sup>5</sup>

efficiency losses. The less a firm and its owners internalize the cost of a firm's activities to third parties, the less the firm and its owners are deterred from engaging in socially harmful conduct. Because of shareholder limited liability, which already caps the recovery rate of all outside creditors, including tort creditors, to the assets available and might make a firm judgment-proof, any other legal or private arrangement further limiting the recovery rate of outside creditors must be carefully weighed. This is especially true when the arrangement is susceptible to penalize tort victims. Only by increasing the probability of having tort claimants compensated will the law mitigate the overproduction of socially undesirable corporate behaviors. See Robert K. Rasmussen, *An Essay on Optimal Bankruptcy Rules and Social Justice*, 1994 UNIVERSITY OF ILLINOIS LAW REVIEW 1, 32 (1994) (“[T]o the extent that a firm knows it will not have to fully compensate its future tort victims, it has too little incentive to take care to prevent accidents in the first instance.”); Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VIRGINIA LAW REVIEW 1887, 1901 (1994) (“[F]ull compensation of tort victims ensures that tortfeasors cannot externalize costs attributable to their operations. That in turn ensures an appropriate allocation of resources.”); Note, *Switching Priorities: Elevating the Status of Tort Claims in Bankruptcy in Pursuit of Optimal Deterrence*, 116 HARVARD LAW REVIEW 2541, 2559 (2005) (“Bankruptcy rules that fail to deter judgment-proofing schemes decrease overall social utility by facilitating further externalization of the cost of tort liability.”); Barry E. Adler & George Triantis, *Debt Priority and Options in Bankruptcy: A Policy Intervention*, 91 AMERICAN BANKRUPTCY LAW JOURNAL 563, 570 (2017) (“[A] debtor who does not pay for the higher risk borne by nonconsensual creditors also does not internalize the full cost of the capital it uses and will tend to overinvest (from a social welfare perspective) in risky endeavors.”).

5. To be sure, automatic subordination of insider loans would not be enough of a remedy to level the playing field between adjusting and nonadjusting creditors. Adjusting creditors are and will remain at a structural advantage over nonadjusting ones regardless of the order of priorities of their respective claims and of those of the shareholder-creditors in bankruptcy. For instance, unlike tort creditors, lenders can get around shareholder limited liability by obtaining personal guarantees from shareholders for the repayment of corporate debt owed them to which tort creditors have no access. See Ronald J. Mann, *The Role of Secured Credit in Small-Business Lending*, 86 GEORGETOWN LAW JOURNAL 1, 22-25 (1997) (providing evidence that lenders request principals of small businesses to provide personal guarantees as a device to committing the latter's private wealth to the solvency of the firm). The structural underprotection of nonadjusting creditors is irremediably inherent in the nature of the exchange they make with their counterparties. While lenders are expected to agree to the exchange with the company and its shareholders only after negotiating the contractual protections they deem best for themselves, thereby ensuring a mutually beneficial, Pareto-efficient deal, tort creditors are dragged into the exchange against their will, with the law aiming to award them compensation *ex post* for the harm they suffered. But the need for compensation of tort creditors must be balanced against the benefit of shareholder limited liability. If limited liability were automatically lifted for the benefit of tort creditors rather than gotten around upon shareholder consent, incentives to provide equity to firms would

Even considering the possibility that insiders might ultimately have their claims subordinated to a lender by contract in jurisdictions allowing contractual subordination would the position of nonadjusting creditors not get any better. While insiders' incentive to take on excessive risk would be reduced owing to their giving up on the bankruptcy dividend they would have been entitled to *qua* creditors, the cost of credit provided by the unsecured senior lender would not fully reflect the riskiness of a firm's capital structure relying on inside debt as a source of financing. If absent both automatic and contractual subordination of inside debt, the unsecured lender would charge an interest rate reflecting the risk of sharing in the estate *pari passu* with the insider creditor and all other general creditors, the senior lender benefiting from contractual subordination would offer credit at discounted rates in response to the larger bankruptcy dividend it would be entitled to. Contractual subordination would provide an individualized, additional equity cushion lowering the risk of loss and reducing the incentive to monitor. As the credit risk and monitoring costs for a particular lender diminish, so does the credit spread charged the borrower by that lender. In being partially protected against the insolvency risk of its borrower and driven to offer cheaper credit than would have been otherwise, the senior lender does not force the insiders to internalize the costs of an imbalanced capital structure and of risky operations. Failure to internalize such costs would in turn lead insiders to take suboptimal financing and investment decisions. Insiders, especially insiders relying on one single major source of debt capital as typically do insiders of small companies, would have a stronger incentive to create suboptimal capital structures characterized by little equity and large amounts of inside debt subordinated to their major lender's debt.

severely be undermined. Against this backdrop, one might conclude that there is no point in seeking to bridge the gap in the level of protection awarded to tort creditors as opposed to lenders, since the former will never catch up no matter what the law provides. Nevertheless, this argument proves too much. The fact that there is a structural disadvantage does not justify foregoing opportunities to remedy it to the extent possible. Quite the opposite, it should stir regulatory interventions to mitigate the structural disadvantage while limiting the efficiency losses generated by the regulatory action itself. And herein lies the difference between seeking protection for tort creditors by lifting shareholder limited liability and affording them protection by means of automatic subordination of shareholder loans. In making loans to its company, a shareholder freely decides to expose further personal wealth to the risk of loss even without automatic subordination. After all, a debt investment, regardless of its priority in bankruptcy, remains a risky investment to the extent chances exist that the borrower will not afford paying it off. Automatic subordination of inside debt claims does not therefore put any more personal wealth at risk than the shareholder wanted it to be. It limits itself to changing the degree of riskiness of an investment claim. But it does so without compromising the social efficiency of shareholder limited liability.

Besides, insiders would not be as deterred from engaging in excessively risky activities as they otherwise would be, since the cost of credit to the firm could be kept artificially lower despite increased enterprise risk. While the disciplining function of outside debt would largely be compromised, suboptimal financing and investment decisions would in turn endanger nonadjusting creditors, reducing the deterrent effect of tort liability and ultimately decreasing social welfare. As a result, contractual subordination might subsidize credit regardless of a firm's financial structure and operational conduct. In so doing, it largely externalizes onto nonadjusting creditors unnecessary financial and operational risks.<sup>6</sup>

Less intuitive is to establish whether lending institutions benefit more from a no-subordination approach that however allows contractual subordination, as is the case in most regimes where no legal subordination is provided for, or from an automatic subordination approach. As it does with nonadjusting creditors, automatic subordination advantages adjusting creditors as a class by placing all of them ahead of the insiders in the order of priorities. If, as might be the case, lenders wanted to seek protection of their interests by contract in light of increased chances of moral hazard and a purportedly prejudicial ranking of their claims in insolvency, automatic subordination would allow them to save in

6. Contractual subordination of inside debt raises concerns similar to those posed by issuance of secured outside debt. The fact that secured debt enjoys priority in bankruptcy, coupled with shareholder limited liability and the possibility to encumber up to all of a firm's assets for the benefit of a lender, has pushed many commentators to question the efficiency, let alone the fairness, of secured debt in the wake of arguments similar to those that may be levied against contractual subordination of insiders' loans. The availability of security reduces credit risk, allows cheaper credit, decreases monitoring incentives and costs, and therefore frees financial resources to be used in risky ventures the firm does not adequately pay for *ex ante* and that shareholders are pleased to undertake in light of their limited risk of loss. Who bears the brunt of excessive risk are the nonadjusting creditors, who helplessly suffer from increased bankruptcy risk without being able to pass any cost onto the debtor firm and its insiders. To be sure, the effect of contractual subordination on the cost of credit is not close to being as dramatic as the one resulting from secured debt, because while security interests, by acting on the left-hand side of the balance sheet, can remove the risk of loss altogether when debt is oversecured, contractual subordination of inside debt, by acting on the right-hand side of the balance sheet, can never annul a creditor's risk of loss in its entirety. Therefore, we could expect that collateralization is more powerful than contractual subordination of insiders' debt in gaining the borrower firm low-cost credit. Nevertheless, contractual subordination has another subtle, perverse effect, which is incentivizing the insider and the senior creditor to agree on a financing arrangement under which the insider, whatever the total amount of its financial commitment to the firm, divides such commitment into minimal equity and most debt so that the latter can be subordinated for the exclusive benefit of the lender. On the contrary, the granting to a lender of a security interest in a firm's assets makes the lender indifferent as to how the insider chooses to finance the firm.

transaction costs,<sup>7</sup> be they high or low.<sup>8</sup> Nevertheless, automatic subordination trails contractual subordination with regard to the share of liquidation value that lenders can appropriate for themselves in bankruptcy. Unlike automatic subordination, which operates for the benefit of all unsecured creditors, contractual subordination is a form of targeted subordination. It by definition benefits the parties to the subordination agreement only. By means of such an agreement, the insider gives up on its share of the estate solely to the advantage of its counterparty, thereby enriching the latter at the expense of all other creditors, including nonsubordinating lenders. Subordination by contract has therefore the potential to transferring value from third-party creditors to the coalition of insiders and senior lenders, while automatic subordination does not give rise to such third-party harmful effects. It actually prevents them in the first place.

As Table 1 above has shown,<sup>9</sup> on an *ex post* basis, *i.e.* focusing on the recovery rate in bankruptcy, while moving from a no-subordination approach which does not allow contractual subordination to an automatic subordination approach is beneficial for all outside creditors, moving from a no-subordination approach allowing contractual subordination to an automatic subordination approach seems to be advantageous solely for the nonadjusting creditors. To be sure, on an *ex ante* basis one might contend that a risk-neutral adjusting creditor should be indifferent between all of these approaches, as such creditor could simply change the price at which it would lend to the corporate borrower in order to seek *ex ante* compensation for any given amount of risk. While under a no-subordination approach prohibiting contractual subordination the expectation of a reduced recovery rate in bankruptcy would translate into a higher interest rate charged *ex ante* to reflect the increased risk, the possibility to benefit from subordination, whether automatic or consensual, would cause a lender to charge a lower interest rate in light of a larger expected recovery rate. To the extent contractual subordination is even more advantageous than

7. It is not just about negotiation costs. It is also about enforcement costs. Holding the content of a provision constant, a law provision having a content is superior to a contract provision having the same content for the purpose of enforcement inasmuch as the validity and enforceability of the former cannot strategically be disputed in court except on constitutional grounds.

8. They likely are low. Drafting a debt subordination clause is no big deal for experienced lawyers. And shareholders cannot credibly be expected to resist for a long time the demand for subordination if they need to raise funds from banks and other lending institutions. Collective action problems could emerge if the consent of many inside shareholders were needed. But it is not a plausible scenario, at least with regard to closely-held companies where inside debt financing is the likely province of just one or very few insiders.

9. See *supra* Part II, Section F.

automatic subordination, a subordinating lender would charge further less under the former than under the latter. But on an *ex post* basis prospective subordinating lenders appear to fare much better under a no-subordination approach allowing contractual subordination than under any alternative approach. Therefore, moving from no legal subordination allowing contractual subordination to automatic subordination may be viewed as overall prejudicial to lenders in that they would be unable to appropriate by contract the whole value that would pertain to the insider if its claim were not already subordinated by law.

The coalition of insiders and adjusting creditors may be deemed as preferring a no-subordination approach allowing contractual subordination to an automatic subordination approach also because of the possibility to bargain and allocate risks among them on a case-by-case basis. To the extent the adjusting creditors of one firm are superior risk-bearers than the firm's insiders, it may be mutually beneficial to forego subordination, because the insiders may wish to incur a higher interest expense in exchange for a greater chance to collect on their debt in bankruptcy. On the contrary, if another firm's insiders are superior risk-bearers than that firm's adjusting creditors, it pays that the insiders' debt might be subordinated for the benefit of the latter, because the insiders could obtain a lower interest rate from the lenders in exchange for assigning them the insiders' dividend in bankruptcy. Besides, contracting out of an automatic subordination regime is more costly than contracting out of a no-subordination regime. While switching from no-subordination to contractual subordination requires the consent of the insider creditor and the outside lender, switching from automatic subordination to no-subordination, which would be a precondition for the insider creditor and the outside lender to be able to enter into a targeted subordination agreement, the insider creditor would have to obtain the prior consent of all the beneficiaries of automatic subordination, that is all adjusting and nonadjusting creditors. Considering that automatic subordination would be for the benefit of prospective creditors, too, bargaining out of automatic subordination would be not achievable in practice. The privately optimal default therefore seems to be a rule of no-subordination allowing contractual subordination, as it would ease bargaining and render the default risk allocation more easily reversible.

But on closer inspection, despite the foregoing considerations it is doubtful that adjusting creditors stand to benefit more under a no-subordination approach allowing contractual, targeted subordination than they do under a generalized automatic subordination approach. To be sure, if a bank were asked *ex post*, *i.e.* once a debtor of its own has already plummeted into insolvency, which rule it would prefer, we would expect it to speak in favour of

the former. And the more so, the more impactful the insolvency of that debtor were on the bank's balance sheet. But if all the banks were asked *ex ante* which rule would make them better off, they would have a good reason to opt for a generalized automatic subordination approach. What is often overlooked is that whatever borrower company, it likely is a trade creditor itself, not just a debtor of other trade creditors. And the other trade creditors may well be bank-financed, too. A rule that reduces chances of recovery of trade creditors indirectly affects the riskiness of all debt claims held against all trade creditors' assets. The chance of a larger recovery in one bankrupt trade creditor must be traded off against an increase in the riskiness, and hence a reduction in value, of all debt claims held against trade creditors as a whole. There is little doubt that if the financier of all existing trade creditors were only one single bank, such a bank would be indifferent between a rule that maximizes recovery *ex post* at the price of a generalized increase of credit risks *ex ante* and a rule that minimizes credit risks *ex ante* at the price of a reduced recovery *ex post*. But in a world where there exist multiple trade creditors and multiple lenders and the lending relationships between them are randomly distributed, the rule that banks as a whole would hypothetically bargain for *ex ante* is a rule of automatic subordination for the reason that while only a few banks are made better off in the event of occasional insolvencies by a rule of no legal subordination coupled with contractual subordination, all banks are made better off having their credit risks reduced with regard to all borrowers, whether they remain solvent or become insolvent, by a rule of automatic subordination.<sup>10</sup> Lending institutions' wealth is therefore maximized under the automatic subordination approach.

In times of full solvency, just as automatic subordination is superior to no-subordination, so is it superior to equitable subordination. In light of the fact that subordination of insiders' debt claims affects a company's capital structure and the ranking of priorities in bankruptcy, *ex ante* certainty of the legal treatment of a debt advance in bankruptcy is key to shaping insiders' and outside creditors' incentives, crafting adequate responses and governing an orderly reorganization or liquidation of a bankrupt company.<sup>11</sup> When a fraud on creditors is required, equitable subordination is not as effective in preventing moral hazard by the insiders as is automatic subordination. Likewise, when

10. A similar reasoning, albeit less stringent, can be made for tort creditors to the extent they may be companies or individuals indebted to banks.

11. For the claim that subordination should be better dealt with as "an implied term in the debt contract" than a "special rule of bankruptcy", see Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 UNIVERSITY OF CHICAGO LAW REVIEW 89, 114 n.46 (1985).

undercapitalization alone triggers equitable subordination, the vague and contestable notion of undercapitalization exposes the application of the remedy to a high degree of indeterminacy. Moreover, in light of the reasonable belief that automatic subordination does not deter debt investing by the insiders so long as the company is fully viable, equitable subordination does not prove advantageous compared with automatic subordination on this count, either. Thus, efficiency is maximized by a rule that reduces legal uncertainty while allocating priority rights in bankruptcy to pure creditors over insider creditors from the onset rather than to pure creditors as a penalty for the *ex post* finding of an opportunistic behaviour by the insider creditors. In other words, an absolute property rule is more efficient than a modifiable one to the extent the former would bestow on the parties clear-cut bargaining positions while the latter would render them more uncertain, thereby increasing transaction costs.

Finally, from a fairness perspective, automatic subordination, by ensuring that nonadjusting creditors' claims neither suffer from the *pari passu* participation in the distribution of the estate by the insiders nor are excluded from sharing in the bankrupt dividend allocated to a lender through contractual subordination, is certainly more equitable to them than is the doctrine of equitable subordination itself despite the latter's appellate.

## *2. Superiority of No-Subordination to both Automatic Subordination and Equitable Subordination when Inside Debt Financing Is Provided to a Firm in the Vicinity of Insolvency*

When the company is near to being insolvent, the no-subordination approach becomes, somewhat counterintuitively, more desirable than the automatic subordination approach.

It is feared that at this stage a firm's insider would make debt advances when it would not be optimal for the firm's other stakeholders that it did so. It is contented that the insider, thanks to these advances, would possibly overinvest, thereby postponing bankruptcy and dissipating further value. This fear is however misplaced or, at the very least, overrated.<sup>12</sup> Admittedly, incentives to gamble with the remaining assets to salvage the residual equity value grow stronger at a time when a firm is bordering on insolvency. Whenever an insider can rely on debt claims of ranking equal to debt claims held by external creditors, the higher probability of recouping some value in bankruptcy than with equity interests would marginally lead to more corporate investment.

12. At best, evidence of overinvestment by financially-distressed firms is mixed. See *supra* Part III, Section C, note 23.

And this additional investment activity may well be value-destroying.<sup>13</sup> But the more effective strategy to address the problem of risk-shifting in the vicinity of insolvency, whether it is real or not, is eliciting additional investment, whatever its nature, from the nearly-insolvent firm's insider.<sup>14</sup> Additional personal wealth put at risk of loss would act as a self-restraint on excessive risk-taking going forward more effectively than would do the lack of any further personal investment induced by an unfavorable treatment of pre-bankruptcy inside debt financing. Besides, preference law may do a comparatively better job in preventing new financing conducive to overinvestment.<sup>15</sup> At the same time, the prospect of sharing in the estate on a parity with the general creditors should bankruptcy occur gives the insider an incentive to provide liquidity and refrain from exercising the default option until after having made a further attempt to restructure the business or seize other business opportunities. As a result, premature and costly court-led insolvent liquidation or reorganizations may be avoided or pushed back. According insiders the benefit of a property-rule-like protection of their entitlement to claim back a percentage of priority rights over the assets if bankruptcy should set in within a short period of time furthers this objective. For the alternative courses of action an insider is likely confronted with are not debt or equity financing, with the insider magically directed to equity if unsubordinated debt is legally crossed out. The alternatives that an insider is most likely prepared to weigh up are unsubordinated debt or nothing. As a result, the absence of a deterrent against additional debt of the likes of automatic subordination helps to tip the balance in favour of debt financing and away from no financing at all, thereby strengthening the chilling effect on extreme moral hazard temptations in dealing with the residual assets and mitigating the underinvestment problem.

While any regulatory action targeting the seniority of unsecured inside debt financing provided in the zone of insolvency would have to trade the benefit of alleviating underinvestment off against the cost of fuelling overinvestment,

13. See *supra* Part III, Section B, notes 10-12 and accompanying text.

14. See *supra* Part III, Sections B and C.

15. Inasmuch as preference avoidance rules void the grant of a security interest on account of antecedent debt within the preference period, they impede that a creditor, be it insider or not, be determined to extend new credit in light of the security received for its preexisting debt. Likewise, the prohibition of preferential payment to any creditor within the suspect period precludes that a troubled firm's management might credibly promise an existing or new creditor repayment of any new debt before reimbursement of other creditors' debts. See Barry E. Adler, *A Re-Examination of Near-Bankruptcy Investment Incentives*, 62 UNIVERSITY OF CHICAGO LAW REVIEW 575, 590-98 (1995) (arguing that preference avoidance rules should be better understood as counteracting overinvestment rather than dismemberment of an insolvent debtor or nearly so).

theory predicts that when a new turnaround project has a large liquidation value in default it is optimal to issue non-subordinated debt to the financier desirous of providing the necessary funding to undertake it.<sup>16</sup> As the average insider of a firm on the verge of insolvency is expected to infuse additional money of its own to preferably finance investments having the prospect of delivering tangible results in a short timeframe given the looming insolvency, the ideal candidate for pre-insolvency investments financed by insiders is assets expected to generate a lower, yet certain value in the short run rather than a higher, yet uncertain value in the long run on condition that the lower value-creating asset manages to foreclose insolvency. The prospect of insiders' investing in assets with a certain and large liquidation value would justify granting the insiders' new financing parity with preexisting outside debt claims.

In the zone of insolvency, considering the incentives for current lenders to act strategically<sup>17</sup> and the disincentives for third-party lenders to extend new credit especially in the absence of unencumbered assets on which to secure new loans, efficiency is achieved if insiders and outside lenders, whether they are current or prospective, are able to negotiate a workout free of most restrictions as to whether owner-managers could contribute additional funds, in what form they could provide them and with what priority in insolvency. Protecting insiders' entitlements by a property rule would ease negotiations between them. Likewise, current trade creditors are better off with a rescue attempt that would preserve the opportunity to trade with a partner otherwise doomed to fail and, together with the rescue of the trading partner, would put in place a capital structure discouraging risk-shifting. Prospective trade creditors will in turn be sufficiently protected if promptly alerted to the fact that the ongoing operations of the company are in whole or in part financed by the firm owners.

To be sure, the least interested in a turnaround that might go either way are the tort creditors. But in the absence of any tool actually forcing the early liquidation of a financially-distressed entity for the protection of involuntary creditors' claims, it is doubtful that soon-to-be-out-of-the-money tort victims having claims against the assets of a company would systematically prefer the scenario of no additional financing from the insiders, stronger insiders' incentives toward moral hazard and a possible disruptive insolvent liquidation to that of some additional financing from the insiders, weaker insiders' incentives toward risk-shifting and a better chance to preserve their claims intact.

16. See Berkovitch & Kim, *supra* note 1, at 783.

17. Existing creditors have little incentive to lend more while having a strong incentive to attempt to collect their existing debt despite the risk that the collection fall within the preference period and be voided *ex post*. See Adler, *supra* note 15, at 578-588.

Just as equitable subordination lags behind automatic subordination when targeting loans made in a situation of full solvency, so too does it lag behind no-subordination with regard to loans made in the vicinity of insolvency. First, equitable subordination does not address the problem of risk-shifting to the extent risk-shifting can occur even without a legally cognizable fraud on creditors. Second, it fails to provide an adequate response to the problem of underinvestment, if at the time of the decision-making the lending insider is left to wonder whether after extending credit its overall conduct might be found inequitable *ex post* and call for subordination of its debt claims. Nevertheless, equitable subordination of pre-insolvency insider loans is fully compatible with an underlying no-subordination approach. To the extent equitable subordination's goal is to remedy inequities in a firm's insider conduct, one could think of no-subordination as the default approach and equitable subordination as a penalty for the misuse of the property rule-protected entitlement allocated to the insider. In effect, a properly-enforced doctrine of equitable subordination should just work this way. But for it to function efficiently, the notion of inequitable conduct inviting application of the doctrine to insider loans should be narrowed down and refined in order to avoid that wrongdoing by a firm's insiders be found in either the capital structure chosen at the company's inception or the decision to advance loans when no other lender would extend credit. On the one hand, initial undercapitalization would already be dealt with by the automatic subordination of early-stage inside debt financing. On the other hand, the inability to take out loans from willing lenders when insolvency looms large should be viewed as a potential market failure to cure rather than a symptom of flawed insider lending.

### *3. Superiority of No-Subordination to both Automatic Subordination and Equitable Subordination when Inside Debt Financing Is Provided to an Insolvent Firm*

When the company finally enters the insolvency stage, the no-subordination approach and its flexibility prove ever more desirable than either of the competing approaches. At this point, the company should stop trading and an insolvency proceeding should commence for the protection of creditors. To this end, rules against wrongful trading by the management, in jurisdictions where they exist, are key to avoiding that the remaining assets are used up recklessly or just hopelessly. Also, debt advances from the insiders may prevent or postpone a cash-flow insolvency but would do nothing to avert a balance-sheet insolvency. A loan by an insider, whether made in solvency or in insolvency and irrespective of its being subordinated or not, counts as a liability

and is entered as such for accounting purposes. As a result, directors would not be relieved of their filing duties, if any, where such duties were associated with liabilities in excess of assets.<sup>18</sup> More generally, any remedy dealing with inside debt should be without prejudice to filing obligations, minimum capital and capital maintenance requirements, as well as wrongful trading rules in those jurisdictions where they are provided for. No choice in respect of inside debt adds anything to, or subtracts anything from, the effectiveness and enforcement of these obligations and requirements.

Conversely, the rules on the financing of an insolvent firm may enhance or decrease the chances of a successful out-of-court turnaround. Vesting the insiders with a property-rule protection of their entitlement to shape the capital structure as they deem fit makes it easier to negotiate a workout. Insiders would be allowed to commit additional funding and make it subordinated to the rescue financing of an outside lender. Automatic subordination of any additional funding provided by the insiders would render this option infeasible. In light of the out-of-the-money claims held by the existing unsecured creditors, coupled with the enhanced risk of overinvestment that would result from discouraging insiders to pledge additional money, it is hard to believe that current creditors would be damaged by allowing insiders to provide emergency financing and “bridge loans” on an unsubordinated basis.

The only parties that might be worse off are the prospective nonadjusting creditors. Nevertheless, prospective creditors are uncertain to emerge at all, while current creditors are real and in trouble. To the extent the interests of the latter can be better defended by granting a property-rule protection to the entitlement of the insiders while the interests of the former would only hypothetically be undermined, one cannot but conclude that maximizing efficiency and fairness requires that the interests of the already-existing creditors be given priority over the interests of any hypothetical, future creditors. Without prejudice of the filing duties owed by a firm’s management, expanding the insiders’ financing options by exempting their last-minute

18. EU law is now clear-cut in this regard. Pursuant to Directive (EU) 2019/1023, art. 19, Member States must ensure that, where there is a likelihood of insolvency, directors take into account the interests of creditors, equityholders and other stakeholders, although no hierarchy is established at EU level. Directors are also directed to take steps to avoid insolvency as well as deliberate or grossly negligent conduct that threatens the viability of the business. Besides, shareholders and management must ensure that the company meet the requirements on minimum legal capital and legal capital maintenance. To the extent subordination of insiders’ debt claims as opposed to recharacterization of debt as equity does not create equity where it has not been originally provided as a such, filing duties and rules on minimum legal capital and capital maintenance are indifferent to whatever choice is made in respect of subordination of inside debt financing.

debt investments from subordination may just help to preserve the social value of the firm and whatever value is left of the claims held by the existing stakeholders.

### C. Optimal Rules on Secured Inside Debt Financing

While pre-petition unsecured insider lending should be subject to subordination depending on its timing, pre-petition secured insider lending should be subject to subordination without exception. To reach this conclusion it is unnecessary to question the overall efficiency of upholding security interests in bankruptcy as a consequence of their detrimental effects on nonadjusting creditors. None of the theories that have been proposed to justify priority of secured debt in bankruptcy, whether persuasive or not when focusing on outside lenders,<sup>19</sup> lends support to secured lending by insiders.

According to one theory, security interests prevent overmonitoring or undermonitoring by lenders that are least capable to monitor. By according security interests to lenders less skilled at monitoring, the borrower prevents that such lenders pass onto it excessive monitoring costs in the form of higher interest rates.<sup>20</sup> When considering insiders this first theory has no bite. Owner-managers *qua* creditors will not fall prey to overmonitoring or undermonitoring because they need not monitor in the first place. In their capacity as insiders, they wield control power over the firm and should if anything be subject to monitoring by others rather than become monitors themselves. According to a second theory, overmonitoring or undermonitoring is reduced by securing a creditor's claim on the firm's asset the creditor is best-equipped at monitoring. As not all creditors may equally specialize in monitoring all the different kinds of a firm's assets, granting security interests based on a creditor's monitoring specialization allocates monitoring efforts more efficiently, thereby decreasing monitoring

19. The debate on whether security interests should be granted priority in bankruptcy has attracted considerable academic attention. The ensuing debate has brought to light a number of efficiency arguments in favor and against bankruptcy priority of secured debt which make it hard, on balance, to establish whether the benefits of secured debt outweigh its costs or vice versa. For a succinct account of the debate, see Lucian A. Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE LAW JOURNAL 857, 915-17 (1996).

20. See Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities among Creditors*, 88 YALE LAW JOURNAL 1143, 1154-56 (1979).

and interest costs.<sup>21</sup> Again, in their capacity as controllers, insiders are specialized by definition and need no additional incentive to provide the proper amount of monitoring. One more theory, building on the freeriding problem that monitoring by creditors raises, argues that collateralization is a form of compensation for the creditor which will engage in monitoring for the benefit of the whole of the creditor class. Security interests can be used to encumber key corporate assets on which the welfare of the firm depends while providing secured creditors an incentive to police the borrower that otherwise would not exist under a *pro-rata* sharing among the creditors of the benefits from monitoring.<sup>22</sup> It is readily apparent that this theory, too, fails when focusing on insiders, because owner-managers, in their capacity as controllers and residual claimants, already have all the power, information and incentive to devote time and efforts to an efficient use of corporate assets. An extra compensation in the form of a security interest against downside risk would just turn their incentives from proper to perverse.

Insiders, especially owner-managers of small firms, might not be the most efficient risk bearers of all corporate constituencies. Yet, their being in control of the company's assets and better informed about the company's operations and prospects than is anyone else provides a basis for denying access to security interests. To the extent insiders are the controllers of the company's affairs and superior monitors, there is no social surplus in allowing them to collateralize the firm's assets for the benefit of their debt claims. By encumbering a firm's assets, the firm insiders diminish their incentive to refrain from an exceedingly risky management of the firm at any stage of the company's lifecycle. There simply is no efficiency reason that justifies granting pre-petition advances from the insiders priority over the claims held by the general creditors.<sup>23</sup> The possibility to encumber assets of their own firm would just encourage extreme moral hazard while exposing unsecured creditors to higher risks of opportunistic expropriation.

If permitting insiders to obtain security interests from a solvent firm seems devoid of any plausible efficiency justification, on the contrary one might argue

21. See Douglas G. Baird, *Notice Filing and the Problem of Ostensible Ownership*, 12 JOURNAL OF LEGAL STUDIES 53, 57 (1983).

22. See Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE LAW JOURNAL 49 (1982).

23. There might be efficiency reasons to allow privileged lending as between insider creditors. For instance, in a joint venture allocating control powers disproportionately between the two partners, the shareholder who has low control power may want to be given security to the exclusion of the partner having high control power in exchange for extending credit to the company alongside the latter.

that allowing insiders to secure an eve-of-bankruptcy debt instrument on the firm's unencumbered assets follows from the logic according to which in a situation of pre-insolvency and insolvency the goal should be that of deterring insiders' underinvestment. On reflection, this argument can be objected to without delving into the debate whether secured lending to an insolvent firm exacerbates overinvestment more than alleviates underinvestment. The point made in this book is that rescue debt financing from an insider should be allowed to achieve economic parity with third party lenders' debt on condition that the insider puts further skin in the game. For this to happen, the insider must run the risk of incurring losses on its additional financing. Only such threat would give the insider an incentive to thoroughly review the chances of a successful turnaround before extending additional credit. In reducing down to zero any risk of incurring losses on the part of the insider lender, secured lending does little to nothing to prevent the overinvestment problem in pre-petition firms. To the extent such problem becomes acute when the firm encounters financial difficulty, collateralization of insider loans should certainly be forestalled upon a firm's pre-insolvency and insolvency as much as it should in times of full solvency.<sup>24</sup>

In light of the foregoing observations, secured insider lending should be reserved the same treatment applicable to unsecured insider lending. Even if collateralized, insider loans should be dealt with as if they were unsecured. To achieve this outcome, security interests taken by the insiders in a firm's assets should be disallowed altogether, whether the secured debt financing is early-stage or pre-petition.

24. Of course, this observation does not entail that that the law of debtor-in-possession (DIP) financing should equally prohibit the bankrupt firm from issuing secured debt to an insider. First of all, the availability of unencumbered assets in the context of a reorganization is a rare occurrence. Therefore, DIP financing on a secured basis is infrequent. Second, all residual equity value is usually lost in bankruptcy. As a consequence, post-petition financing, including secured financing, cannot be conceived to attempt to salvage pre-petition equity value. By contrast, it is precisely the perverse incentive to preserve the option value of equity that justifies disallowance of security interests executed for the benefit of insiders in the vicinity of insolvency. Third, and more importantly, insofar as the taking of a security interest by an insider extending post-petition credit must be authorized by the bankruptcy court, the scope for an opportunistic use of such financing to the detriment of other creditors may significantly be reduced by an *ex ante*, close judicial scrutiny. But see James M. Wilton & William A. McGee, *The Past and Future of Debt Recharacterization*, 74 BUSINESS LAWYER 91, 92 n.2 (2019) (implying that secured insider loans, to the extent they further the statutory objectives of Chapter 11 reorganizations, cannot *per se* be deemed in breach of the principle of Evenhandedness discussed in Robert Clark's seminal article *The Duties of the Corporate Debtor to Its Creditors*, 90 HARVARD LAW REVIEW 505 (1977) even if made pre-petition). See also *infra* Section F.

## D. Subordination, No-Subordination and the Absolute Priority Rule

A remedy that provides for subordination of advances made by insiders in times of solvency and no-subordination of advances made by them in times of pre-insolvency and insolvency does not run counter to the logic of the absolute priority rule (“APR”) of bankruptcy law. It actually strengthens the protection of the very same interests underlying the APR where such protection is most needed.

The thrust of the APR is that in the context of a restructuring proceeding of a firm’s capital structure featuring liabilities in excess of assets, holders of senior claims must be paid in full before holders of junior claims receive anything, and holders of junior claims must be satisfied in full before holders of equity interests receive anything, unless the holders of higher-ranking claims consent otherwise.<sup>25</sup> Absent either full payment of claimants of higher ranking or consent from them to receive less than full payment, holders of lower-ranking claims, including holders of ownership interests, are excluded from any distribution. The rationale is avoiding that a reorganization plan might be achieved at the expense of statutory priority rights of more senior claimants, which fact would render the *ex ante* pricing of the claims inaccurate or difficult at best and the behaviour of debtholders and equityholders before and after the unfolding of the crisis less predictable and socially desirable.<sup>26</sup> To the extent the APR reflects the creditors’ bargain and mitigates moral hazard temptations in owner-managers, it is believed to reduce overall borrowing costs and help keep the firm on track.

It may be argued that by providing unsubordinated debt rather than equity, owner-managers could factually and unilaterally circumvent the APR in that they would reserve a chance for themselves to have an in-the-money claim in insolvency, thereby reducing the recovery rate of nonconsenting creditors. In light of this concern, automatic subordination of inside debt claims arising on a date on which the firm was presumably solvent may be viewed as a

25. For an historical account and a description of the functioning of this rule as provided for in the US Bankruptcy Code, see Douglas G. Baird & Thomas H. Jackson, *Bargaining after the Fall and the Contours of the Absolute Priority Rule*, 55 UNIVERSITY OF CHICAGO LAW REVIEW 738 (1988).

26. See Lucian A. Bebchuk, *Ex Ante Costs of Violating Absolute Priority in Bankruptcy*, 57 JOURNAL OF FINANCE 445 (2002) (arguing that deviations from the APR aggravate the moral hazard problem and thereby produce the adverse *ex ante* effects of inducing equityholders to prefer riskier projects and lenders to charge higher interest rates, with the two effects reinforcing each other).

tool preventing the purpose of APR from being entirely defeated. In effect, automatic subordination of debt claims arising in times of solvency, such as those arising from the debt financing of a newly-formed company, ensures that equityholders cannot strategically meddle with the order of priorities in bankruptcy to the detriment of the outside creditors when there is no countervailing efficiency or fairness argument to let them do so.

But when the company is in or near insolvency, the main question turns to being what could escape unsecured outside claims from being irremediably underwater and left unpaid. Allowing equityholders to have their own debt claims resulting from loans made in insolvency or in the vicinity thereof to rank *pari passu* with those of general creditors in bankruptcy ensures that a unique, and perhaps exclusive, source of liquidity for a troubled firm not be shut down *ex ante*. Only by keeping this source of funding alive may general creditors have an increased chance of being paid off in bankruptcy. No harm is therefore inflicted on the logic underlying the APR. At the same time, an increase in chances to recover on loans made in the period leading up to the commencement of an insolvency proceeding on condition that the filing of the petition not be delayed past a short deadline, rather than incentivizing an endless postponement of the filing for bankruptcy to the detriment of current secured creditors and prospective unsecured creditors, would create an incentive to file for a corporate reorganization as soon as the insider lenders reach the conclusion that an out-of-court turnaround is beyond their reach. The strict requirement for an insider lenders' claims to rank on a par with outside creditors' claims would therefore mitigate the former's notorious incentive to unduly delay the formal acceptance of an irreversible financial failure.

Furthermore, allowing insider creditors not to rank behind all other creditors may have unique value in the domain of closely-held firms. The value of pre-petition ownership interests of shareholder-managers is inevitably wiped out upon insolvency. Because of the APR and the requirements to be met to get around it, shareholder-managers of small firms may find it hard to retain equity in the reorganized firm.<sup>27</sup> Nevertheless, it may be socially desirable that shareholder-managers hold equity *ex post* and cultivate this hope *ex ante*. Retention of an equity interest might favour continuation of the business because the cash-flow and governance rights which come with it

27. See Ralph A. Peeples, *Staying in: Chapter 11, Close Corporations and the Absolute Priority Rule*, 63 AMERICAN BANKRUPTCY LAW JOURNAL 65 (1989) (highlighting the different consequences for shareholders and creditors of widely-held companies and closely-held companies arising from the application of the undifferentiated absolute priority rule of the 1978 Bankruptcy Code).

provide the necessary incentives and levers for pre-petition owner-managers to continue to exert effort.<sup>28</sup> To the extent the participation of the pre-petition shareholder-manager is needed to preserve a valuable input for the viability of the post-petition company and is not easily replaceable, cancellation of her equity interest might backfire.<sup>29</sup> By ranking on a par with general creditors with regard to their inside debt, shareholder-managers who would wholly lose their equity value would still have a chance to preserve some unsubordinated debt value, however small it may be. Such residual inside debt value could be paid back in stock of the reorganized company. In light of the advantage of ensuring continuation in the ownership of pre-petition shareholder-managers, there is an argument to avoid an undifferentiated subordination of all of the inside debt financing. The existence of some unsubordinated inside debt would increase chances for some pre-petition inside debt to be turned into a post-petition equity position, thereby raising the likelihood of a beneficial continued participation of pre-petition shareholders in the ownership and management of the reorganized firm. Besides, the awareness that a restructuring procedure would not automatically expel pre-petition owner-managers from the ownership base so that they could entertain the hope of preserving some equity value and governance rights in the reorganized firm should also mitigate what otherwise would be another potent disincentive against the timely filing of a voluntary petition for the benefit of all stakeholders.

## **E. Subordination, No-Subordination and the Relative Priority Rule**

While not being hostile to the APR, an approach pairing subordination of inside debt originated in solvency with no-subordination of inside debt originated in pre-insolvency and insolvency comports particularly well with a relative priority rule (“RPR”) as is allowed under European Union

28. See Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 UNIVERSITY OF PENNSYLVANIA LAW REVIEW 125, 149 (1990) (“[T]he claims of creditors are compromised, but shareholder-managers usually retain their shares without dilution. The dependence of the business upon the continuing services of the shareholder-manager is the primary bargaining leverage used to accomplish this feat.”).

29. See *id.* at 149 (“Unsecured creditors are willing to waive their right to priority in order to create an incentive for the shareholder-manager to continue her participation in the business. They realize that without such participation, the business will fail, and the assets will be liquidated for the benefit of the secured creditors, leaving nothing for the unsecured creditors.”).

law,<sup>30</sup> according to which a restructuring plan is permitted to provide that holders of junior claims and equity interests can receive value even as holders of higher-ranking claims are not satisfied in full, without the latter being allowed to object to such a plan, provided that the corporate reorganization does not leave any dissenting creditor worse off than it would have been in an insolvent liquidation. The rationale of an RPR, when applying to closely-held companies, is twofold. First, assuring shareholder-managers' chances to retain equity in the reorganizing firm despite the balance-sheet insolvency thereof may help achieve a timely filing for a court-led restructuring. Awareness that a restructuring procedure would not expel them from the ownership base so that they could preserve some value and governance rights should mitigate what otherwise would be a deterrent against the filing of a voluntary petition for the benefit of all stakeholders. Second, retention of a pre-petition equity interests might favour continuation of the business. To the extent the participation of the pre-petition shareholder-manager is needed to preserve a valuable input for the viability of the post-petition company and is not easily replaceable, cancellation or dilution of her shareholding might be inefficient.<sup>31</sup> The adoption of an RPR makes the case of subordination of eve-of-insolvency insider loans weaker on both theoretical and practical grounds. If the assumption is that preserving the participation of a pre-petition shareholder-manager might be socially desirable despite lack of full payment to holders of debt claims, automatic subordination of all debt claims held by insiders to those held by outsiders with a view to avoiding that the former can receive a distribution in the absence of the prior full satisfaction of the latter would be contradictory, because equityholders could participate in the distribution anyways. Instead, distinguishing late advances from early advances for purposes of subordination would conjugate the exercise of some deterrence against moral hazard, which an RPR might come to unleash in times of solvency, with the guarantee of preservation of greater value than would otherwise be achieved should the firm ultimately enters bankruptcy, provided that the filing is done timely.

30. According to Directive (EU) 2019/1023, art. 11(1)(c), in the case of a cross-class cram-down for the judicial or administrative confirmation of a restructuring plan, a dissenting voting class of affected creditors can be protected by ensuring that it be treated at least as favorably as any other class of the same rank and more favorably than any more junior class (*i.e.*, by applying an RPR), as opposed to being protected by ensuring that their claims are satisfied in full before a more junior class is to receive any payment or keep any interest under the restructuring plan (*i.e.*, by applying the APR).

31. See *supra* Section D, notes 28-29 and accompanying text.

## F. Subordination, No-Subordination and Debtor-in-Possession Financing

The regulation of debtor-in-possession (“DIP”) financing, whose main task is identified in alleviating the incentive to underinvest in valuable projects,<sup>32</sup> cooperates to incentivize a timely filing for bankruptcy of insolvent firms apt for a reorganization. Insofar as credit extended by a firm’s insiders in the context of a reorganization is allowed to rank ahead of debt issued to pre-petition creditors, owner-managers of a financially troubled but economically viable company are given an incentive to first file and then finance as opposed to first finance and then hope and see if their financing will help the company to avoid bankruptcy. But rules on DIP financing may effectively pursue their joint goal of mitigating underinvestment and incentivizing a prompt filing without the need of accompanying rules aimed at penalizing the status of pre-petition unsecured loans made by insiders. What matters is that the incentive to accede to an early restructuring given by rules on DIP financing is not offset by a countervailing benefit from delaying the opening of an insolvency proceeding.

A remedy which provides for subordination of insiders’ advances made on a date sufficiently remote from the date of bankruptcy and no-subordination of insiders’ advances made within a few months prior to the date of bankruptcy does not seem to defeat the purpose of the regulation on DIP financing. If the regulation on DIP financing allowed insiders to extend credit enjoying superpriority, the pattern would be as follows: debt advances made in times of full solvency would be subordinated; debt advances made in pre-insolvency and insolvency would rank on a parity with those of general creditors; debt advances made in the context of a restructuring proceeding, whose commencement would itself attest to the irreversible nature of the financial demise, would benefit from superpriority. Such a pattern would result in insiders’ debt claims being ranked according to an inverse correlation with the deterioration of a company’s financial status. In doing so, they would operate countercyclically to preserve the financial soundness of the firm. In effect, the farther the date of the inside financing from adjudication of the borrower as a bankrupt, the lower the ranking in bankruptcy of the inside financing if an insolvency proceeding should ultimately commence. The deeper into financial trouble the company would be at the time of the insider’s debt advance, the higher the status of the advance would be in the order of priorities applicable in bankruptcy, with the

32. See George G. Triantis, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 VANDERBILT LAW REVIEW 901, 919 (1993).

depth of the priority benefit varying according to whether the financing was made shortly before or after commencement of the reorganization.

## G. Optimal Avoidable Preference Rules

Whilst rules on repayment of inside debt are formally and substantially independent of rules on subordination, rules on subordination are formally independent of the former, but are not quite so substantially. Rules on repayment are in fact instrumental in safeguarding the effective functioning of rules on subordination. After all, for a subordination remedy to apply, the claim must still be standing upon a firm's bankruptcy. If an insider's claim is satisfied ahead of bankruptcy, there is nothing left to subordinate.

Without avoidable preference rules targeting insiders, insiders' debt could easily slip through the fingers of the subordination remedy no matter how the latter is fashioned. Therefore, preference rules are key to the effectiveness of any one subordination remedy. Yet, rules on the avoidance of transactions preferring insider creditors to outside creditors are useful even on a stand-alone basis. While these provisions generally aim at ensuring the integrity of the bankrupt estate and equal treatment of all creditors, when specifically targeting insiders they help to avert easy attempts to siphon assets (*e.g.* cash reserves) out of the company when insolvency looms. To the extent insiders know, or ought to know, better and earlier about a looming bankruptcy and are well positioned to obtain the repayment regardless of the financial conditions of the firm, insiders may be tempted to transfer the firm's residual value to themselves, thereby hastening or deepening the crisis. Therefore, halting inside debt repayment by means of an outright prohibition based on actual or constructive knowledge of a firm's looming insolvency casts a protective ring around a faltering debtor's residual assets where and when such a protective ring is most needed.<sup>33</sup> And such a prohibition can be enforced straightforwardly.

The logic that militates in favour of a more stringent policy on preference rules when the beneficiary of a preference is a firm's insider is not undermined by concerns about transactional certainty. Extending by statute the preference period regarding the reimbursement of insiders' claims beyond the preference period concerning the payment of outside creditors' claims is all the more justifiable and desirable. While an extended look-back period for preference avoidance might disincentivize third parties from trading out of fear of accidentally falling victim to it, insiders, who at any point in time are

33. See *supra* Part V, Section D.

better-equipped to gauge the financial conditions of the firm, would not be discouraged from trading merely by a reasonably extended look-back period.

## **H. The Notion of Insider for Purposes of Subordination of Inside Debt Financing and Avoidance of Preferences**

A further question is about the claim of which insider should fall within the ambit of application of the subordination remedy and be subject to extended look-back periods for purposes of preference avoidance.

Efficiency requires that not all shareholder-creditors' claims arising when insolvency is out of sight be subject to automatic subordination, but only the claims pertaining to those individuals or corporate entities that as a result of the equity interest they have or the managerial position they hold are in control of the company or ought to exercise close oversight having the power to do so and being privy to sensitive corporate information. To the extent automatic subordination aims to prevent a firm's capital structure incentivizing moral hazard and debt dilution, it should solely hit the claims of the stakeholders who have or may have an impact on the company's fortunes. Likewise, only the payment of claims held by such individuals or corporate entities should be subject to more stringent preference avoidance provisions. To the extent the avoidance of preferences should respond to attempts to dilute the asset base of an insolvent firm or a firm which is nearly so, it makes sense that avoidable preference provisions distinguish between creditors based on their capacity to influence a firm's decision to pay off its liabilities.

As to the equityholders other than inside equityholders, their debt claims, if any, should be treated for purposes of subordination and preference avoidance as those of other outside debt investors. The status of a small equityholder excluded from managerial positions is closer to that of an outside creditor than is to a controller. Actually, as cases of lender liability show, outside debt investors may weigh on corporate governance significantly more than may small equityholders despite the latter's formal ownership rights. As is well known, lenders of closely-held corporate borrowers can deploy strong-arm tactics to affect a firm's management which are unavailable to small equityholders. Regardless of the formal position as a co-owner of the company and the availability of corporate information rights on paper, a small nonmanagement shareholder is no better equipped to force the company's hand more than is an outside creditor, and in all likelihood is much less so. In light of this truth, there is no efficiency or fairness reason justifying subordination of debt claims held by a small nonmanagement shareholder to those of pure creditors.

On closer inspection, efficiency considerations do actually suggest the opposite, that is, a small nonmanagement shareholder's debt claims must not be subordinated at all. Empirical evidence shows that the presence of dual-claim holders, *i.e.* holders of both non-inside equity interests and debt claims, contributes to maximize firm value to the extent it helps deflate conflicts between equityholders and debtholders. By holding a blended position, dual-claim holders bridge the gap between the two sides. First, when holding stock of the borrower, lenders become better and longer-term monitors, which conditions allow them to charge the borrower lower interest rates.<sup>34</sup> Second, they have no interest in transferring value to the equity side as opposed to the debt side or vice versa whenever pulling the cord in either direction results in a zero-sum game. In other words, dual-claim holders internalize the conflict of interest between equity and debt, thereby contributing to firm value creation.<sup>35</sup>

The degree with which the presence of dual-claim holders mitigates the

34. See Wei Jiang, Kai Li & Pei Shao, *When Shareholders Are Creditors: Effects of the Simultaneous Holding of Equity and Debt by Non-Commercial Banking Institutions*, 23 REVIEW OF FINANCIAL STUDIES 3595, 3612-17 (2010) (finding that the participation of non-commercial banking institutional shareholders in a sample of 13,545 syndicated loan facilities associated with 9,891 loan deals between 1987 and 2006 and 3,031 US borrowers has been a conduit to a lower loan yield spread, and the higher the equity holding by creditors the lower the borrowing cost).

35. While the presence of non-commercial banking dual-claim holders is more common in borrowers that are riskier at the time of the loan origination, which evidence is justified by the enhanced monitoring capacity they rely on, the same riskier borrowers face a lower degree of deterioration of their creditworthiness after receiving the loan. This fact signals a lower propensity of shareholders and management of firms participated by dual-claim holders to engage in risk-shifting. See Jiang, Li & Shao, *supra* note 34, at 3626-30. Later studies confirm that the presence of dual-claim holders facilitates incentive alignment between shareholders and creditors, thereby preventing opportunistic behaviors, fostering investment efficiency and creating firm value. For example, excessive dividend payouts to shareholders in times of a company's financial distress is found to be mitigated when the company's capital exhibits simultaneous holders of both debt and equity. See Yongqiang Chu, *Shareholder-Creditor Conflict and Payout Policy: Evidence from Mergers between Lenders and Shareholders*, 31 REVIEW OF FINANCIAL STUDIES 3098 (2018). Dual ownership is also found to reduce the need for capital expenditure restriction covenants and together with it the risk of curbing efficient investment. See Sudheer Chava, Rui Wang & Hong Zou, *Covenants, Creditors' Simultaneous Equity Holdings, and Firm Investment Policies*, 54 JOURNAL OF FINANCIAL AND QUANTITATIVE ANALYSIS 481 (2019). Additionally, while the presence of commercial banking dual-claim holders is found to have only minor disciplining effects on overinvestment and to slightly aggravate underinvestment, the presence of non-commercial banking dual-claim holders is found to significantly reduce overinvestment, whether induced by shareholders or managers, and counteract underinvestment for the benefit of pure shareholders and pure creditors alike. See Miguel Anton & Luca X. Lin, *The Mutual Friend: Dual Holder Monitoring and Firm Investment Efficiency*, 9 REVIEW OF CORPORATE FINANCE STUDIES 81 (2020).

agency costs of debt obviously depends on the balance of equity and debt in their portfolio. At any rate, dual-claim holders stand to benefit from acting as information intermediaries between the two camps and have an incentive to use their bargaining position to help the parties hammer out solutions in the joint interest when a conflict of interest arises. For this balancing effect to unfold, however, holders of non-inside equity must be left free to hold unsubordinated debt. While holding subordinated debt would give dual-claim holders a stronger incentive to monitor against overinvestment, it would give them little incentive to take action against underinvestment in financially-distressed firms, as they would not easily reap the fruits of positive-NPV investments in the presence of a large amount of unsubordinated debt. Holding subordinated debt would also compromise their ability to monitor effectively, as shareholder-lenders would be deprived of the levers that unsubordinated loan agreements customarily provide to exert creditor influence over the management of the firm, thereby mitigating the shareholder-creditor agency conflict.<sup>36</sup>

Moreover, the typical nonmanagement dual-claim holder, at least in a closely-held company, is not an investor who starts off as a small nonmanagement shareholder to later turn into a provider of debt financing at the request of management. It rather is an investor, such as a commercial bank, that starts off as a pure lender, but later obtains a minority equity position as a result of a debt-to-equity swap implicated by a workout or a foreclosure on a shareholder-debtor's equity interest. If subordination of outstanding debt claims were the corollary of the acquisition of a minority equity interest *per se*, not only would the above-mentioned balancing effect resulting from the presence of dual-claim holders in between pure equityholders and pure debtholders be curtailed but also desirable transactions aimed at restructuring corporate debt or ensuring payment of shareholders' personal debt would be discouraged.

36. Creditor governance is grounded on the presence of information rights and restrictive covenants, whether affirmative or negative, in loan agreements. Violation of a covenant is an event of default that accelerates the maturity of the debt obligation and commands prompt payment of principal and accrued interest. The threat of debt acceleration following a covenant violation is used as a bargaining tool to renegotiate the terms of the lending relationship and possibly force changes in the firm management favorable to the lender. See *supra* Part II, Section G, note 61. But a default on subordinated debt without a simultaneous default on unsubordinated debt is an unlikely event due to ubiquitous cross-default clauses in unsubordinated debt issuances. Therefore, dual-claim holders would never be alone at the negotiating table with the defaulting borrower. Should the defaulting borrower be in financial difficulty, dual-claim holders may then be easily outmanoeuvred by senior lenders threatening to plunge the firm into bankruptcy and asserting their priority against junior lenders. As a result, dual-claim holders, if forced to hold subordinated debt, may cease to be the effective monitors which the empirical evidence has so far shown them to be.

PART VII  
A NOVEL TIME-PHASED,  
INFORMATION-FORCING SUBORDINATION  
APPROACH TO INSIDE DEBT FINANCING  
AND THE ACCOMPANYING AVOIDABLE  
PREFERENCE RULES

This Part outlines and discusses a proposal for a regulatory approach to inside debt financing which is novel to most (if not all) of the world's most prominent jurisdictions. Section A illustrates the characteristics of what I call a time-phased, information-forcing subordination approach, which invokes subordination of inside debt advances made before a year prior to the advent of bankruptcy and no-subordination of inside debt advances made within a year prior to bankruptcy on condition that such advances are properly disclosed. Section B proposes that insider loans secured on a firm's assets be dealt with by the law as if they were unsecured. Section C recommends that the avoidable preference rules supporting a time-phased, information-forcing subordination approach extend the suspect period for insiders compared with non-insiders. Section D discusses the benefits of this novel regulatory approach, whereas Section E discusses the costs. Section F compares this novel regulatory approach with alternative solutions.

**A. The Contours of a Time-Phased, Information-Forcing Subordination Approach**

My proposal first advocates that that all debt advances to the company made by its insiders prior to 12 months before the commencement of an insolvency proceeding should automatically be subordinated to all other debt claims.<sup>1</sup> Second, it suggests that debt advances made to the company by its

1. To this end, no distinction should be made between credit from the beginning extended by the insider and credit originally extended by a third party with the resulting claims then assigned to an insider during the subordination period. See Leonard J. Long, *Automatic*

insiders within 12 months prior to the opening of an insolvency proceeding should be eligible for no-subordination on condition that the advance be properly and timely disclosed by the borrower company. While debt claims held by equityholders not qualifying as insiders should rank *pari passu* with those held by the general creditors,<sup>2</sup> the notion of insider for purposes of this novel regulatory approach should include holders of a voting equity interest in excess of 20%<sup>3</sup> and, more generally, all holders of voting equity interests coalesced in a control group. But it should also include directors and officers regardless of their holding equity below the relevant threshold of 20% in light of their direct control over the company's financing and investment decisions.<sup>4</sup> In fact, directors and officers' claims should be subject to subordination even if they hold no equity at all.<sup>5</sup>

As earlier mentioned, the nature of an advance made by an insider in the 12-month period leading up to bankruptcy, for the advance to be exempt from automatic subordination, would have to be properly disclosed by making the information available to the public. For such a disclosure mechanism to work, however, there would be no need to disclose the name of the lending insider. Disclosure of the date and amount of the advance from the insider would suffice. But disclosure, for it to be effective, would have to be timely. For instance, mere disclosure in the annual financial statements would not be enough to promptly alert the creditor class. When not based on a one-to-one targeted communication, which would be a possibility, disclosure could be ensured by resorting to the general means of corporate information dissemination to the public. Among such means one could think of the companies register, the public depository with which the corporate foundational documents are filed, a corporate data repository made available for public inspection, the corporate commercial and financial documentation routinely submitted to counterparties, or a combined use thereof. Once made known through one

*Subordination as Incentive for Insider Creditors' Prudential Investing*, 13 JOURNAL OF LAW & COMMERCE 97, 136-39 (1993).

2. For the reasons discussed *supra* in Part VI, Section H.

3. The 20% threshold stands to signal the status of a seemingly influential blockholder if not that of a controlling shareholder.

4. The combination of the financial incentives to maximize shareholder value arising from their equity stake and the managing power arising from the authority vested in them should be balanced by downgrading the status of their debt claims against the firm assets, whenever existent, so that they will personally bear to a great extent the burden of their decisions.

5. This conclusion is imposed by directors' and officers' allegiance to the controlling shareholders or the shareholders as a whole arising from the nomination process. Only by having their advances subordinated and their personal risk of loss enhanced can we expect them to be less prone to accommodate the equityholders' appetite for excessive risks.

or more of these means of corporate information disclosure, lenders and trade partners would gain actual or constructive knowledge about the fact that the disclosed amount of recent debt funding from an insider may wholly or partially be exempt from subordination depending on whether bankruptcy sets in on the company at some point in the near future.<sup>6</sup>

According to this novel approach, therefore, the subordination of advances made by insiders would hinge on the time to the event of the opening of an insolvency proceeding and the degree of transparency of a company's capital structure.<sup>7</sup>

The date of 12 months prior to the commencement of an insolvency proceeding ideally draws a line between debt claims arising when the company is still sufficiently solvent or expected to be able to regain solvency despite the ongoing financial difficulty, on the one hand, and debt claims arising when the company is in irreversible pre-insolvency or deeply into insolvency, on the other hand. Debt issued by the company to its insiders when the start of an insolvency proceeding proved *ex post* to be more than 12 months away is presumed to have been originated when the company was still in good shape or in any event still able to cope with the pending, critical state of its finances. It follows that such debt must eventually fall within the automatic subordination perimeter. On the contrary, debt issued by the company to its insiders when the start of the insolvency proceeding proved *ex post* to be only 12 months away or less would be presumed to have been incurred when the company was already irreversibly doomed, with evidence of such fact being given by the subsequent opening of a court-led corporate reorganization or liquidation within the next few months.

6. In this regard, if the information were disclosed through a companies registrar or depositor of corporate information number, size and date of these advances could easily be tracked. This would allow third parties to make a precise assessment of how much of the debt owed insiders might be exempt from subordination should insolvency occur within a given timeframe.

7. While David A. Skeel & George Krause-Vilmar, *Recharacterization and the Nonhindrance of Creditors*, 7 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW 259, 272 n.32 (2006), points out that if one were to focus exclusively on the company's solvency or insolvency, the regulatory option to subordinate loans made in times of solvency and to leave loans made in times of insolvency unscathed could make sense, they ultimately dismiss this approach. In their view the state of the company's finances turns out to be a "very imperfect measure" of whether insider loans should be hailed or feared. That is why they explicitly favor solely the disallowance of insiders' security interests, which they believe aggravate the overinvestment problem, while they recommend to preserve the status of insiders' unsecured claims, whose perniciousness is much less obvious. See *id.* at 273-75. This work has sought to demonstrate that the state of a firm's finances matters and it is better to draw a dividing line between hailed inside debt and feared inside debt, however imperfect such line may be, than affording insiders unconstrained freedom to shape a firm's capital structure at any stage of its lifecycle.

Though unable to precisely separate claims of the former type from claims of the latter type, such a bright-line rule would be of straightforward application and reflects a pattern widely used in insolvency law.<sup>8</sup>

The no-subordination of pre-petition inside debt financing is the counterintuitive feature of the proposal. The reasons for shifting from automatic subordination to no-subordination as the time to the event of insolvency shortens are manifold and have already been illustrated at length.<sup>9</sup> What is more, this rule creates no incentives for an opportunistic postponement of the start of the insolvency proceeding. The insider would know that strategically pushing back the filing for bankruptcy past 12 months from the date of the advance would backfire with regard to the legal status of the advance, as such a behaviour would automatically relegate it to a lower status in the bankruptcy's ranking of claim priorities. The 12-month grace period would just provide a temporary relief from the threat of subordination as a response to impending, extraordinary circumstances calling for insiders still believing in the possibility of a turnaround to provide last-minute rescue financing. But such a windfall would vanish if the company ultimately traded out of its financial woes or simply postponed its demise. Therefore, an insider would gain nothing from putting together a "loan-to-postpone" strategy as far as exemption from subordination is concerned. An insider holding debt would likely be incentivized to get its ailing company to file for bankruptcy as early as possible if it wanted to have its debt relieved of the penalty of subordination.

As regards the mode of operation, subordination of insider loans extended during the subordination period should be inchoate rather than complete. To be sure, a complete subordination could always be the result of *ad hoc* negotiations between the insider creditor and one or more of the firm's outside creditors. A complete subordination arrangement may well prove in the interest of both an outside lender and an insider creditor if conducive to a lower risk for the lender and a lower cost of borrowing for the insider creditor. Besides, a complete subordination arrangement would simultaneously give rise to positive externalities for all third-party creditors. But a subordination remedy

8. Alternatives to the 12-month rule herein advocated for might equally be feasible. For instance, the no-subordination period could be extended up to 18 months or shortened to 6 months. Each alternative trades the goal of capturing the time when a company can be thought of as approaching insolvency off against the goal of avoiding that the benefit of no-subordination be accorded to loans made at a time when the company is outside a narrowly-defined twilight zone. Insofar as one year is a familiar standard for look-back periods, it is a reasonable solution for purposes of distinguishing between mandatorily subordinated insider loans and insider loans entitled to escape subordination, too.

9. See *supra* Part VI, Section B, Paragraphs 2 and 3.

made unconditionally complete by law would be a step too far. It would entail that any payment on account of insiders' debt claims would be frozen as long as some outside creditor's debt claim were outstanding independently of the financial viability of the company. In so doing, an unconditionally complete subordination provision would distort the foundations of corporate finance law itself. The relationship between inside equity and inside debt would be upended. It is well known that equity distributions in the form of dividend payouts, cash reserve distributions, and share buybacks are always permitted to the extent they do not prejudice the solvency of the company. A complete subordination of inside debt would prohibit a reduction in the asset base by way of satisfaction of inside debt claims regardless of the solvency of the company while inside equity distributions would still remain permissible subject to the above-mentioned solvency-related constraints. In addition to placing a structural inconsistency in the regulation of insiders' financial claims against a firm's assets, a complete subordination regulatory approach would likely annihilate inside debt as a source of financing for fully solvent firms, with severe pitfalls on group of companies relying on the flexibility of intragroup loans to allocate and transfer funds within the perimeter of the group. Although the annihilation of insider lending could marginally favour inside equity capital for funding purposes, with the effect that there could be firms coming through as more strongly capitalized than they would otherwise be, the overall flexibility of insider financing, and together with it the range of financing options available to any one firm, would be impaired far beyond what efficient creditor protection actually requires.

The reader will notice that the novel regulatory approach advocated herein entails a divided entitlement along a temporal dimension. This feature largely distinguishes it from the traditional no-subordination and automatic subordination approaches, which allocate absolute, unmodifiable entitlements and protect them by a property rule regardless of the financial conditions of the company and the time to bankruptcy. Until 12 months prior to the commencement of the insolvency proceeding the entitlement would be given to the creditors and could not be taken from them without their unanimous consent. From 12 months prior to the commencement of the insolvency proceeding to the commencement date, the entitlement would revert to the insiders, with the property rule protection nonetheless conditioned on full transparency about the exercise of the entitlement. Unlike the divided entitlement arising from the equitable subordination approach, where the shift of both the entitlement and the accompanying property-rule protection is based on an *ex-post* court assessment about the meritorious or opportunistic nature of the relevant insider advance, according to this novel approach the

*ex post* reallocation of the entitlement and the accompanying property-rule protection would result from an unequivocal bright-line rule.

It must however be emphasized that the adoption of the novel approach put forth in this book would not at all be inconsistent with, and thus would not preclude, the simultaneous application of the doctrine of equitable subordination of insider advances when made within the 12 months prior to bankruptcy. The disapplication of automatic subordination with regard to the inside debt issued in the 12 months preceding bankruptcy would be fully compatible with a court-ordered subordination of an insider's debt claim should the equities of the case demand that a misconduct by an insider creditor be redressed for the benefit of one or more creditors. In other words, insider advances would still fail to benefit from the safe harbor discussed herein if the insider were found to engage in inequitable conduct to the detriment of one or more creditors. Nevertheless, for the two doctrines to peacefully coexist, the notion of inequitable conduct could not include those very same facts or behaviors which this novel approach is meant to remedy or incentivize. For example, a company's initial undercapitalization *per se* could not be grounds for subordination of last-minute inside debt financing. Initial undercapitalization would purposefully be dealt with by subordinating the debt raised from the insiders outside the 12-month period leading up to bankruptcy. Similarly, the controversial standard according to which the inequity of inside debt funding may be derived from establishing that no other outside lending institution would have lent in the given circumstances would become even more untenable than it already is, since the logic of exempting 11<sup>th</sup>-hour rescue attempts by insiders would precisely be that of helping insiders to respond to external credit shortage whatever the causes thereof.

## **B. The Treatment To Be Reserved for Secured Inside Debt Financing**

This novel approach also advocates the full disallowance of security interests taken by insiders in a firm's assets.<sup>10</sup>

As with unsecured inside debt, collateralized inside debt should automatically be subordinated when issued by a firm prior to 12 months before bankruptcy while it should rank on a par with outside unsecured debt when issued within 12 months before bankruptcy, provided that the debt financing is properly disclosed. Only by denying insiders the chance to earn their debt a senior status thanks to the use of security interests would the insiders'

10. Conversely, secured credit from non-inside equityholders should enjoy the same level of priority enjoyed by secured credit from pure lenders.

incentives to overinvest and dilute outside debt effectively be curbed and an overall consistency of this regulatory proposal be achieved.

In recommending that secured inside credit be dealt with much like unsecured inside debt is, the proposal partially follows in the previous footsteps of commentators who voiced their concern about allowing insiders to secure their loans on the firm's assets.<sup>11</sup>

### **C. The Avoidable Preference Rules Needed in Support of a Time-Phased, Information-Forcing Subordination Approach**

Debt claims held by insiders should stop being reimbursed as soon as the firm experiences severe financial distress. If such claims were satisfied despite the prohibition, the payment transaction should be avoidable as a preference.

In more detail, the repayment of inside debt should be halted whether the debt matures past the date on which the insolvency proceeding commences or matures prior to it. To be sure, while the early repayment by a floundering company of a debt not yet fallen due as of the date of the commencement of the insolvency proceeding is necessarily an opportunistic move to the advantage of the recipient with no underlying justification, the payoff of a debt fallen due before such commencement could be justified on grounds of debt maturity under ordinary contract law. Yet, the look-back period is conceived to avoid that the official commencement date of the insolvency proceeding operate as an arbitrary watershed for creditors' rights. Because insolvency in all likelihood sets in before such a commencement date, a repayment made prior but close to such a date is likely to have occurred in a situation of insolvency. Besides, insiders could be tempted both to manipulate the maturity date of their debt claim through an opportunistic eve-of-bankruptcy renegotiation and to not file for bankruptcy until after the payoff of their debt. Only by anticipating the outright ban on reimbursement of inside debt at a sufficiently earlier point in time can the law mitigate the risk of a run of the insiders on a firm's leftover value.

The informational and positional advantages which insiders benefit from further justify that the preference period applicable to related-party payment transactions be extended beyond the preference period applicable to payment

11. See Skeel & Krause-Vilmar, *supra* note 7, at 284 (contending that secured insider lending deepens the overinvestment problem); Andreas Cahn, *Equitable Subordination of Shareholder Loans?*, 7 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW 287, 298 (2006) (same).

transactions with outside creditors, which in turn must be kept short enough for reasons of transactional certainty. A balanced rule would provide that the suspect period be set at no less than 12 months prior to the commencement of an insolvency proceeding.<sup>12</sup>

#### **D. The Benefits of a Time-Phased, Information-Forcing Subordination Approach**

The divided allocation of the entitlement to gain priority in bankruptcy under this novel regulatory approach can intuitively be argued for by noticing that in times of healthy financial conditions a property rule vested in the insider creditors would likely give them and the strongest lenders an incentive to generate harmful externalities for the nonadjusting creditors, *i.e.* a social cost in excess of the private benefit captured by the insiders and the lenders, and would also make the adjusting creditors as a class worse off *ex ante*.<sup>13</sup> On the other hand, granting property-rule protection to the creditors would not severely compromise insiders' incentives to invest in the firm if positive net present value projects were in sight. Plausibly, the equity or quasi-equity nature of insiders' claims would direct the firm to look at projects carrying a lower degree of risk.

Conversely, in times of financial distress, where the incentive for the insiders to invest additional personal wealth weakens on its own, a property rule vested in the creditors' class would aggravate the hold-out problem as an impediment to inside debt financing while current unsecured creditors as a class, given their already being on the verge of extensive losses, would gain no apparent benefit from holding the entitlement. Besides, while prospective trade creditors would

12. Hand-picking an optimal suspect period for purposes of avoidance rules is as much a challenging task as is hand-picking an optimal period for purposes of a time-phased debt subordination remedy. Once again, it is all about trading off outside creditor protection against the incentives for insiders to provide debt. The guarantee that their debt can be reimbursed forms the bulk of such incentives. The 1-year look-back period should therefore be seen as a reasonable compromise between the conflicting interests of the two sides. More sophisticated solutions are nevertheless imaginable. For instance, one could think of a 1-year period for the avoidance of repayment of inside debt which fell due before the advent of the insolvency proceeding and a 2-year period as to the avoidance of repayment of inside debt which did not become due until after the opening of the procedure. After all, most inside debt advances are open-ended, long-term or renewed a number of times to enable the company to avail itself of the necessary liquidity all along the way. The early termination of these loans is more suspect. A longer look-back period may thus be justified.

13. See *supra* Part VI, Section B, Paragraph 1.

be put on notice of the amount of inside debt keeping the company afloat, nonconsensual creditors would possibly be harmed only by the amount of inside credit extended in the relatively short, 12-month period preceding bankruptcy.<sup>14</sup>

The key advantages of this approach are simplicity, objectivity and straightforwardness. As with the automatic subordination approach and unlike the equitable subordination approach, there would be no need for the bankruptcy court to evaluate *ex post* the financial conditions of the company based on the dates of the advance and of its reimbursement. The court would only have to assess the date of the loan. The time lapse between the date of the loan and date on which the insolvency proceeding commenced would be a proxy of whether the loan was made at a time when the company was solvent<sup>15</sup> or, in stark contrast, the loan was made under conditions of irreversible insolvency. But for the avoidance of doubt, it must be pointed out once more that reference to the different states of a firm's finances only serves to justify the proposal on theoretical grounds. It would have no bearing on the court's assessment. Rather than forcing the court into a complex *ex post* evaluation of the financial conditions of the company at the time of the advance and of the optimal financing decision that a reasonable insider should have taken in the given circumstances,<sup>16</sup> this remedy commands subordination as a consequence of a straightforward *ex post* finding of the time lapse between an easy-to-assess date of the loan and the starting date of the insolvency proceeding.

One more advantage is that such finding requires no speculative assessment as to whether the loan did play any role in avoiding or postponing bankruptcy. Whether the loan played a major, successful role *per se* in the rescue attempt or not would not matter for the purpose of the remedy, for the penalty of subordination would more generally hinge on the choice of the capital structure made by the firm owners at any given point in time and the opening date of an insolvency procedure.

In turn, the additional requirement that the debt nature of the financing furnished by the insiders be disclosed in order to avoid subordination would operate as a "penalty default rule"<sup>17</sup> or, more generally, as an information-

14. See *supra* Part VI, Section B, Paragraphs 2 and 3.

15. Or, at the very least, the company was going through a state of reversible financial trouble.

16. Evaluation to be made against the backdrop of the decision that a hypothetical third-party lender would have made as is required under the various equitable subordination approaches.

17. The concept of "penalty default rules" was famously introduced in Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 *YALE*

forcing mechanism.<sup>18</sup> The goal would be to prompt the lending insiders to share with third parties the private information of the extension of credit to the firm by offering the former the benefit of having debt claims originated on the dawn of bankruptcy escape subordination.<sup>19</sup> When put on actual or constructive notice of the advances made by an insider potentially eligible for no-subordination, current and prospective lenders and trade creditors would be alerted to the fact that the company might still be standing solely thanks to inside debt and that such financing might rank *pari passu* with their claims should insolvency ultimately occur. Rather than mandating a predetermined contractual framework for the protection of third parties or supplying a default contractual framework with a view to economizing on transaction costs, the law would supply a default allocation of priorities in bankruptcy that would force

LAW JOURNAL 87 (1989), which argues that penalty defaults are efficient rules “purposefully set at what the parties would not want – in order to encourage the parties to reveal information to each other or to third parties (especially the courts).”. See *id.* at 91.

18. According to Ian Ayres, the doctrine of equitable subordination in the US already operates as a penalty default rule to the extent it “induces the insiders to make unusual patterns of equity and debt claims known”. See Ian Ayres, *Making a Difference: The Contractual Contributions of Easterbrook and Fischel*, 59 UNIVERSITY OF CHICAGO LAW REVIEW 1391, 1399 (1992) (quoting from Easterbrook & Fischel, THE ECONOMIC STRUCTURE OF CORPORATE LAW 60 n.13 (1991)). The argument is that a majority of firms’ insiders and creditors does not necessarily want a default rule commanding equitable subordination of insider creditors’ claims. But in order to opt out of the rule, the insider would have to disclose in advance the unusual capital structure of its firm. By doing so, it would make its counterparties aware of their enjoying no priority vis-à-vis the insider’s debt claims. And this knowledge would result in explicit contracting for a higher interest rate. The finding of a penalty default rule in the doctrine of equitable subordination as is currently applied by US courts is however questionable. As case law stands as of today, subordination does not result from a judicial assessment of excessive financial leverage except for sparse cases. Some additional wrong by the insiders is usually required. Nor is *ex ante* disclosure of the unusual pattern of financial claims held against the company sufficient to rule out subordination, if some additional wrongdoing by the insiders has occurred. Put succinctly, nondisclosure of over-indebtedness without any wrong does not trigger subordination, while disclosure thereof if coupled with a wrong does not avoid it. While the doctrine of equitable subordination as has been applied to date in the US might induce the revelation of information on a firm’s capital structure to reduce the risk of subordination, inasmuch as the revelation of information does not eliminate such a risk, its information-forcing effect is severely impaired, and so is its capacity to induce explicit contracting.

19. This would be an example of a cost, referred to as a bonding cost in Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 JOURNAL OF FINANCIAL ECONOMICS 305, 338-39 (1976), which would lift the penalty of subordination on the insiders while still containing the monitoring expenditures to be incurred by the lenders. The insider will incur such bonding cost if the net increment of its wealth, once accounting for the expected reaction of current and prospective adjusting creditors, is greater than the one produced by automatic subordination of its debt.

the insiders to internalize the social cost of their financing choice, whatever it be. Without disclosure, insiders would bear the burden of subordination. With disclosure, they would escape subordination while prompting adjusting creditors to adjust the interest rate charged the firm and nonadjusting trade creditors to gauge whether to continue to trade or not.<sup>20</sup>

A possible effect is that insiders be induced to disclose their financing as soon as they estimate some probability of default in the coming months. More precisely, a lending insider would decide whether to disclose or not by trading off the benefit of escaping subordination against the cost of signalling its subjective estimation of some probability of default, which might undermine ongoing and prospective trade and credit relationships. As the probability of an imminent default is estimated to near zero, there would be no disclosure, for disclosure would be counterproductive. In addition to not ensuring subordination should bankruptcy strike in the distant future, disclosure would wrongly signal a probability of imminent default. But as the probability of an imminent default increases, so too would the incentive to disclose. The prediction is that some advances might occasionally happen to be disclosed even prior to the 12-month period leading up to the start of the insolvency proceeding. An insider creditor who is aware that the demise of company cannot be ruled out from unfolding in the near future might feel like not missing out on the opportunity to have its claim exempt from subordination, even though disseminating this information might hasten the crisis itself by alienating some credit and trade counterparties. But the decision whether to keep the financing confidential for a while or to risk a self-fulfilling prophecy would still rest in the hands of whom can make a better assessment

20. To be sure, if the means chosen by the firm to disclose information about the indebtedness to the insider required that interested creditors take steps to access it, the cost for the creditors to acquire information would still be positive. To the extent the cost of acquiring information is positive, creditors for whom the benefit from acquiring such information does not outweigh the cost admittedly would not take steps to access it even if potentially interested in the information. Consequently, some creditors with small claims having little incentive to get acquainted with the amount of debt exposure to the insiders would exist even under the disclosure remedy illustrated *supra* in Section A. See Susan Block-Lieb, *Why Creditors File So Few Involuntary Petitions and Why the Number Is Not Too Small*, 57 BROOKLYN LAW REVIEW 803, 840 (1991) (“[C]reditors with small claims – especially small claims that arise out of a single, discrete transaction – will have little incentive to acquire information about the debtor’s financial condition”). Nevertheless, a means of dissemination of the information to the public would arguably reduce the cost of getting informed for the trade creditors to a large degree. Therefore, the size of the claim, for it to disincentivize a potentially interested creditor to access now-easily-accessible information, would predictably have to be very small and, in any event, much smaller than under alternative regimes which neither penalize nondisclosure nor reward disclosure.

of bankruptcy risks. To the extent such a disclosure would signal the subjective estimation of some probability of default entertained by the lending insider, it would efficiently contribute to bridge the informational gap between insiders and third parties on the state of a firm's finances earlier and more accurately.

Taken together, the 12-month grace period and the disclosure of debt claims would ensure that chances, if any, for emergency debt financing from willing insiders could be kept alive without unduly externalizing to third parties any substantial risk of dilution of their claims in an artificially postponed insolvency.<sup>21</sup>

Finally, a remedy which provides for subordination of insiders' advances made on a date sufficiently remote from the bankruptcy date and no-subordination of insiders' advances made within a few months prior to the bankruptcy date would not undermine the regulation on debtor-in-possession ("DIP") financing, either. To the extent the regulation on DIP financing, whose main task is to alleviate the incentive to underinvest in valuable projects,<sup>22</sup> allows insiders to extend credit enjoying superpriority,<sup>23</sup> the ranking of insiders' debt in bankruptcy would hinge on the state of a company's finances on the date of the financing. Debt advances made in times of full solvency would be subordinated. Debt advances made at a time when the company is in or near insolvency would rank *pari passu* with the claims of general creditors if properly disclosed. Debt advances made in the context of a reorganization, whose commencement would in and of itself attest to the irreversible nature of the financial demise, would benefit from superpriority. Such a pattern would result in insiders' debt claims being ranked according to an inverse correlation with

21. Under this proposal institutional lenders participating in a workout attempt would still be expected to bargain for the contractual subordination of eve-of-bankruptcy inside debt financing. Should they succeed in obtaining contractual subordination, all other creditors' claims would end up suffering from unequal treatment in the event of bankruptcy. But under the circumstances of an imminent insolvency, the possibility of unequal treatment of some creditors' claims in bankruptcy appears to be a reasonable price to pay *ex post* in order to avoid the social cost of deterring late emergency financing and the feasibility of a workout plan *ex ante*.

22. See George G. Triantis, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 VANDERBILT LAW REVIEW 901, 919 (1993).

23. In the US, according to the Bankruptcy Code, §364(c), a DIP may be authorized by the bankruptcy court to obtain credit benefitting from superpriority over both pre-petition debt and §364(a) and § 364(b) priority administrative expenses only if the trustee is unable to obtain unsecured credit pursuant to either §364(a) or §364(b). Insider credit is allowable as DIP financing. See *In re Medical Software Solutions*, 286 BANKRUPTCY REPORTER 431, 437 (United States Bankruptcy Court for the District of Utah, 2002) (recognizing that DIP financing from an insider was instrumental in ensuring that the debtor could continue its operations). See *supra* Part V, Section B, Paragraph 1, note 59. Similar rules apply across Europe.

the deterioration of a company's financial conditions.<sup>24</sup> If the degree of priority of insiders' claims in bankruptcy were made to vary based on the timing of the advance and the state of a firm's finances, it would operate countercyclically to set proper financing incentives for the insiders, thereby contributing to both safeguard the financial soundness of firms *ex ante* and dig insolvent firms out of their financial hurdles *ex post*.

## **E. The Costs of a Time-Phased, Information-Forcing Subordination Approach**

Two sets of costs may be identified in connection with the novel regulatory approach proposed in this work. A first set of costs has to do with the automatic subordination of insiders' debt incurred outside of the safe-harbor period. A second set of costs revolve around the possibility for an insider extending credit during the safe-harbor period to opt out of automatic subordination by disclosing its advance.

With regard to dropping insiders' debt back in the priority line when incurred outside of the safe-harbor period, the social costs which immediately come to the fore – and which are routinely waived in the face of pro-subordination arguments – are the chilling effects on entrepreneurship and investments. Knowing that the only claims that a firm's founders can hold are equity interests or quasi-equity interests, some potential entrepreneurs may refrain from venturing into setting up companies in the first place. In respect of already established companies, some firm owners may decide to abandon viable investment options in light of the heightened risk of loss resulting from striking out unsubordinated debt from the menu of the financing alternatives available to them. Indeed, once unsubordinated debt is ruled out and financing can solely take the form of either equity or subordinated debt, any business venture or corporate investment opportunity marred by downside risk would look less advantageous in the eyes of a firm's insiders. If the payoff available in the adverse scenario – say, in the advent of bankruptcy – is reduced in light of the nature of the claims that owner-managers are allowed to hold, keeping the payoff available in the favourable scenario constant will result in a lower expected payoff. A lower expected utility for a potential entrepreneur deciding whether to start up a firm or not and for a firm owner deciding whether to take a business opportunity or not may result in the *ex ante* abandonment of these options despite their potential in terms of firm value creation.

24. See *supra* Part VI, Section F.

Furthermore, regardless of the magnitude of payoffs available in the best-case scenarios of profitable firms and investment opportunities, increasing the downside risk might just scare away the more risk-averse, and yet value-creating businesspeople. Mandatory subordination of inside debt – so the argument goes – disincentivizes insider lending at the margin by increasing the cost of lending to the insiders.<sup>25</sup>

There is little doubt that the choice of eliminating unsubordinated debt from the insiders' menu of financing alternatives for solvent firms might have some chilling effect on entrepreneurship and investment, which is an efficiency loss. But is this cost something to worry about? It rather seems to be the minimal price to be paid for achieving the benefits which automatic subordination is intended for in the first place. By reducing the expected payoff in downside scenarios automatic subordination would prompt firm owners and their managers to search for opportunities with a higher upside potential or a lower probability of downside potential, which would correspondingly bring in a greater potential for firm value creation. Second, by filtering out *ex ante* the most risk-averse entrepreneurs, *i.e.* those for whom limited liability is not protective enough, automatic subordination would police the market by leaving it in the hands of owner-managers whose business acumen is aligned with, and supported by, a more balanced and productive attitude toward business risk.

More generally, the chilling-entrepreneurship theory proves too much. Brought to its extreme, such theory would justify that an entrepreneur be legally safeguarded against any risk of loss insofar as full protection against losses would maximize incentives to finance and carry out business operations *ex ante*. But once moral hazard problems enter the picture, efficiency requires to set optimal incentives to finance and invest rather than to maximize them. As the level of protection against the risk of loss enjoyed by the insider increases, so does the risk of moral hazard. A trade-off exists between entrepreneurial incentives and containment of moral hazard. Efficiency is achieved if enterprise risk is allocated to the party who can bear it at least cost, *i.e.* to the party who is better positioned to reduce enterprise risk *ex ante* or spread it *ex post*. Enterprise risk arising from management of closely-held companies must be shared by insiders and outside creditors because neither of the two classes of stakeholders necessarily bears risk more efficiently than the other. While insiders exerting control over the firm assets are better situated to prevent or remedy losses, outside creditors are

25. See Richard A. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 UNIVERSITY OF CHICAGO LAW REVIEW 499, 518 (1976) (arguing that if a parent could just make equity investments in subsidiaries, the investment process would be undermined and the comparative advantage of a parent as a more efficient lender would be lost).

more likely to be able to diversify the risk of loss away. Therefore, a risk-sharing scheme is needed to maximize joint efforts aimed to create firm value. If insiders were fully shielded from losses, they would be not deterred against a reckless use of their control rights. They would have fewer incentives to reduce risk despite the power to do so. Externalization of additional risk to nonadjusting creditors would likely result in more than optimal risk-taking by insiders. Insiders must therefore bear some amount of risk to keep their incentive to eschew excessive risk-taking alive. To be sure, how large a fraction of the overall enterprise risk they should bear to mitigate moral hazard is an empirical question. Nevertheless, the overall amount of risk that inside equityholders run on their investments must be higher than the overall amount of risk run by pure debtholders, or else allocating control power to the former to the exclusion of the latter would have no economic justification. Allowing insiders of a solvent company to substitute lower-risk, unsubordinated debt for higher-risk, fully subordinated equity while retaining full control of the corporate entity by no means sets optimal incentives to finance and carry out business.<sup>26</sup>

Among the social costs deriving from automatic subordination of inside credit extended in times of solvency one might also list the increasing cost of bank finance and the resulting diminished availability of external financial resources for productive uses. To the extent banks would no longer obtain the

26. One additional disadvantage inuring to the proposal put forward herein is the creation of an incentive for the interested parties to circumvent the rule by having insiders personally guarantee a firm's debt obligations to the firm's lenders so as to preserve lenders' exclusive rights against the insiders' assets. The fact is that insiders routinely provide personal guarantees even under a regime contemplating no automatic subordination of inside debt. See David Kravitz, *The Outer Fringes of Chapter 11: Nonconsenting Senior Lenders' Rights Under Subordination Agreements in Bankruptcy*, 91 MICHIGAN LAW REVIEW 281, 295 (1992) ("Often an insider... personally guarantees obligations of the company to increase lenders' willingness to lend, much as insiders subordinate their claims against the debtor to those of outside lenders."). While it is possible that introducing a regime of automatic subordination of insider loans to solvent firm would be partially counteracted by a marginal increase in numbers and size of insiders' personal guarantees in support of external financing, it is doubtful that such a financing scheme might be able to fully supplant direct inside debt financing. Inside debt financing exists where readily available liquidity is needed by the borrower as a consequence of unexpected circumstances or in the ordinary course of business. The arrangement consisting of a personal guarantee offered to a bank by an insider to be followed by personally-guaranteed bank financing is not a complete substitute because it takes longer to get accomplished and, holding the firm's need of cash constant, requires a larger cash infusion from the bank. Assuming that a firm needs \$100 of financing and assuming that an insider and a bank would each provide \$50, if the financing from the insider were to be replaced with a financing from the bank, the latter would have to double the size of its loan to the borrower firm. The ensuing effect on the bank's balance sheet may make the bank unwilling or unable to agree to it in the first instance. A bank's willingness and possibility to make up for the lack of direct insider financing is hardly a foregone conclusion.

benefit of a contractually-targeted subordination of existing and prospective inside debt if incurred prior to the year before bankruptcy, they would loan money to the firm at a higher cost in response to the diminished chance of recovery in bankruptcy. While subordination for the benefit of all creditors marginally disincentivizes an individual lender to extend credit compared with the alternative of contractual subordination solely for the benefit of that individual lender, this outcome does not present a net social cost. First, a first-priority objective of lenders in no-subordination jurisdictions allowing contractual subordination is to have insiders run a risk of loss higher than the one the former are exposed to in order to deter insiders' moral hazard. Automatic subordination of inside debt to all creditors ensures just that. Second, as a result of the benefits from automatic subordination accruing to outside creditors in proportion of their debt, the larger the percentage of a debt financing relative to the percentage of the existing outside debt, the more automatic subordination benefits the provider of that financing. Third, a generalized automatic subordination remedy would put all trade creditors and involuntary creditors of inside debt-financed firms in a better position by reducing their credit risk. As a consequence, while banks lending to insider-financed firms would not be able to obtain the full benefit of contractual subordination, such loss would be more than offset by the indirect benefit of having all of their direct borrowers, including those qualifying as trade and involuntary creditors of other firms, earn an enhanced creditor status vis-à-vis their insider-financed debtors. Forth, in the presence of multiple, uncoordinated lenders all being willing to achieve subordination of inside debt to their exclusive benefit, one might argue that the race to subordinate on the part of the lenders would cause the laggards among them to respond by raising their interest cost to the borrower firm. When a firm is expected to borrow from multiple lenders at subsequent points in time, the first lender has an incentive to demand initial and/or subsequent subordination of any inside debt to its advantage. The subsequent lenders would have no other alternative but asking for a higher price on their loans. Consequently, the benefit of a lower interest expense on one loan might partially or wholly be offset by an increase in the interest expense on subsequent loans. Ultimately, contractual subordination of inside debt enables insiders to substantially lower the borrowing costs only when all or most of the lenders benefit from it.

Even assuming that shifting from a no-subordination legal remedy allowing contractual subordination to automatic subordination on average increases the overall firm's borrowing costs, it is unlikely that the private cost to the insiders outweighed the ensuing social benefit. Under automatic subordination, there would be no transfer of value from a firm's nonadjusting creditors to the

coalition of the firm's insiders and adjusting creditors. Hence, the expected value of nonadjusting claims would rise. As we have noted, lenders in turn would protect themselves adjusting upward the interest rate charged the firm to more accurately reflect firm risk. In equilibrium, the additional cost would thus be passed onto the firm insiders, who by being obliged to internalize the cost of their firm's activities would act more efficiently.

To be sure, to the extent loan transactions would become more costly to the firm and raise the riskiness of the deal for the lenders, some of the latter might be deterred from lending in the first place, thereby foreclosing the efficient corporate activities that should have counted on such financing. Still, this occurrence is improbable. When a firm is solvent, a lender would unlikely refrain from lending just because inside debt would be automatically subordinated for the benefit of the whole creditor class as opposed to being subordinated to that lender's claims only. It is more realistic to assume that a lender under automatic subordination would still lend, albeit charging the solvent firm a higher interest rate in anticipation of a reduced share of the bankruptcy estate. Because of the higher cost to the firm, insiders would take out a costlier loan to finance comparatively higher expected value projects. Besides, insiders would have an incentive to take precautions to minimize the amount of nonadjusting debt claims – especially tort claims –, a course of action which would be socially desirable. To sum up, while both automatic subordination and contractual subordination may equally help mitigate insiders' moral hazard, automatic subordination does so without the accompanying social cost of inflicting harm on nonadjusting creditors' chances of recovery in bankruptcy.

It has been argued with regard to groups of companies that a reduced prospect of payment to the parent resulting from subordination of its debt claims against a subsidiary would jeopardize the creditworthiness of the parent, thereby eliciting a greater effort to investigate a subsidiary's creditworthiness from the parent's creditors at a higher cost for the parent.<sup>27</sup> But investigation efforts should not significantly increase if the parent held subordinated debt rather than unsubordinated debt. To the extent unsubordinated debt, too, is unlikely to be fully paid back in bankruptcy, in no circumstances may the parent's creditors entirely forego an *ex ante* investigation into the parent's unsubordinated debt holding in a subsidiary, if they wished to pursue an optimal assessment of the parent's creditworthiness. In other words, whether the debt issued by a subsidiary to its parent is subordinated or not, such debt is subject to a risk of loss which must be weighed *ex ante* by a parent's lenders. At the same time, because the maximum amount of loss to the parent does not

27. See Posner, *supra* note 25, at 517.

vary with the nature of the debt issued by the subsidiary, we should not expect a severe surge in investigation costs to the parent's creditors, although the risk of loss slightly increases with subordination.<sup>28</sup> Even if the cost of inquiring into the parent's creditworthiness were to soar, the cost to a subsidiary's unsubordinated outside creditors of inquiring into the creditworthiness of the subsidiary would correspondingly diminish. The resulting higher value of the equity of the subsidiary would go to the advantage of the parent, thereby offsetting the parent's increased direct borrowing costs.

Other costs under this novel approach would be those associated with the timely production of information for the benefit of current and prospective creditors, which is necessary to meet the requirement of full transparency. While such costs would undeniably arise, they can be expected to be negligible. All means of disclosure briefly mentioned *supra* in Section A are low-cost information dissemination tools. Most of them are either already in use for various corporate purposes or could be employed with little corporate effort and expenditure. Likewise, little effort would be required of potential counterparties willing to retrieve such information before extending credit or trading goods and services. In any event, no more effort than is already required to get basic knowledge of other corporate details of any borrower or trading partner.

## **F. Comparing This Novel Approach with Alternative Solutions**

A final thought is worth giving to the viability of alternatives to a remedy coupling automatic subordination of insider loans provided to a solvent firm with no-subordination of insider loans provided to a firm at or near insolvency. Perhaps, alternative legal arrangements might result in functional equivalents of the proposal pinned down in this work with greater or more convincing attributes of efficiency and fairness.

First of all, one might think of taking a shortcut by granting superpriority to nonadjusting creditors in bankruptcy over all other creditors, whether the latter are insiders or outsiders. Aside from the difficulty in sorting out all creditors that truly deserve to be categorized as such for the purpose of allocating the

28. In this respect, it becomes apparent how the consequences arising out of subordination of insider claims stiffly differ from those stemming from the judicial disregard of shareholder limited liability. In making the parent unlimitedly liable for all of the debts of the subsidiary, the doctrine of piercing the corporate veil increases both the risk of loss and the maximum amount of loss that the parent may have to sustain.

superpriority benefit<sup>29</sup> and the feasibility of pursuing such superpriority from a political economy perspective,<sup>30</sup> a likely response by adjusting creditors, especially outside lenders, would be fewer or more costly debt investments in firms to the detriment of economic efficiency. The deterrent effects on outside debt financing would of course be mitigated if the benefit of superpriority were afforded to tort creditors only, as has repeatedly been proposed in the literature. But in addition to the difficulty in supporting a discrimination against non-tort, and yet nonadjusting creditors such as small suppliers on fairness grounds, it would follow that the discriminated nonadjusting creditors would be left without any alternative protection and once again prone to the very same risk of expropriation at the hand of lending insiders and outside lenders that any alternative remedy should help avert in the first instance for it to be a functional equivalent.

As a further alternative, one might suggest that subordination of insiders' debt be legally imposed for the benefit of nonadjusting creditors only, provided that such debt is incurred by the company prior to 12 months before the start of an insolvency proceeding. Besides the identification problem mentioned above,<sup>31</sup> the best response for the professional lenders to this targeted priority benefitting nonadjusting creditors to their exclusion would once again be

29. For instance, while a small supplier should be deemed as being nonadjusting creditor, a large supplier may well figure as an adjusting creditor to the extent it likely has the resources to adjust the contract terms in light of the counterparty risk on a case-by-case basis. Using the categories of adjusting and nonadjusting creditors for purposes of the benefit of superpriority would raise an identification problem insofar as the bankruptcy trustee and the bankruptcy court would have to inquire *ex post* into whether an unpaid supplier was sophisticated enough to warrant the appellation of adjusting creditor or not. Inevitably, an assessment of this sort would be highly subjective to the detriment of legal and transactional certainty.

30. The order of priorities in bankruptcy has public good-like features. A favorable ranking automatically benefits all similarly situated creditors, *i.e.* all creditors belonging to the class whose ranking is moved up in the priority scheme, whether they have contributed to better the ranking or not. But while adjusting creditors, which are mostly banks and other lending institutions, result in a cohesive, homogenous interest group organized and powerful enough to successfully lobby lawmakers for a comfortable ranking of their claims in bankruptcy, nonadjusting creditors are mostly small, heterogenous and uncoordinated. As far as trade creditors are concerned, they are too disparate and fragmented to be able to coordinate at a reasonable cost. Any lobbying attempt would pose a collective action problem in that each trade creditor would be tempted to free-ride on the efforts of others. As to tort creditors, in their falling victim to corporate torts against their will and mostly accidentally, they assign little probability *ex ante* to acquiring such status, thereby rationally refraining from investing in upgrading the treatment of tort claims in bankruptcy as long as they are tort-free. When achieving the status of a tort creditor, victims of corporate harm face similar if worse collective action problems than those faced by trade creditors.

31. See *supra* note 29 and accompanying text.

that of ticking upward the interest rates charged the borrower company, although not as much as they would charge it if nonadjusting creditors enjoyed superpriority.<sup>32</sup> In light of a surge in external borrowing costs and the indeterminacy of the category of the nonadjusting creditors as opposed to the adjusting ones, this alternative remedy does not seem to be more advantageous than the one advocated in this work.

One more alternative solution could be a regime under which insiders' debt were subject to subordination from the company's inception and through to bankruptcy unless disclosed to the public. In the event of disclosure at whatever point in time, the insider's debt would gain a ranking in bankruptcy equal to that enjoyed by outside creditors' debt. Yet, the inferiority of this alternative arrangement is self-evident. If the lending insider did not disclose, the outcome would be the same as under the approach put forth in this book. If the lending insider did disclose, the outside lenders could still attempt to obtain contractual subordination to the exclusion of all other creditors, which would bring us back to the defects of the no-subordination model. In fact, insiders and outside lenders would have an incentive to opt into this socially inferior disclosure-followed-by-contractual subordination pattern to exploit their mutual private bargaining advantage. Even though the law could prohibit contractual subordination after disclosure, disclosure would bring the efficiency and fairness costs of a mandatory no-subordination model to light. On the one hand, such an approach would prompt adjusting creditors to either obtain severe, and thus suboptimal, limitations to the amount of insiders' debt or seek *ex ante* compensation in the face of the risk of *ex post* opportunistic insider loans. On the other hand, nonadjusting creditors would remain vulnerable to the very same risk of opportunism without any safety net.

On a different note, one might argue in favor of distinguishing loans made by noncorporate insiders to small, privately-owned firms and loans made by parent companies to their subsidiaries, with the former being exempt from

32. While the superpriority mentioned above (see *supra* notes 29-30 and accompanying text) would ensure that nonadjusting creditors' debt be fully paid off before any payment could be made on all other creditors' debt, the targeted priority mentioned here would mean that adjusting creditors' debt and nonadjusting creditors' debt would rank equal in the distribution of the bankrupt's estate, with the bankruptcy dividend pertaining to insiders' debt, if any, being turned over to nonadjusting creditors only. Everything else being equal, a generalized superpriority would increase nonadjusting creditors' recovery rate compared with a targeted priority, because while in both scenarios nonadjusting creditors would get the dividend otherwise due to the insiders, in the former they would also get the dividend otherwise due to the adjusting creditors. In light of a comparatively higher risk of recovering less, adjusting creditors would demand a higher extra-compensation under a nonadjusting creditors-oriented superpriority than under a nonadjusting creditors-oriented targeted priority.

automatic subordination and the latter being subject to it depending on their timing along lines similar to the ones discussed throughout this work. The logic would be to distinguish between risk-bearers recognizing that small entrepreneurs setting up a company are at a disadvantage compared with a parent company in managing and reducing enterprise risk. Nevertheless, moral hazard is a problem to be dealt with in respect of small firms, too. Actually, it can even be worse to the extent the small entrepreneur, unlike a holding company repeatedly seeking outside finance for its affiliates, might not have other lending relationships, businesses or reputation to preserve. Therefore, small entrepreneurs may not necessarily act less opportunistically than parent companies in dealing with their controlled firms. Small firms are also less likely to afford and buy third-party liability insurance. Therefore, victims of corporate torts are comparatively less likely to be paid off by a small firm than by the affiliate of a business group. As a result, all else being equal a full exemption from legal subordination of inside debt, especially when coupled with the possibility to contractually subordinate such debt for the benefit of a major lender, may harm nonadjusting creditors of small firms more than it would harm nonadjusting creditors of group affiliates.



# CONCLUSION

Much has been written about how to deal with debt claims held by insider lenders against the assets of an insolvent firm. This book adds to the existing literature by, first, giving a detailed account of the practice of inside debt financing and, second, proposing a novel regulatory approach based on insights from corporate finance and agency theory. Such a novel approach advocates the automatic subordination of debt owed insider lenders when originating while the company was solvent and no-subordination of debt owed insider lenders when arising while the company was insolvent or in the zone of insolvency, provided that the financing was disclosed. This remedy should be accompanied by the disallowance of insiders' security interests in their firm's assets as well as the avoidance of preferences favouring insiders while insolvency looms large.

Barring insiders from extending unsubordinated credit at a time of full solvency, when both internal and external financing alternatives are readily available, alleviates the agency costs of outside debt and prevents subordination arrangements that may be privately efficient but are socially harmful. Equally important, disincentivizing insiders from having additional skin in the game at a time of a liquidity shortage or looming insolvency, when other internal and external sources of funding likely dry up, foster overinvestment or underinvestment at the expense of current general creditors and firm value.

To the best of my knowledge none of the most sophisticated jurisdictions in the world uses a similar approach. This fact signals that that there still is ample room for innovative legal experimentation with respect to the multifaceted issue of debt financing from a firm's insiders.

Not surprisingly, in the midst of the economic crisis triggered by the Covid-19 pandemic lawmakers of most European countries providing for automatic or equitable subordination of insider loans scrambled to suspend the

application of their rules.<sup>1</sup> In difficult times, prominent European jurisdictions seem to have taken the view that the only financing timely available to a cash-strapped company may well be raised from among its most affectionate insiders. After all, when a liquidity crisis hits the firm, it is the insiders who can at lower cost provide readily-available funds preventing insolvency or averting reversible insolvency. But for this to happen, insiders cannot be punished for betting their money once more. To overcome a legitimate reluctance to put further wealth of their own at risk of destruction when nobody else would come to the rescue, controlling shareholders and other insiders need to be reassured they can at least share in the estate assets *pari passu* with pure creditors should the worst-case scenario of a default take hold. The truth is that insiders cannot be expected to be indifferent between providing equity and providing debt at a time when their company is in deep financial trouble. The only realistic alternative for them and their company's urgent need for liquidity may well be unsubordinated debt or nothing.

While using emergency laws to elaborate on the efficiency and fairness of a regulatory policy for ordinary times is misplaced, it is extreme circumstances that usually put the efficiency and fairness of legal solutions to unambiguous test. The decision of many European jurisdictions to revert to a regime of no-subordination, however temporary such a decision might be, proves that the undifferentiated subordination of all debt advances made by a firm's insiders in times of crisis is widely considered undesirable. Yet, it is unclear why a distinction should be made between a liquidity crisis originated by adverse macroeconomic conditions and a liquidity crisis prompted by adverse firm-specific conditions in the first place.

When dealing with a company's financial hardships in a challenging economic environment, it is better to be safe than sorry. Perhaps this is a lesson that can be learned for quieter times, too.

1. Austrian law prompted by the Covid-19 pandemic exempted short-term shareholder loans, *i.e.* loans to be reimbursed within 120 days, from subordination if made from March 1, 2020 through to June 30, 2020. Likewise, German emergency law provided that advances to the company made by its shareholders from March 1, 2020 through to September 30, 2020 were exempt from subordination in the context of insolvency proceeding commencing on or before September 30, 2023. Similarly, Spanish law enacted in response to the Covid-19 pandemic stated that advances made to the company since the declaration of the state of emergency were exempt from subordination in the context of the bankruptcy proceedings commenced between March 2020 and March 2022. As to Italy, the rules on subordination of equityholders' debt claims were suspended until the end of 2020.

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# Inside Debt Financing

Debt finance raised from corporate insiders has attracted the attention of legal scholars over the past several years. Such an interest comes as no surprise. The variety of legal treatments reserved for insider loans across Europe, the United States and in other jurisdictions attests to an intriguing absence of any regulatory uniformity despite similar financing patterns. After reviewing the literature on the benefits and costs of inside debt financing and illustrating the diverse regulatory approaches adopted by prominent jurisdictions, the book reassesses the risk of opportunistic insider lending based on the state of a company's finances. In doing so, the book sheds light on the net costs associated with financially sound firms issuing senior debt, whether secured or unsecured, to their insiders and, by contrast, the net benefits of allowing insiders to make senior unsecured loans to firms that are in or near insolvency. Following the re-examination of the benefits and costs of insider lending, novel requirements are recommended for an efficient and fair legal response to inside debt as a source of funding for both solvent firms and financially-distressed ones.

Alessandro Pomelli is Associate Professor of Commercial Law at University of Bologna. He has been Visiting Professor at the Universities of Hamburg, Tel Aviv, Haifa and at China University of Political Science and Law (Beijing). Author of articles on corporate governance, takeover law and securities regulation, his main research interests lie in the law & economics and law & finance of corporations and capital markets. He has been involved in policy work with the European Commission and in 2016 was appointed expert for the European Parliament in corporate law.