Subordination of non-arm's length creditors' claims: at a crossroads

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Abstract. In several European countries and the US, corporate and insolvency law principles allow the courts to subordinate the claims of non-arm's length creditors (i.e., affiliates, shareholders, controlling persons, officers, etc.) of an insolvent entity. However, there is no universal approach across the above jurisdictions. Instead, the scholars observe a whole range of subordination regimes. Each of them derives from a unique and unsteady balance between the interests and values protected by law. This paper examines the Russian subordination rules and their evolution and discusses the values and incentives behind the subordination of non-arm's length creditors claims in search for an optimal approach.

1 Introduction

The *pari passu* principle is a cornerstone of insolvency law in most jurisdictions all over the world. Latin for "equal footing" it means that all and any available assets of the debtor should be equally distributed between its unsecured creditors during the insolvency proceedings pro-rata to the debt due to each creditor. However, not unlike any other rule, the *pari passu* principle is subject to certain exceptions and reservations, one of which is the treatment of shareholders and other non-arm's length creditors such as affiliates, officers and controlling persons. An exceptional legal regime applicable to the persons mentioned above is based on a common understanding that such persons can usually influence the debtor's business decisions, have better knowledge of its financial position, and the debtor's financial distress often stems from the improper management by these very persons. Therefore, many jurisdictions drew up some statutory and case law-based rules intended to protect the interests of *bona-fide* economic agents and to "contain" the controlling and affiliated creditors by way of subjecting them to more scrutiny and potentially subordinating their claims to all other claims as well as providing the external (independent) creditors and/or the bankruptcy trustee with a right to challenge the transactions between the debtor and such non-arm's length creditors.

But how rigid should such rules be, and could their adverse effects (if any) outweigh the positive intention?

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1.1 The problem

The question mentioned at the end of the previous section is, in fact, a derivative of a more fundamental issue, namely – which subordination model should the lawmaker (or the judiciary, as the case may be) choose in the first place. The subordination models existing in the developed countries may be described as follows. The first one to mention is a German “hard subordination” model (installed by the regulatory reform consummated in 2008) under which all shareholders’ claims and any other claims of similar economic nature are subordinated with the exceptions applicable to the minority shareholders (*Minderheitsgesellschafter*) and the shareholders who acquired their stake under the financial rehabilitation procedures (*Sanierungsprivileg*). Another approach may be found in Austria and Italy, where the shareholders’ claims are not subordinated unless the financing has been provided during the debtor’s financial distress. The next model is the *debt recharacterisation* mechanism applied in the United States, which is aimed at investigation of the true intention of the shareholder or another non-arm’s length-capital provider based on the numerous criteria developed and used by the courts to establish if the financing should indeed be considered equity injection and therefore subordinated (in other words – it is a model tilting towards the hard subordination, although a somewhat more complicated from the procedural point of view). Another approach may also be found in the United States – it provides for the subordination of only those claims arising out of bad faith transactions featuring a malign intent to harm the other creditors (*equity subordination*). Finally, there are jurisdictions with no subordination rules whatsoever (such as France and the UK).

The present paper is not suitable for a comprehensive analysis of the historical choices made by the judges and lawmakers, which in each case led to the adoption of the above models. However, it is necessary to name the fundamental interests or values that drive these choices. As mentioned previously, subordination as a concept was brought into existence by a premise that competition between a shareholder or any other affiliate or insider of the debtor and an independent creditor with no ties to the same is unfair, therefore, the law should intervene to prevent the abuse. At the same time, it would be unreasonable to simply assume that the English or French law are free of any subordination rules to promote injustice, which brings us to the question if there are any competing values, the protection of which could justify the absence of a special mechanism ensuring the formal equality of creditors. Arguably, these would be the freedom of contract as a legal representation of a free market (which would be further discussed below) and investment climate, which suffer the most from any type of restriction or state intervention (in this regard, some scholars observe that soft or absent subordination rules are promoting the so-called *COMI*- (“centre of main interest” which from a procedural point of view acts as one of the key criteria in the determination of the bankruptcy proceedings jurisdiction [1]) migration and capital inflow as a result [2]).

Yet another view proposes that to stabilise the market and to increase the trust level among the market agents, the law must incentivise the debtors and their controlling persons to apply for bankruptcy (as soon as the insolvency of a company becomes inevitable in the absence of an urgent capital injection) by way of subordination all non-arm’s length creditors’ claims if they continued to provide funding to the debtor on the brink of collapse to prolong its “life”.

The combination of the above values and considerations and the importance assigned to each of them from time to time by the lawmakers and judges govern the dynamics of subordination rules development and evolution.

1.2 Scope of the analysis

It was not our goal to go deep into the history of the problem and observe in detail the evolution of the Russian legal framework, although we refer to the past to the extent it is necessary to aid the discussion.

Our analysis and argumentation focus on the scenarios involving mid-market and large enterprise-debtors conducting a business ripe to attract external financing from institutional investors and lenders. We do not extend our inquiry onto the SMEs unfamiliar with covenant packages and the agency cost of debt problem.

Proceeding from the above, the rest of the paper is organised as follows. Section 2 provides the analysis of the Russian caselaw-based subordination legal regime, Section 3 offers a discussion of the subordination rules' rationale, and Section 4 concludes the paper and presents our conclusions and propositions.

For the avoidance of doubt, subordination of claims is not the only instrument to "contain" or disincentivise the non-arm's length creditors. It is important to mention the doctrines of "substantive consolidation" and "lifting/piercing the corporate veil", which serve as an ultimate punishment for the debtor's shareholders. These are related concepts since both offer the elimination of fraudulent corporate group use, and the courts use similar formulations in consideration of these cases. Thus, in a lawsuit against a corporation that ignored corporate formalities or was intentionally undercapitalised, the court may revoke its legal personality and allow a direct lawsuit against its shareholders. But in a situation where there are debts of several debtors to several creditors, the application by one of the creditors of the doctrine of "lifting / piercing the corporate veil (veil)" in relation to a particular debtor does not always contribute to obtaining greater satisfaction of their claims than the implementation of "substantive consolidation" with regard to the assets of all debtors at once with their subsequent distribution among all creditors. It should also be noted that the doctrine of "lifting/piercing the corporate veil" ignores the subsidiary rule of limited liability, while the doctrine of "substantive consolidation" ignores the subsidiary rule of protection of legal entities [3]. However, it should also be noted that, for instance, in Russia, the arbitration court has the right to reduce the amount or completely release from subsidiary liability if a person subject to it proves that it did not actually exert a determining influence over the activities of the debtor (or performed the functions of the governing body nominally), and further, if, based on the information provided by such person, the actual controlling person of the debtor would be identified, and (or) the property of the debtor and (or) the controlling person would be traced and recovered [4].

2 Russian law developments

The Russian Bankruptcy Law (No. 127-FZ of 26 October 2002) does not formally contemplate any rules for treating shareholders' claims (or any other non-arm's length creditors' claims, for that matter). Thus, although the definition of an "eligible bankruptcy creditor", which carves out the founders and the participants of a debtor, offers a hint for a special position of shareholders, the Bankruptcy Law remains silent on the matter otherwise. As a result, quite notably, the rules regulating the subordination of certain non-arm's length claims in their entirety have been a product of the case law created by the Russian courts since 2010 when the High Arbitration Court of the Russian Federation ruled that the shareholders of a company forming its key governing body (the general meeting of shareholders) are responsible for the effective operation of the company and should bear the risk of any adverse change in its financial performance and therefore disallowed the shareholder's claims [5].

For almost seven years after that, the courts did not go any further on this path until, in 2017, the Supreme Court of the Russian Federation issued a series of rulings providing for additional scrutiny and restriction of certain rights and abilities of affiliated creditors [6]. In 2018 the Supreme Court further ruled for the first time that the claims of an affiliated creditor should be subordinated if the underlying financing was provided to the debtor to aid its financial position while it was already in financial distress [7]. Later on, in 2019, the Supreme Court issued another milestone ruling providing for certain exceptions from the subordination principles, e.g., a scenario in which one of the shareholders provides financing to the debtor because it is prohibited to attract any other external funding by a facility agreement entered into with an institutional lender [8].

Further, in 2019 – 2020 the Russian courts of the West-Siberian District considered a landmark case of Antipinsky Refinery (ANPZ) – the largest bankruptcy case ever to feature the subordination discussion [9]. The matter brought before the courts related to the potential subordination of claims of one of ANPZ's creditors (the largest Russian bank) based on that creditor enjoying the benefits of several quasi-security mechanisms, including a golden share in the parent company of the debtor (providing a veto right with respect to certain "reserved" matters) and introduction of the creditor's representatives into the governing bodies of the debtor and its parent company as well as an extensive covenant package providing for, among other things, the prohibition to enter into certain transactions, to make certain business decisions, etc. without the prior written consent of the creditor. The courts ruled that the above does not amount to the degree of control over the debtor, which could be considered an equivalent of shareholding, and the terms and mechanisms described previously were put in place in good faith to protect the creditor rather than to provide it with an unfair advantage. The Antipinsky case sent a reassuring message to the market and cemented the gradual transition to the Austrian-like "soft" subordination model, which the legal community observed over the last 10 years.

Finally, at the end of January 2020, the Russian Supreme Court issued an Overview of the Court Practice related to Affiliated and Controlling Creditors' Claims in Insolvency Proceedings, which today serves as a "codification" of subordination rules currently in place under Russian law [10]. The Overview emphasised, among other points, that (i) the mere fact of a creditor's affiliation with or shareholding in the debtor is insufficient for the subordination of its claims (an intention to infringe the other creditors' rights or to cause harm should be established or it should be proven that a controlling person provided the funding to a debtor while it was already in financial distress) and, most importantly, (ii) the ability of a creditor to influence or control the activities of the debtor for the sole purpose of ensuring the due repayment of its debt and not aimed at or resulting in the participation of such creditor in the profit distribution, is insufficient for the subordination of claims of such creditor.

The parallel between the latter position of the Russian Supreme Court and the German BGH's ruling issued in June 2020 [11] is quite notable. In that case, the lenders of an insolvent company requested the establishment of a trusteeship; otherwise, they threatened to accelerate the credit facilities provided to the debtor. The loan agreements, among other things, contemplated reservations of consent in favour of the lenders for distributions and profit withdrawals to the trustors (shareholders). BGH nevertheless denied that the lenders held a shareholder-like position, pointing out that lenders' mere factual economic influence on the management and the ability to veto certain decisions and activities is not sufficient for the subordination. Although the proposed legal tests and structuring of the reasoning is slightly different, both have reached a similar conclusion.

3 Discussion

The Supreme Court's Overview was a major step forward for many reasons. First of all, it consolidated and organised the case-law accumulated during the previous years, reconfirmed, and brought forward a number of legal positions. It also gave the lower courts and the market a clear message that a soft model-based, case by case approach is the way forward. However, like everything else in this world, the Overview is not perfect.

The ability to exercise control is a criterion fundamental to almost all legal positions of the Supreme Court included in the Overview. Without any exaggeration, in many scenarios, it alone may predetermine the priority of a creditor's claims as it is a mandatory prerequisite for the application of most of the subordination rules and principles. At the same time, it is unclear from the Overview what should be considered an ability to control for the subordination rules purposes. E.g., an independent creditor may formally acquire control and even become a proper shareholder due to enforcement under a share pledge agreement preceding the bankruptcy proceedings (which is not an uncommon scenario). Should the courts differentiate between an artificial controlling person and an actual shareholder in charge of the debtor's business from the outset? The only adequate answer to this question would be "yes", as anything else would practically kill the pledge of shares as a security instrument under Russian law. Yet, the Overview is silent on this matter.

Further, as mentioned above, paragraph 11 of the Overview reads that the ability of a creditor to influence or control the activities of the debtor for the sole purpose of ensuring the due repayment of its debt and not aimed at or resulting in the participation of such creditor in the profit distribution is insufficient for the subordination of claims of such creditor. Therefore, the formulation of paragraph 11 gives rise to a natural query – could the subordination rules be applied to an independent lender not participating in the profit distribution, if its control over the debtor is excessive and disproportionate, and could not be justified by the "purpose of ensuring the due repayment"? In other words, is there any limit or a threshold that, if exceeded, would trigger subordination?

Finally, we would like to discuss the third problem of the Overview. It is crucial to understand that bilaterally agreed-upon contractual undertakings of the debtor, i.e., covenants, usually influence the credit risk for third-party creditors and affect the relationship between the debtor such third-party creditors, therefore they can produce the so-called externalities (in economics – a cost or benefit of a transaction for a third party who did not agree to it) [12].

And while this paper is not meant to contain a detailed analysis of the third-party effects of covenants, it should be mentioned that there is a particular type of such provisions which is usually neglected and is not considered significant for the purposes of insolvency. We refer to the informational covenants – undertakings to report certain events to the lender(s) and regularly provide the lenders with extensive information on the debtor's financial performance. Unlike all other covenants, the informational covenants generate information asymmetry (in contract theory and economics, a situation where one party has more or better information than the other capable of producing an imbalance of power in transactions, which can cause market transactions to be inefficient).

We note that the Supreme Court's Overview acknowledges that certain creditors (even those not affiliated with or in control of the debtor) may be able to receive more information about the debtor's financial health than any other external creditor. However, the Supreme Court does not comment on that any further. At the same time, it appears to be one of the most important (if not the most important) issues in the context of subordination rules which does not receive sufficient attention in Russia.

As mentioned above, the whole concept of subordination is based on the assumption that independent and affiliated creditors may not be treated equally, as it would be unfair. Using

the same logic, it would not be unreasonable to assume that different legal tests and standards should apply to the creditors having access to more or better information about the debtor and its financial position than everyone else. Unfortunately, the Russian case law is yet to take any position on that.

4 Conclusion: in search of an ultimate solution

The above analysis shows that a successful subordination model should simultaneously meet a wide range of criteria. It should protect the external independent creditors from abuse by the non-arm's length creditors gaining advantage through their affiliation with the debtor or on the basis of some contractual arrangements. Also, the rules should be precise and calibrated in order to be able to punish bad faith and reckless creditors as well as poor management and inefficient "rescue attempts" while incentivising the efficient rehabilitation. The policymakers should not try to transform the subordination rules into a universal punishment tool as there are stiffer penalties such as veil piercing for exceptional instances. It is also important to ensure that the chosen subordination model does not impede the investment climate by way of restriction of certain market-standard financing structures, such as mezzanine financing and venture capital arrangements featuring debt to equity swaps.

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