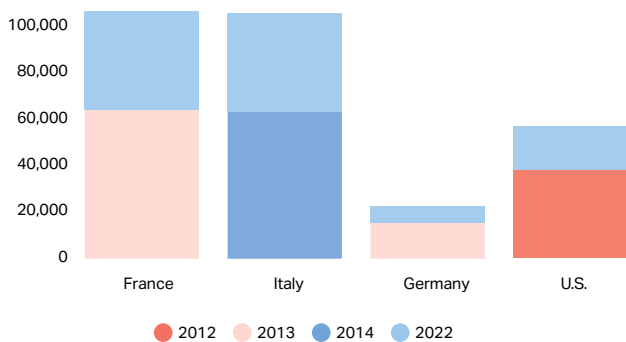


The Doctrines of “Abusive” Support and Equitable Subordination

Financial support given by a shareholder or any third party (including banks) to a company in financial distress may in certain jurisdictions be considered “abusive” support resulting in adverse consequences for the support provider.

A Decade of Change: Business Failure Rates Compared Across Years and Jurisdictions



Source: Dun & Bradstreet

Relatedly, in certain jurisdictions, bankruptcy courts may lower the priority of a creditor’s claim by paying the claim of other, junior claimholders first by ordering the remedy of equitable subordination (or pursuant to comparable principles in other jurisdictions). Security obtained in such circumstances may be subject to challenge. Equitable subordination (or such comparable

principles) and the doctrine of “abusive” support are both aimed at deterring, and correcting, inequitable or wrongful conduct by shareholder lenders and other creditors in distressed situations.

In this article, we will set out the main features of these doctrines in the following key jurisdictions – France, Germany, Italy, and the U.S.

France

“Abusive” Support: Threshold and Mitigating Factors

Traditionally, French case law considers that a financing granted to a distressed debtor which subsequently goes bankrupt could classify as “abusive” if the financing was reckless because the situation of the debtor was irreparably compromised, or if the financing was granted under ruinous conditions (i.e., the cost of the financing exceeded the repayment capacity of the debtor).

The risk of liability for “abusive” support has been significantly limited since the 2006 reform. In particular, in the case of financing provided in the context of bankruptcy proceedings, a creditor can only be held liable for “abusive” support if, in addition

to the above-mentioned criteria, it has committed fraud or interfered in the management of the debtor or if the security provided to secure the financing was disproportionate.



THE RISK OF LIABILITY FOR “ABUSIVE” SUPPORT HAS BEEN SIGNIFICANTLY LIMITED SINCE THE 2006 REFORM

Given the limitations introduced since the 2006 reform, creditors are now encouraged to provide new financings in the context of court-supervised proceedings that are intended to find a solution to the debtor’s difficulties before it becomes insolvent. Financings granted in such context are unlikely to be considered as “abusive”, as those proceedings involve some level of court control over the new financings. This is particularly the case in conciliation proceedings, where financings granted as part of a conciliation agreement approved by the court cannot be considered as “abusive” and benefit from a new money privilege in case of subsequent bankruptcy proceedings (except for equity).

“Abusive” Support: Consequences

If the conditions for “abusive” support are met, providers of the “abusive” support may be liable for civil damages in an amount equal to the portion of the company’s liabilities that result from – or have been made possible by – the “abusive” support. This generally corresponds to the amount of the company’s liabilities that have been incurred since the grant of the financing, as the financing allowed the company which should have gone bankrupt to carry on its business for a longer period. The action shall be exercised by the representative of the creditors appointed in the bankruptcy proceedings. Creditors cannot take individual actions, except if they can prove that they have suffered a specific damage that is different from the damage suffered by the community of creditors.

Equitable Subordination

There is no concept of equitable subordination available under French law.

Germany

“Abusive” Support: Threshold and Mitigating Factors

Under German law, the question of “abusive” support pivots around whether the financing would merely prolong an otherwise inevitable insolvency filing, potentially coupled with the intention to prolong the filing for the benefit of the party providing the financing at the risk of other creditors e.g., trade creditors.

It is market practice in Germany for banks to require a so-called restructuring opinion if they are asked to provide financing to a distressed company (i.e., typically in case of an upcoming maturity or if the company is already nearing insolvency), evidencing that the financing is sustainable. Broadly speaking, a financing is considered “sustainable” if it can be expected to be repaid or refinanced at maturity. A restructuring opinion will usually go along with a financial and often also an operational restructuring.

Shareholders may have some more flexibility: if they are willing to absorb further losses and compensate these (e.g., through providing further financing), providing the refinancing might not constitute “abusive” support, depending on the facts and circumstances. This could be the case, for example, if a strategic shareholder is willing to continue funding the operations of a company incurring losses because the shareholder/parent company wants to retain the subsidiary for broader business reasons. In such a case, the point to stop the support would be when the shareholder/parent is no longer willing to provide such comprehensive further support.

“Abusive” Support: Consequences

Creditors providing “abusive” support to German companies primarily face the risk of civil law liabilities. The insolvency administrator is entitled to claim

damages on behalf of persons who were already creditors of the debtor at the time the “abusive” support was provided. Such damages would be calculated as the difference between (i) the amount that the creditor would have collected had the “abusive” support not been provided and had the debtor properly filed for insolvency at such time and (ii) the (lower) amount that the creditor collects in the insolvency proceedings due to the late filing. Creditors who traded with the debtor after the time the “abusive” support was provided can themselves claim damages for all their losses incurred in respect of such trading activities due to the late filing i.e., they can claim full compensation.



IT IS MARKET PRACTICE IN GERMANY FOR BANKS TO REQUIRE A SO-CALLED RESTRUCTURING OPINION IF THEY ARE ASKED TO PROVIDE FINANCING TO A DISTRESSED COMPANY

Equitable Subordination

Debt financing provided by shareholders to their subsidiaries is generally subordinated by operation of law, and security provided to secure such subordinated shareholder debt is subject to challenge.

Italy

“Abusive” Support: Threshold and Mitigating Factors

No codified rule of Italian law provides for a definition of what constitutes “abusive” financial support. Under Italian case law, the determination of whether granting financing qualifies as “abusive” is typically based on the provision of financing to a company in a state of insolvency or severe financial distress where concrete prospects for resolving the company’s financial crisis are lacking. Knowledge by the lender of the state of distress or insolvency of the recipient

company, potentially delaying the declaration of bankruptcy, is not the sole decisive factor. The critical consideration for such a determination often revolves around the absence of well-substantiated and reasonable prospects for effectively addressing the financial crisis, to be evaluated on a prospective basis.

Shareholders and third parties willing to grant financing to distressed companies in Italy are typically encouraged to rely on the safe harbors and protections provided by insolvency law. The recently adopted Italian Insolvency Code provides for a broad range of tools aimed at the recovery of business continuity, including both out-of-court instruments and proceedings including various degrees of court supervision and approvals. Among other things, certain criminal liabilities are expressly excluded with respect to financings granted in the context of out-of-court certified recovery plans, debt restructuring agreements, or compositions with creditors.



SHAREHOLDERS AND THIRD PARTIES WILLING TO GRANT FINANCING TO DISTRESSED COMPANIES IN ITALY ARE TYPICALLY ENCOURAGED TO RELY ON THE SAFE HARBORS AND PROTECTIONS PROVIDED BY INSOLVENCY LAW

“Abusive” Support: Consequences

Providers of “abusive” financial support may be liable for civil damages both vis-à-vis the debtor company and the company’s creditors (including as a result of such creditors having increased their exposure on the erroneous impression of financial soundness created by that provider continuing to lend to it). Also, the financing provider may be exposed to criminal liability to the extent it is shown to have conspired with the debtor in order to keep it afloat while a bankruptcy filing would have been warranted.

Equitable Subordination

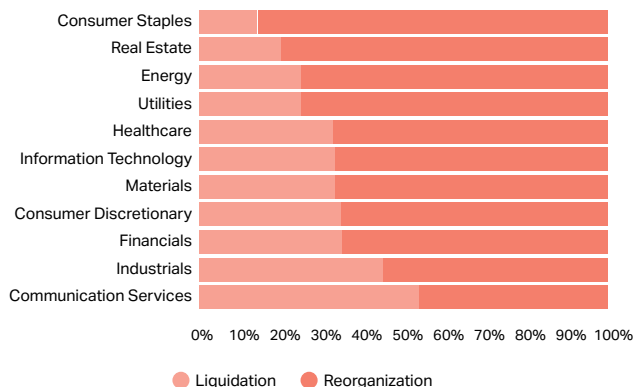
Under Italian law, financings granted by shareholders are subordinated to other creditors, to the extent such financings have been granted at a time when there is a “material disproportion” between the company’s equity and its indebtedness, or otherwise the company is in a financial situation such that an equity injection would have been “reasonable” instead.

U.S.

Under U.S. law, a bankruptcy court has the equitable power to “subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim (or equity interest).” Interestingly, even though the power is codified in the U.S. Bankruptcy Code, the equitable principles that guide courts in wielding it are not. Although different bankruptcy courts have developed their own frameworks to determine whether equitable subordination is appropriate, they generally consider (i) whether the creditor was engaged in wrongful conduct, (ii) whether that conduct unfairly advanced the creditor or disadvantaged other creditors, and (iii) whether subordination would be consistent with other provisions of the U.S. Bankruptcy Code. Notably, a creditor’s bad acts typically do not need to be tied to the claim at issue. Typically, these claims are asserted against insiders or other debtor fiduciaries. However, nonfiduciary lenders have also been targets. In the lender context, courts have subordinated a pre-bankruptcy loan to equity status where, for example, the lender exercised undue influence or domination of the borrower to benefit itself and harm other creditors, committed fraud, or violated its contractual obligations to the borrower.

Claims of equitable subordination concerning debt may also be paired with claims for recharacterization i.e., a request that the bankruptcy court reclassify the debt in question as equity. This typically requires a debtor to show that, when the economic realities of the transaction in question are scrutinized, it is better viewed as a capital infusion than a true loan.

U.S. Bankruptcies by Sector Between 2022 and 2023



Source: S&P Global

Finally, in the most egregious (and therefore rare) scenario, a court may allow a debtor to pursue tort claims against a lender whose flagrant misconduct caused or hastened the debtor’s bankruptcy.



CREDITORS SHOULD BE COGNIZANT OF THE DOCTRINES OF “ABUSIVE” SUPPORT AND EQUITABLE SUBORDINATION WHEN EXTENDING FINANCIAL SUPPORT TO COMPANIES IN DISTRESS

Creditors should be cognizant of the doctrines of “abusive” support and equitable subordination when extending financial support to companies in distress. While fraud needs to be established in France to cross over the threshold, in Italy and Germany a more lax test is applied. A finding of “abusive” support can attract civil law liabilities in each of the European jurisdictions we have looked at, and in Italy lenders, risk being found criminally liable as well.

While there is no concept of “abusive” support in the U.S., remedies for claims of equitable subordination, which may also be paired with claims for recharacterization, represent significant tools in the bankruptcy courts’ arsenal allowing it to provide relief against inequitable or wrongful conduct by shareholder lenders and other creditors in distressed situations.

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Global Restructuring Trends: Geopolitical Risks and an Upcoming Maturity Wall Will Continue to Drive Distressed Debt Decisions

The distressed debt landscape is shaped by various risks that may not be immediately evident. Of course, geopolitical shifts will be just as relevant for emerging market companies as the impact of regulation will be on businesses in the U.S. However, examining less obvious risks within the credit markets, beyond the headlines, can equip companies to anticipate future challenges. This article delves into the “stories behind the stories,” shedding light on these nuanced risks, and presents our 2024 projections based on observations from the start of the year.

Sector Pinch Points

The real estate market, including commercial real estate and real estate development, and the healthcare industry will continue to face challenges this year. Last year, we detailed the reasons for disruptions in these sectors.¹

On the healthcare side, 2024 will see continued litigation as pharmaceutical companies push back against the Biden Administration’s program for lowering what Medicare pays for costly drugs.² Market participants are increasingly focused on the

downward pressure these measures are putting on the healthcare sector.

2024

2024 WILL SEE CONTINUED LITIGATION AS PHARMA PUSHES BACK AGAINST THE BIDEN ADMINISTRATION’S PROGRAM FOR LOWERING WHAT MEDICARE PAYS FOR COSTLY DRUGS

Tightening financial conditions coupled with increased teleworking and e-commerce will continue to see a negative impact on commercial real estate.³ Perhaps one of the most visible jurisdictions where the real estate developers’ market has generated a significant activity in the restructuring space is China, and we do not expect this crisis to fade anytime soon. A large wave of defaults began in the second half of 2021. In June 2021, out of 72 offshore high-yield bond-issuing developers, four were in default of their bonds. Since then, another 53 developers have defaulted, including seven in 2023.⁴

¹ <https://www.clearygottlieb.com/news-and-insights/publication-listing/global-restructuring-snapshot-september-2023>

² <https://news.bloomberglaw.com/health-law-and-business/bidens-action-on-drug-pricing-set-for-legal-battles-in-2024>

³ <https://www.imf.org/en/Blogs/Articles/2024/01/17/us-commercial-real-estate-remains-a-risk-despite-investor-hopes-for-soft-landing#:~:text=Notwithstanding%20recent%20declines%20in%20US,have%20further%20restricted%20funding%20availability.>

⁴ <https://ionanalytics.com/insights/debtwire/reviewing-the-offshore-restructuring-progress-of-chinese-property->

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OFFSHORE HIGH-YIELD BOND-ISSUING DEVELOPERS IN DEFAULT OF THEIR BONDS AS OF JUNE 2021

Some of these issuers had already restructured and subsequently defaulted. Many developers had attempted to extend maturities and buy time to wait for a recovery that never came. This appears to be a never-ending saga, with ongoing cases featuring billions of dollars in debt.

One recent example is that of Chinese property giant China Evergrande Group, which received a liquidation order from a Hong Kong court on January 29.⁵ Hong Kong High Court Judge Linda Chan ordered China Evergrande Group to be wound up, leaving to the liquidators the work of providing creditors with recovery. This is just one prominent example of China’s boom-to-bust story of property development, with the company amassing more than \$300bn of liabilities.

Even the Middle Eastern market, so far relatively resistant to market pressures, may well experience restructurings in the real estate and construction sectors. The construction sector is particularly vulnerable to distress as it is notoriously capital-intensive.



EVERGRANDE IS JUST ONE EXAMPLE OF THE BOOM-TO-BUST STORY OF PROPERTY DEVELOPMENT, WITH THE COMPANY AMASSING MORE THAN \$300BN OF LIABILITIES

53

DEVELOPERS HAVE DEFAULTED SINCE THEN, AS OF DECEMBER 2023

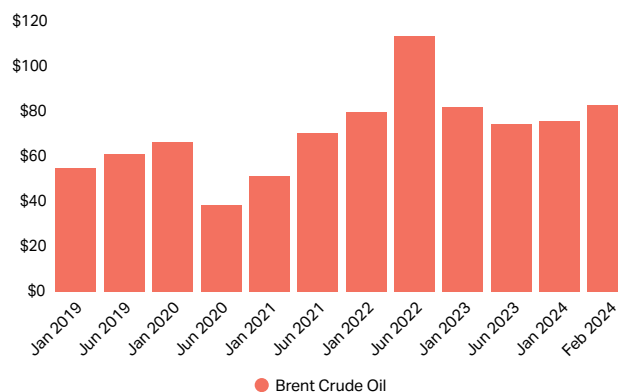
The market has started to feel the pressure of higher interest rates and lower investment in the area, due to the higher risks associated with the sector. We expect that bigger developers will be better supported, as they can naturally hedge themselves with projects near completion as they seek the funding to launch new ones. It is smaller developers and their suppliers, however, who will feel the heat to a greater extent.

Continued Geopolitical Impacts

The impact of recent conflicts on commodity prices and their effects on certain sectors and geographies have been well-documented.⁶ For example, oil prices briefly rose above \$80 a barrel for the first time in 2024 following U.S. and UK military strikes in Yemen.⁷

However, geopolitics can also have a more nuanced effect on specific sectors, and market participants should look beyond headlines that simply address their impact on commodity prices.

Price of Brent Crude Oil (\$ Per Barrel)



Source: Trading Economics • Data as of 21st February 2024

⁵ <https://www.bloomberg.com/news/articles/2024-01-29/china-evergrande-receives-winding-up-order-from-hong-kong-court?embedded-checkout=true>

⁶ <https://www.clearygottlieb.com/news-and-insights/publication-listing/five-transformative-forces-facing-emerging-markets-restructurings-in-2024>

⁷ <https://www.ft.com/content/97f31f14-0697-4fa9-bff0-64c23799651f>

Transportation Routes

The U.S. and the UK have carried out military strikes against Houthi rebels in Yemen, in response to shipping attacks by the militias in the Red Sea.⁸ This latest development is having a knock-on effect on transportation routes, with hundreds of cargo ships being rerouted to avoid the attacks.

Activity from the rebels has exposed the international trade sector to a number of challenges, including increased shipping time and fuel costs along one of the main trade links between Asia, the Middle East, and Europe. An estimated 10% of world trade by volume utilizes this route.⁹

10%

AN ESTIMATED 10% OF WORLD TRADE BY VOLUME UTILIZES THE ROUTE THROUGH THE RED SEA

Shipping companies reported millions in costs as a result of diverting vessels in the Red Sea due to the militant attacks. For example, Danish oil tanker group TORM said it had decided to pause all transits through the southern Red Sea for now. Meanwhile, Hong Kong-headquartered container group OOCL said it instructed its vessels to either divert their route away from the Red Sea or suspend sailing. It also stopped accepting cargo to and from Israel until further notice. Danish shipping group Maersk said it expected the Red Sea-related disruption to global shipping would likely last at least a few months.¹⁰ Diversions in transportation routes will likely raise shipping costs. The businesses most at risk may include car manufacturers and consumer goods retailers, which rely on a just-in-time model and are thus significantly affected by sudden and severe transportation delays.

Shifts in the market created by these geopolitical tensions could impact the shipping industry and their users more broadly in the years to come.

U.S. Political Risks

Political risk is always key in the emerging market space given how the markets are intrinsically involved with governments and global politics, as well as their susceptibility to geopolitical trends.

The 2024 U.S. elections are scheduled to be held in November and historically we have seen that the political outcomes in the country have invariably influenced emerging markets. The potential for change to major political stances in the U.S. is one factor, but the impact of a new administration could bring wider geopolitical implications, as well as affect the credit market given today's intricately connected markets.

Facing the 2025 Maturity Wall

We expect a continued increase in liability management exercises – or even holistic restructurings – in anticipation of a large maturity wall faced by a number of issuers across both developed and emerging markets.

\$89Bn

\$89BN IN LOANS WILL COME DUE IN 2025, COMPARED WITH \$9.3BN IN 2024

According to a recent study of the U.S. leveraged loan market, as of December 15, 2023, \$89bn in loans will come due in 2025, compared with \$9.3bn maturing in 2024. According to the study, more than half (51%) of the 2025 maturity wall is from riskier credits – issuers with a B-rating or lower.¹¹

⁸ <https://www.ft.com/content/ocbe7cbb-382d-49d1-8846-4f96b58358of>

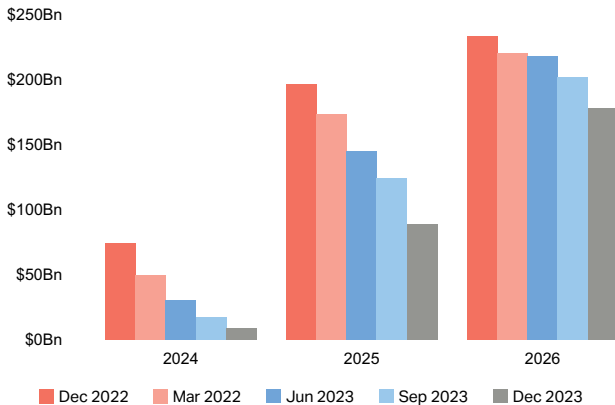
⁹ <https://www.atlanticcouncil.org/blogs/econographics/the-long-shadow-of-the-red-sea-shipping-disruption/>

¹⁰ <https://www.reuters.com/world/middle-east/shipping-firms-avoid-red-sea-houthi-attacks-increase-2023-12-18/>

¹¹ <https://pitchbook.com/news/articles/q4-us-volume-wrap-refinancings-grab-record-share-as-ma-witthers>

We have already seen some early indications of this in 2023, when a number of companies engaged in liability management exercises and raised refinancing (inevitably at significantly higher rates and less commercially favorable terms) to address the 2024 (and in some cases 2025) maturities.

Leveraged Loans Maturity Wall in the U.S., 2024–2026



Source: Pitchbook

Adjusting Expectations and Embracing Flexibility in 2024

From a thematic perspective, one key lesson from 2023 is for investors to be more flexible in their expectations. Many investors last year were waiting for a bottoming out of the market, which never materialized. Instead, investors should be prepared to roll with the market in any direction to avoid being unprepared for a quick recovery.

There were opportunities for significant profits to be made in 2023 when the markets recovered that weren't taken advantage of, as some investors waited for a deeper bottom of the curve before they were prepared to deploy capital. This year could provide more opportunities for more nimble companies and investors.

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