"Equitable subordination in the US and 'Eigenkapitalersatz' in Austria - is there a need for codification?"
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Introduction

This paper focuses on remedies for what many lawyers might see as a small legal niche rather than a commonly known legal field. However, equitable subordination is a highly important subject. There are a relative small number of cases but the values of the involved claims tend to be quite remarkable. Many countries haven't yet developed remedies for the problems where US Courts apply equitable subordination and Austrian and German Courts apply the doctrine of "Eigenkapitalersatz". One of the many emerging questions in this context is how to technically regulate the field. As this paper will show, rules for equitable-subordination-situations have to grapple with a wide array of facts and a permanent flux of economic and legal needs. Germany tried to codify applicable rules, the USA decided to give leeway to it's courts to develop applicable rules tailor-made for each case. Austria is trying to solve the problem by codification - the Austrian Department of Justice is currently working on a bill. This paper tries to show the wide scope of problems which should be covered by these rules by comparing the status quo of the relevant US law to Austrian law. This paper will further try to show reasons why a codification of rules in the field of equitable subordination can be problematic, and why even in a civil law jurisdiction like Austria it could be useful to make an exception and allow the further development of case law instead of issuing a code.

Since the topic focuses on very specific parts of already very specific areas of law, this introduction remains brief in order to make way for an introduction to the principles of bankruptcy law (part I) and an explanatory example (part II). After presenting the two approaches in part III (US Law) and part IV (Austrian Law), part V discusses the question of whether this field of bankruptcy law should be regulated by case- or statutory law.
I. The general purposes of bankruptcy procedures

In order to understand the doctrine of equitable subordination as a specialty of bankruptcy law, one must be aware of the purposes of bankruptcy law. Bankruptcy law aims at the fair distribution of a debtor’s assets to its creditors. As a first step, these assets are spotted and if necessary repossessed and marshalled. This includes the remaining assets as well as any property that may previously have been disposed of in a transaction found to be a fraudulent conveyance or a preferential transfer. As a second step, all those assets are being distributed to the creditors. Eventually remaining surplus will be distributed to the equityholders.

The equality of the distribution can turn out to be rather complicated. In the ideal case, all creditors have the same priority and receive the same *per centum quota* of their claims against the debtor. To remedy inequities, which the application of bankruptcy codes sometimes cannot avoid, bankruptcy courts invoke their 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" and subordinate certain claims. That means that one claim of a certain type will only be satisfied after all the other claims were fully paid. In praxis that mostly means that it will not be satisfied at all.

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1 See e.g. the summary of Andrew De Natale & Prudence B. Abram, *The doctrine of equitable subordination as applied to nonmanagement creditors*, 40 BUS. LAW. 417 (1985).

II. The standard problem

The best way to get a grip on the problems and principles of equitable subordination ("Deep Rock Doctrine") is by a simple example of the standard situation:

A corporation (C) is struggling with threatened insolvency. C’s sole shareholder (SSH) doesn’t want to risk more money but also wants to supply his corporation with the needed working capital. SSC therefore decides to issue a loan to C. C’s situation finally turns out to be hopeless. Shortly before SSH makes C actually file for bankruptcy, SSC collects his loan (sometimes even including interest). C’s remaining creditors are left behind with a bled-to-death debtor in bankruptcy (C). Because SSC typically collects his loan at the very last moment, no assets are left for the remaining creditors who dealt with C at arm’s length.

The (here simplified) solution is to prohibit the claimant (SSC) from collecting his loan. US courts justify this by arguing to prevent inequity. Austrian and German courts do so by holding that the loan actually was a substitute for equity (in the sense of paid-in capital) and must therefore be treated as equity for as long as all other claims are fully satisfied. However, the application of the principles of equitable subordination is not generally limited to overreaching insiders. Some courts will, at times, subordinate the loan of a third-party creditor who, in the courts view, acts selfishly at the expense of the debtor or other creditors (infra).

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4 See a similar example in Douglas G. Baird & Thomas H. Jackson & Barry E. Adler, Bankruptcy 457 (2000).
III. The US approach

A. Equitable subordination

The concept of equitable subordination developed without any specific statutory authority but derived from the equitable jurisdiction of the bankruptcy courts and the cardinal principles of equity jurisprudence. In fact, the first statutory recognition of the doctrine of equitable subordination did not occur until the enactment of the Bankruptcy Reform Act of 1978 (Code). The Bankruptcy Code recognizes the possibility (and necessity) of equitable subordination, but it doesn’t specify any standards for it. The code simply provides for that courts may subordinate claims under the principles of equitable subordination, meaning the existing case law.

In addition to attacking technically legal but inequitable conduct, the flexibility of the doctrine is useful in enabling a court to grant effective relief where practical considerations render the undoing of the illegal acts impossible or impractical. Equitable subordination is to be used measuredly. Its purpose is not to punitively take away a good-faith creditor’s rights but to level off actual inequitable disparities on the bankruptcy terrain for which a creditor is responsible, to the point where they will not create unjust disadvantages in claim positions and liquidation results. Even the mere existence of a

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6 See Andrew De Natale & Prudence B. Abram, The doctrine of equitable subordination as applied to non-management creditors, 40 BUS. LAW. 417, 421 (1985).
7 See Andrew De Natale & Prudence B. Abram, The doctrine of equitable subordination as applied to non-management creditors, 40 BUS. LAW. 417, 422 (1985).
8 See e.g. Trone v. Smith (In re Westgate-California Corp.), 642 F.2d 1174, 1178 (9th Cir. 1981).
fraudulent scheme or inequitable conduct will not require the equitable subordination of a claim unless the improper conduct resulted in actual harm to the other creditors.\(^9\)

Where the claimant has provided full restitution or adequate assurances thereof, subordination of his claims will operate only to punish his wrongdoing and will therefore be inappropriate.\(^10\) The doctrine of equitable subordination is meant to serve as a catch-all to conform the bankruptcy results to the statutory scheme where fraud or inequitable conduct threatens to defeat it. The doctrine has never been meant to enable the court, or the parties to cause the court, to amend freely the statutory scheme, but merely to enforce it.\(^11\) Equitable subordination is largely confined to three general paradigms: (1) when a fiduciary of the debtor misuses his position to disadvantage of other creditors; (2) when third party controls debtor to the disadvantage of other creditors; and (3) when a third party actually defrauds other creditors.\(^12\)

**B. The relevant US provision**

Until 1978, the generally recognized power of bankruptcy courts to equitably subordinate claims had been without congressional authorization.\(^13\) This situation was changed

\(^9\) Andrew De Natale & Prudence B. Abram, *The doctrine of equitable subordination as applied to nonmanagement creditors*, 40 BUS. LAW. 417, 425-426 (1985) citing Comstock v. Group of Institutional Investors, 335 U.S. 211, 229 (1948) and further cases.

\(^10\) In re Westgate-California Corp., 642 F.2d 1174, 1178 (9th Cir. 1981).


\(^12\) United States Abatement Corp. v. Mobil Exploration & Producing U.S., 39 F.3d 556 (5th Cir. 1994).

by the Bankruptcy Reform Act of 1978 (Code) which expressly provides for equitable subordination in 11 U.S.C. § 510(c):14

**TITLE 11. BANKRUPTCY**  
**CHAPTER 5. CREDITORS, THE DEBTOR, AND THE ESTATE**  
**SUBCHAPTER I. CREDITORS AND CLAIMS**

§ 510. Subordination  
...

(c) Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may--

(1) under principles of equitable subordination15, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or

(2) order that any lien securing such a subordinated claim be transferred to the estate.

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14 The full text of 11 USC § 510 (2000) § 510. is:

Subordination  
(a) A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law.  
(b) For the purpose of distribution under this title, a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock.  
(c) Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may  
(1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or  
(2) order that any lien securing such a subordinated claim be transferred to the estate.

15 Emphasis added by me.
Although the Bankruptcy Code recognizes the possibility of equitable subordination, it does not specify any standards by which the doctrine is to be applied. According to the legislative history, section 510(c) is intended to follow existing case law and leave the development of the doctrine to the courts.

C. The principles of equitable subordination

1. The three prong test of Mobile Steele

In the landmark case In re Mobile Steele Co., 563 F.2d 692 (5th Cir. 1977) the Fifth Circuit uses a three prong test to determine whether and to what extent a claim should be equitably subordinated: (1) The claimant must have engaged in some type of inequitable conduct, (2) the misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant, and (3) equitable subordination of the claim must not be inconsistent with the provisions of the bankruptcy code.

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18 In re Mobile Steele Co., 563 F.2d 692, 700 (5th Cir. 1977). See e.g. In re Clark Pipe & Supply Co., Inc, 893 F.2d 693 (5th Cir. 1990).
19 See also Comstock v. Group of Institutional Investors, 335 U.S. 211, 229 (1948); Spach v. Bryant, 309 F.2d 886, 889 (5th Cir. 1962); Frasher v. Robinson, 458 F.2d 492, 493 (9th Cir. 1972).
20 See also Comstock v. Group of Institutional Investors, 335 U.S. 211, 229 (1948); In re Branding Iron Steak House, 536 F.2d 299, 302 (9th Cir. 1976); In re Brunner Air Compressor Corp., 287 F. Supp. 256, 265 (N.D.N.Y. 1968); see also Wages v. Weiner, 381 F.2d 667, 670 (5th Cir. 1967).
21 See also Luther v. United States, 225 F.2d 495, 499 (10th Cir. 1955); In re Columbia Ribbon Co., 117 F.2d 999, 1002 (3d Cir. 1941); American Mutual Life Ins. Co. v. City of Avon Park, Florida, 311 U.S.
The essence of the three prong test is whether under all circumstances a transaction can be regarded as an arm's-length transaction.

a) Inequitable conduct

For the purposes of inequitable subordination, "inequitable conduct" generally refers to conduct that would make it unfair to allow a claim alongside with other creditors. The following three general categories contain conduct sufficient to satisfy the first prong of the three-part test (i.e. inequitable conduct): (1) fraud, illegality or breach of fiduciary duties; (2) undercapitalization; and (3) a claimant's use of the debtor as a mere instrumentality or alter ego. However, it is not necessary to show wrongful conduct in order equitably to subordinate claims under 11 USC § 510(c). To warrant subordination under 11 USC § 510(c), the case law does not demand that misconduct reaches the level of moral turpitude - it need only be inequitable. Equitable subordination serves not to punish but to nullify inequitable conduct of a claimant.

138, 145 (1940), quoting SEC v. United States Realty & Improvement Co., 310 U.S. 434, 455 (1940); In re Texas Consumer Finance Corp., 480 F.2d 1261, 1265 (5th Cir. 1973).

22 See also DOUGLAS G. BAIRD & THOMAS H. JACKSON & BARRY E. ADLER, BANKRUPTCY 460 (2000).


24 In re Kansas City Journal-Post Co., 144 F.2d 791, 800 (8th Cir. 1944).


against the bankrupt or its creditors can be sufficient to warrant subordination of a
case irrespective of whether it was related to the acquisition or assertion of that
claim. \(^{29}\) Inequitable conduct need not be related to acquisition or assertion of claim in
order to justify equitable subordination. \(^{30}\)

(1) Fraud

Fraud in the context of equitable subordination has a much wider scope than common-

law fraud. While common-law fraud consists of (1) a false representation, (2) known by
the defendant to be false, (3) that is intended to deceive, and (4) does in fact deceive the
plaintiff, and (5) results in damage to the plaintiff, \(^{31}\) fraud in the context of equitable
subordination was for example being seen in a breach of fiduciary duty owed by a
shareholder to his corporation. Thus the Supreme Court held in Pepper v. Litton, 308
U.S. 295, 310 (1939):

[w]hen there is added the existence of a "planned and fraudulent scheme," as
found by the District Court, the necessity of equitable relief against that fraud
becomes insistent. No matter how technically legal each step in that scheme may
have been, once its basic nature was uncovered it was the duty of the bank-
ruptcy court in the exercise of its equity jurisdiction to undo it. Otherwise, the
fiduciary duties of dominant or management stockholders would go for naught;

\(^{29}\) In re Kansas City Journal-Post Co., 144 F.2d 791, 804 (8th Cir. 1944).

\(^{30}\) In re Lemco Gypsum, Inc., 911 F.2d 1553, 1556 (11th Cir. 1990).

\(^{31}\) See e.g. W. Clark Watson, Deep rock in the deep south - equitable subordination of claims in Fifth Circuit
1985).
exploitation would become a substitute for justice; and equity would be perverted as an instrument for approving what it was designed to thwart.32

(2) Illegality & breach of fiduciary duty

"He who comes into equity must come with clean hands".33 That doctrine is rooted in the historical concept of the court of equity as a vehicle for affirmatively enforcing the requirements of conscience and good faith, it necessarily gives wide range to the equity court's use of discretion in refusing to aid the unclean litigant.34 In accordance with this maxim, claims acquired or asserted through illegal transactions are not allowed parity with the claims of other creditors.35 A fiduciary position of a claimant alone does not justify equitable subordination. There is nothing illegal in an officer or director lending money to his corporation provided he does not use his corporate position to defraud creditors or take unfair advantage of them.36

(3) Undercapitalization

Under the doctrine of equitable subordination, a stockholder's loans to his company will be treated as capital contributions when under the equities a company is deemed

36 See e.g. in re Madelaine, Inc., 164 F.2d 419, 420 (2nd Cir. 1947); Spach v. Bryant, 309 F.2d 886, 889 (5th Cir. 1962).
undercapitalized. Still, the mere fact of an insider loan may be insufficient to warrant subordination. But undercapitalization is often a "bedfellow of other insider misconduct" sufficient to built justification for equitable subordination. The concept of undercapitalization has not yet been defined precisely. As the Supreme Court explained in Pepper v. Litton, that where the paid-in capital is purely nominal, the capital necessary for the scope and magnitude of the operations of the company being furnished by the stockholder will be treated as a loan. Necessarily, this inquiry is highly factual and may vary substantially with the industry, company, size of the debt, account methods employed, and similar factors. In In re Multiponics, Inc., 622 F.2d 709 (5th Cir. 1980) the Fifth Circuit used the inquiry of Mobile Steel, namely to ask whether, under the circumstances, reasonably prudent men with a general business background would deem the company undercapitalized. The court then also particularized that standard as follows:

38 In re Multiponics, Inc., 622 F.2d 709, 717 (5th Cir. 1980).
42 In re Multiponics, Inc., 622 F.2d 709, 717 (5th Cir. 1980).
43 In re Multiponics, Inc., 622 F.2d 709 (5th Cir. 1980).
44 In re Mobile Steele Co., 563 F.2d 692, 703 (5th Cir. 1977).
45 In re Multiponics, Inc., 622 F.2d 709, 717 (5th Cir. 1980).
(1) Capitalization is inadequate if, in the opinion of a skilled financial analyst, it would definitely be insufficient to support a business of the size and nature of the bankrupt in light of the circumstances existing at the time the bankrupt was capitalized;

(2) Capitalization is inadequate if, at the time when the advances were made, the bankrupt could not have borrowed a similar amount of money from an informed outside source.46

It is, however, obvious that still no precise definition of undercapitalization can be given because the question whether a business has sufficient capital depends among other things on the constantly changing variables of the specific field of business, current customs of trade and the general economic situation etc. Under certain circumstances, a failure to supply a debtor-corporation with sufficient paid-in capital can also constitute inequitable conduct. In order to warrant equitable subordination, the Fifth Circuit held in Mobile Steele that there must be at least constructive knowing undercapitalization in order to warrant subordination:47

[w]e think that for the purposes of determining whether claims against the bankrupt estate held by organizers or shareholders should be subordinated on the ground of undercapitalization, the amount of capitalization that is adequate is what reasonably prudent men with a general background knowledge of the particular type of business and its hazards would determine was reasonable

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46 In re Multiponics, Inc., 622 F.2d 709, 717 (5th Cir. 1980).
47 In re Mobile Steele Co., 563 F.2d 692, 703 (5th Cir. 1977); See also W. Clark Watson, Deep rock in the deep south - equitable subordination of claims in Fifth Circuit bankruptcy proceedings, 11 CUMB. L. REV. 619, 629 FN 70 (1981).
capitalization in the light of any special circumstances which existed at the time of incorporation of the now defunct enterprise.\textsuperscript{48}

Under this rationale, shareholder loans made to an undercapitalized corporation will be treated as capital.\textsuperscript{49} This also is the core of the Austrian/German doctrine of "Eigenkapitalersatz", described below. It is irrelevant whether the parties whose claim is about to be equitably subordinated intended to make a loan or a contribution to capital.\textsuperscript{50} The operative facts are knowing undercapitalization and the attendant unfairness to the creditors of the corporation.\textsuperscript{51} Mere undercapitalization by itself is not enough to justify the subordination of the legitimate claims of officers, directors, and shareholders of a bankrupt corporation to those of other creditors.\textsuperscript{52} A claim may be subordinated even in the absence of fraud or mismanagement, nevertheless, equitable subordination requires some showing of suspicious, inequitable conduct beyond mere initial undercapitalization of the enterprise.\textsuperscript{53}

\textbf{(4) The 'mere instrumentality requirement' and the instrumentality rule}

A better understanding of relevant indicia of control can be obtained by examining the so-called instrumentality rule cases relating to creditor liability to third parties because

\textsuperscript{48} In re Mobile Steele Co., 563 F.2d 692, 703 (5th Cir. 1977).


\textsuperscript{50} In re Mobile Steele Co., 563 F.2d 692, 702 (5th Cir. 1977).

\textsuperscript{51} In re Mobile Steele Co., 563 F.2d 692, 702 (5th Cir. 1977).

\textsuperscript{52} In re Branding Iron Steak House, 536 F.2d 299, 302 (9th Cir. 1976).

\textsuperscript{53} In re Branding Iron Steak House, 536 F.2d 299, 302 (9th Cir. 1976).
of the creditor's control over a debtor. The instrumentality rule deals with cases of self-serving domination of a corporation by a creditor to the detriment of other creditors, shareholders, or the debtor himself. In these cases it is the self-interest of the claimant that dominates his relationship to corporation and is the motivation for the questioned transactions. Such fact patterns are often found when parent companies (or sole/dominating shareholders) file a claim for loans made to a subsidiary after the domination by the parent has precipitated the subsidiary's bankruptcy. For example in Krivo Industrial Supply Co. v. National Distillers & Chemical Corp., 483 F.2d 1098 (5th Cir. 1973) the Fifth Circuit required the "actual, participatory, total control of the debtor" in order to subordinate a controlling third party's claim. The court described the instrumentality rule the following way: "when one corporation controls and dominates another corporation to the extent that the second corporation becomes the 'mere instrumentality' of the first, the dominant corporation becomes liable for those debts of the subservient corporation attributable to an abuse of that control".

Of course, sheer domination of a subsidiary is not enough to justify equitable subordination of a parent's claim. It is the unconscionable use of that control to the advantage of the parent coupled with disadvantage to the subsidiary and/or it's creditors that

54 Andrew De Natale & Prudence B. Abram, The doctrine of equitable subordination as applied to nonmanagement creditors, 40 BUS. LAW. 417, 443 (1985).
triggers equitable subordination. A dominant corporation can be held liable for the subservient corporation’s debts if it misuses the subservient corporation’s corporate form for the dominant corporation’s own purposes under the instrumentality rule. Although the instrumentality rule can stand on its own and sometimes differs from the concept of equitable subordination under the bankruptcy laws, the rationales for the two are quite similar, namely, the misuse of control to the detriment of other creditors of the controlled entity. Hence, the indicia of control in the instrumentality cases are relevant indicia for determining control for equitable subordination. The instrumentality rule on itself requires a higher level of control than the doctrine of equitable subordination.

b) The injury necessity / cause-and-effect standard

Inequitable conduct alone is not yet enough to permit equitable subordination. Subordination is not something to be mechanically invoked when elements of wrongdoing are found to be present. The misconduct must have resulted in injury to the creditors

60 Krivo Industrial Supply Co. v. National Distillers & Chemical Corp., 483 F.2d 1098, e.g. 1102-04 (5th Cir. 1973). See also Andrew De Natale & Prudence B. Abram, The doctrine of equitable subordination as applied to nonmanagement creditors, 40 BUS. LAW. 417, 443 (1985).
63 See also In re American & Foreign Power Co., 80 F. Supp. 514, 529 (D. Me. 1948).
of the bankrupt or conferred an unfair advantage on the claimant. At the same time, claims should be subordinated only to the extent necessary to offset the harm which the bankrupt and its creditors suffered on account of the inequitable conduct. As the Supreme Court stated in *Comstock v. Group of Institutional Investors*, 335 U.S. 211, (1947): "It is not mere existence of an opportunity to do wrong that brings the rule into play; it is the unconscionable use of the opportunity afforded by the domination to advantage itself at the injury of the subsidiary that deprives the wrongdoer of the fruits of his wrong".

### c) Consistency with the provisions of the Bankruptcy Code

In *US v. Noland*, 517 U.S. 535 (1996) the Supreme Court clearly framed the leeway courts have in applying the doctrine of equitable subordination regarding the Bankruptcy Code:

A bankruptcy court may not equitably subordinate claims on a categorical basis in derogation of Congress's priorities scheme. The language of § 510(c), principles of statutory construction, and legislative history clearly indicate Congress's intent in its 1978 revision of the Code to use the existing judge-made doctrine of equitable subordination as the starting point for deciding when subordination is appropriate. [...] It is also clear that Congress meant to give courts some leeway to develop the doctrine. However, a reading of the statute that would give

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64 *In re Mobile Steele Co.*, 563 F.2d 692, 700 (5th Cir. 1977).
65 *In re Mobile Steele Co.*, 563 F.2d 692, 701 (5th Cir. 1977).
courts leeway broad enough to allow subordination at odds with the congressional ordering of priorities by category is improbable in the extreme.\textsuperscript{67}

Therefore, the courts have no power fundamentally to change the rules of bankruptcy proceedings and subordinate for example a high priority category claim such as the trustee-in-bankruptcy’s administrative expenses to a lower category claim such as an old unsecured loan. It is obvious that by enacting 11 U.S.C. § 510(c) with the Bankruptcy Reform Act of 1978 (Code), Congress meant to give courts some leeway to develop the doctrine, rather than to freeze the pre-1978 law in place.\textsuperscript{68}

2. The claims of nonmanagement creditors

For the purposes of this paper the term "nonmanagement creditors" will be used for those creditors who do not have a formal or official role in the management of the debtor. Therefore people or legal entities who factually exercise control over the debtor but are not formally in charge of the debtor’s affairs are within the scope of this definition. Originally, the application of equitable subordination was limited to the claims of management creditors, such as officers, directors, or stockholders of the debtor, who have fiduciary duties for the entire community of interests in the debtor including creditors and equityholders.\textsuperscript{69} The courts place a very high burden upon these fiduciaries’ conduct towards the debtor.\textsuperscript{70} But where the facts and circumstances of a certain

\textsuperscript{68} See also US v. Noland, 517 U.S. 535, 540 (1996).
\textsuperscript{69} Pepper v. Litton, 308 U.S. 295, 306-07 (1939); see also Andrew De Natale & Prudence B. Abram, The doctrine of equitable subordination as applied to nonmanagement creditors, 40 BUS. LAW. 417, 443 (1985).
\textsuperscript{70} See also Andrew De Natale & Prudence B. Abram, The doctrine of equitable subordination as applied to nonmanagement creditors, 40 BUS. LAW. 417, 443 (1985).
case are extreme, the doctrine of equitable subordination has been applied to subordi-
nate the claims of nonmanagement creditors as well.\textsuperscript{71}

Equitable subordination is most feared and most controversial in cases with asserted
domination and control by a nonmanagement creditor, e.g. a bank. A bank can easily
get into the scope of equitable subordination when it e.g. opens a line of credit to a fi-
nancially struggling enterprise and takes a security interest in shares, sometimes even
including the respective voting power. If the enterprise finally goes bankrupt despite
the recently issued line of credit, the bank’s claims are likely to be subordinated. In sub-
stance, a controlling creditor is perceived to be in control of the debtor’s affairs and is
held to the same rigid standard of conduct applied to management creditors.\textsuperscript{72} In the
US, control alone does not result automatically in the equitable subordination of a
creditor’s claim. The control goes only to establishing a duty of care with respect to the
remaining shareholders. In order to equitably subordinate a creditor’s claim, the con-
trol must be coupled with the use of that control to the creditor’s advantage and to the
other creditor’s harm.\textsuperscript{73}

3. \textbf{What type of conduct constitutes control?}

For example, through its loan agreement, every lender effectively exercises control over
its borrower to some degree. To answer the question of whether equitable subordina-

\textsuperscript{71} Andrew De Natale & Prudence B. Abram, \textit{The doctrine of equitable subordination as applied to nonman-

\textsuperscript{72} Andrew De Natale & Prudence B. Abram, \textit{The doctrine of equitable subordination as applied to nonman-

\textsuperscript{73} Andrew De Natale & Prudence B. Abram, \textit{The doctrine of equitable subordination as applied to nonman-
tion is justified in a certain case, courts have to distinguish between the unilateral remedies that a creditor may properly enforce pursuant to its agreements with the debtor and other inequitable conduct such as fraud, misrepresentation, or the exercise of such total control over the debtor as to have essentially replaced its decision-making capacity with that of the lender.  

The crucial distinction between what is inequitable and what a lender can reasonably and legitimately do to protect its interests is the distinction between the existence of control and the exercise of that control to direct the activities of the debtor.

The question of whether a certain type of conduct constitutes control that triggers equitable subordination cannot be answered following a simple scheme. The wide array of circumstances which could suffice to justify equitable subordination reaches from actual shareholder's voting power to effective domination of management functions in less obvious ways. Sometimes it is quite difficult to determine whether a creditor's actions stay within the boundaries of his right to observe a debtor's operation or whether his actions have crossed the frontier of controlling the debtor. The fact, that the case law offers no steadfast guidelines to distinguish between proper observation and inequitable conduct is not only caused by the actually small number of cases but also is due to the difficulty of establishing general rules on a concept that totally de-

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74 See In re Clark Pipe & Supply Co., Inc, 893 F.2d 693 (5th Cir. 1990), e.g. printed in DOUGLAS G. BAIRD & THOMAS H. JACKSON & BARRY E. ADLER, BANKRUPTCY 463 (2000).

75 See In re Clark Pipe & Supply Co., Inc, 893 F.2d 693 (5th Cir. 1990) also printed in DOUGLAS G. BAIRD & THOMAS H. JACKSON & BARRY E. ADLER, BANKRUPTCY 463 (2000).

76 See e.g. Andrew De Natale & Prudence B. Abram, The doctrine of equitable subordination as applied to nonmanagement creditors, 40 BUS. LAW. 417, 432-33 (1985).

pends on the facts and particularities of each case.\textsuperscript{78} De Natale and P.B. Abram for example propose the following cumulative Test:

For purposes of analysis, it would be helpful to consider the concept of control as a cumulative test. In order to determine whether a creditor has assumed control, the court will examine the \textit{sum of a creditor's conduct with respect to the debtor},\textsuperscript{79} total up all the indicia of control, and determine whether the cumulative conduct has tipped the scales. [Footnote: Of course, certain indicia of control may be so significant as to tip the scales by themselves. One such indicium would presumably be the exercise of the right to vote the majority of a debtor's common stock.\textsuperscript{80}]

\section*{(1) Voting power and other means of control}

In equitable subordination cases, the courts have long been recognizing a creditor's power to vote a debtor's stock as a means of control, triggering the same rigorous scrutiny as for the conduct of fiduciaries.\textsuperscript{81} Voting power may not only be achieved by stock ownership, but also through a pledge of securities as collateral coupled with the power

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\textsuperscript{78} Andrew De Natale & Prudence B. Abram, \textit{The doctrine of equitable subordination as applied to nonmanagement creditors}, 40 BUS. LAW. 417, 442 (1985). See also W. Clark Watson, \textit{Deep rock in the deep south - equitable subordination of claims in Fifth Circuit bankruptcy proceedings}, 11 CUMB. L. REV. 619, 626 (1981): "[a]n attempt to delineate the legion of misdeeds that could qualify as 'inequitable conduct' would be futile...".

\textsuperscript{79} Emphasis added by me.

\textsuperscript{80} Andrew De Natale & Prudence B. Abram, \textit{The doctrine of equitable subordination as applied to nonmanagement creditors}, 40 BUS. LAW. 417, 442 (1985).

\textsuperscript{81} See e.g. the "mere instrumentality" argument of Taylor v. Standard Gas & Electric Co., 306 U.S. 307, 312 (1939).
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to vote the shares.\textsuperscript{82} The environment for equitable subordination may also be created by control effected by domination of the management function of the debtor without voting rights. Such control can be gained by a loan and security agreement or actual acquiescence of the debtor.\textsuperscript{83}

(2) Secured creditors and control

The court in \textit{In re Process-Manz Press, Inc.}, 236 F. Supp. 333 (N.D. Ill. 1964) equitably subordinated a financial institution’s (Armstrong) claims even though they were secured with a lien. Armstrong held between 90 and 92 percent of the debtor’s stock. The court therefore found that Armstrong was not a secured creditor but \textit{de facto} the owner of the debtor (Process-Manz) because it held more than 90\% of its stock and controlled its income.\textsuperscript{84} When viewed in an ex-post (i.e. bankruptcy-) perspective, the effect of Armstrong’s activities was to deplete substantially the assets available to general unsecured creditors and to use these assets to satisfy equity interests at a time when the financial condition of the debtor was yet critical.\textsuperscript{85} The courts do recognize a creditor’s legitimate concern to assure the proper operation of a debtor’s business and to collect just indebtedness.\textsuperscript{86} There is nothing inherently wrong with a creditor carefully monitoring his debtor’s financial situation or with suggesting what course of action the

\textsuperscript{82} See e.g. \textit{In re Process-Manz Press, Inc.}, 236 F. Supp. 333 (N.D. Ill. 1964).

\textsuperscript{83} See e.g. \textit{In re T.E. Mercer Trucking Co.}, 16 Bankr. 176 (N.D. Tex. 1981).


\textsuperscript{85} Andrew De Natale & Prudence B. Abram, \textit{The doctrine of equitable subordination as applied to nonmanagement creditors}, 40 BUS. LAW. 417, 436 (1985).

\textsuperscript{86} Andrew De Natale & Prudence B. Abram, \textit{The doctrine of equitable subordination as applied to nonmanagement creditors}, 40 BUS. LAW. 417, 438 (1985); Harris Trust & Sav. Bank v. Keig (\textit{In re Prima Co.}), 98 F.2d 952, 965 (7th Cir. 1938); Cosoff v. Rodman (\textit{In re W.T. Grant Co.}), 699 F.2d 599 (2nd Cir. 1983).
debtor ought to follow.\textsuperscript{87} However, when a creditor leaves the frame of the traditional debtor-creditor relationship and controls the actual operation of the debtor, the courts tend to make the creditor subject to a higher standard of conduct.\textsuperscript{88}

In collecting on its claim, a creditor generally has no fiduciary duties regarding the debtor or his fellow creditors. The permissible parameters of a creditor's efforts to seek collection from a debtor are generally those with respect to voidable preferences and fraudulent conveyances proscribed by the Bankruptcy Act. Besides that there is generally no objection to a creditor's using his bargaining position, including his ability to refuse to make further loans needed by the debtor, to improve the status of his existing claims.\textsuperscript{89}

4. Salary claims

Salary claims of controlling employees are typical for equitable subordination cases. They also are a recognized fact pattern for the Austrian/German doctrine of "Eigenkapitalersatz", see below. In the standard scenario a shareholder who also is a director or officer does not collect his salary until there are no more assets left in the debtor company but to pay for his accrued salary claim. The shareholder makes the debtor pay and shortly thereafter bankruptcy proceedings are opened. The landmark

\textsuperscript{87} In re Teltronics Services, Inc., 29 B.R. 139, 172 (Bankr. E.D.N.Y. 1983); In re Clark Pipe & Supply Co., Inc, 893 F.2d 693, 702 (5th Cir. 1990).

\textsuperscript{88} Andrew De Natale & Prudence B. Abram, The doctrine of equitable subordination as applied to nonmanagement creditors, 40 BUS. LAW. 417, 438 (1985); Harris Trust & Sav. Bank v. Keig (In re Prima Co.), 98 F.2d 952, 965 (7th Cir. 1938).

\textsuperscript{89} In re Clark Pipe & Supply Co., Inc, 893 F.2d 693, 702 (5th Cir. 1990) referring to In re W.T. Grant Co. 699 F.2d 599, 609-10 (2d Cir. 1983).
case\textsuperscript{90} for the equitable subordination of salary claims is \textit{Pepper v. Litton}\textsuperscript{91} which was decided by the Supreme Court only ten months after the “\textit{Deep Rock}” decision (\textit{Taylor v. Standard Gas & Electric Co.}, 306 U.S. 307 [1939]) which introduced the concept of equitable subordination. \textit{Pepper v. Litton} still is a leading authority on equitable subordination. The claimant was a controlling stockholder, and therefore his salary claim was subject to strict scrutiny. The claimant had allowed his salary claims to lie dormant for years and sought to enforce them only when his debtor corporation was in financial difficulty. Even though the Court assumed that the alleged salary claim on which the Litton judgment was based was not fictitious but actually existed, the Court reached the opinion that the District Court properly subordinated it.\textsuperscript{92} Part of the Supreme Court’s rationale was that the claimants conduct was fraudulent and intended to exclude creditors.\textsuperscript{93} In \textit{Pepper v. Litton} the Supreme Court described the reasoning for equitable subordination:

\begin{quote}
He who is in such a fiduciary position cannot serve himself first and his \textit{cestuis} second. He cannot manipulate the affairs of his corporation to their detriment and in disregard of the standards of common decency and honesty. He cannot by the intervention of a corporate entity violate the ancient precept against serving two masters. He cannot by the use of the corporate device avail himself of privileges normally permitted outsiders in a race of creditors. He cannot utilize his inside information and his strategic position for his own preferment. He
\end{quote}


\textsuperscript{91} Pepper v. Litton, 308 U.S. 295 (1939).

\textsuperscript{92} Pepper v. Litton, 308 U.S. 295, 303 (1939).

\textsuperscript{93} Pepper v. Litton, 308 U.S. 295 (1939).
cannot violate rules of fair play by doing indirectly through the corporation what he could not do directly. He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference, or advantage of the fiduciary to the exclusion or detriment of the cestuis. Where there is a violation of those principles, equity will undo the wrong or intervene to prevent its consummation.⁹⁴

5. **Prima facie case, burden of proof, relationship to the claim**

Dormant salary claims are only one of many examples of claims eligible for equitable subordination. In order to have a claim subordinated, one must consider the following mechanics of shifting the burden of proof, which the Fifth Circuit outlined in *Mobile Steel*:

The proper rule is that the claimant's verified proof of claim obliges the objecting trustee to come forward with enough substantiations to overcome the claimant's *prima facie* case and thus compel him to actually prove the validity and honesty of his claim. This is not to say that once the initial presumption of validity that attaches to all claims is overcome, claims asserted by fiduciaries do not demand es-

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especially close scrutiny. The courts must examine the conduct of fiduciary-claimants with a large measure of watchful care. 95

Equitable Subordination of a claim therefore requires a three step procedure of proof. After the prima facie case of the claimant, the trustee in bankruptcy has to present sufficient evidence to prepare the grounds for equitable subordination. If the claimant is thereafter not able to weaken the trustees assertions, his claim is likely to be equitably subordinated.

D. Conclusion USA

The courts appear ready to recognize all forms of inequitable conduct and to correct the liquidation results where appropriate. The financial details of many bankruptcies are extremely complicated. Equitable subordination is a catchall to conform the bankruptcy results to the statutory scheme and basic principles of bankruptcy proceedings and equity, when they are threatened by fraud or inequitable conduct. 96 The very flexibility of the doctrine of equitable subordination, however, makes it difficult to delineate with particularity the type of fraud or inequitable conduct that may give rise to the application of the doctrine. 97 But it also is the flexibility of the doctrine that makes it useful in enabling a court to grant effective relief where practical considerations render the undoing of the illegal acts impossible or impractical. 98 It is hard to imagine a less flexible

95 See e.g. In re Mobile Steele Co., 563 F.2d 692, 701 (5th Cir. 1977).
96 See e.g. Andrew De Natale & Prudence B. Abram, The doctrine of equitable subordination as applied to nonmanagement creditors, 40 BUS. LAW. 417, 428 (1985).
doctrine or even a statute as a tool for attacking mostly technically legal but inequitable conduct.

The concept of undercapitalization serves as a good example for the necessity of a flexible doctrine of equitable subordination, since it has not been precisely defined yet.\(^9\) As with most factors that might lead to the equitable subordination of a claim, the inquiry for undercapitalization is highly factual and varies substantially with the industry, company, size of the debt, account methods employed etc.\(^10\) The same can be said regarding the fact that the doctrine offers no one-fits-all rules to distinguish between proper observation of a debtor by its creditor and inequitable conduct. Also here the concept totally depends on the facts and particularities of each case.\(^11\)

By passing 11 USC § 510 the US Congress wisely did not even attempt to establish stiff rules for equitable subordination in the form of a code. The complexity of the matter would have made it very likely that the courts would more or less have ignored such codified rules as not conclusive.

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\(^10\) *In re Multiponics, Inc.*, 622 F.2d 709, 717 (5th Cir. 1980).

IV. The Austrian approach: "Eigenkapitalersatz"\textsuperscript{102}

A. Introduction

The following pages will try to describe the Austrian/German doctrine of "Eigenkapitalersatz". The translation of the doctrine's name couldn't be more tale telling. The German word "Eigenkapitalersatz” means equity- (“Eigenkapital”) substitution (“Ersatz”). The word "equity” is here of course used as a term of corporate law, meaning paid-in capital of a corporation. Austrian (and German) courts subordinate claims when they refer to payments which substituted equity and therefore must be treated as equity. But the doctrine of "Eigenkapitalersatz” also really is a substitute for equity, now meaning the body of principles constituting what is fair and right, because there are no courts of equity in the Austrian Legal System and "Eigenkapitalersatz” is kind of a substitute for what is equity in the US and Great Britain.

B. How case law came to Austria

Beginning in 1938, the Rules of "Eigenkapitalersatz” developed in the higher courts of Germany on the basis of sections 30 and 31 of the German Limited Liability Company Act. Relating to the German Federal Supreme Court, the "Bundesgerichtshof” (BGH), these rules are called BGH-Rules\textsuperscript{103}. In 1980, the German legislature created sections 32a and 32b of the German Limited Liability Company Act providing only for a part of the BGH-Rules in codified form. The BGH has not been impressed at all by these new pro-

\textsuperscript{102} See the overview in RAOUl G. WAGNER, GESCHÄFTSFÜHRERHAFTUNG UND URG 65, (Linde ed., Vienna/Austria 1999).

\textsuperscript{103} German: "BGH-Regeln".
visions and still applies the BGH-Rules alongside with the new sections 32a and 32b going far beyond the scope of these statutory provisions.

In 1991 the Austrian (Federal) Supreme Court\textsuperscript{104} fully adopted the entire German doctrine of "Eigenkapitalersatz" with the landmark decision SZ 64/53\textsuperscript{105}. Despite of the fact that the Austrian Supreme Court justified this decision with a very weak analogy to section 74 of the Austrian Limited Liability Company Act\textsuperscript{106}, it was obvious from the beginning, that the Austrian Supreme Court adopted and developed pure case law. The Austrian Supreme Court not only continuously applied the German doctrine of "Eigenkapitalersatz" but also developed it by increasing it's scope to more and more types of claims. This is even more remarkable because the Austrian Supreme Court did not even have solid statutory basis for it's holdings but justified them with case law developed in another nation. This, of course, is quite unique in the Austrian Legal System which used to be a civil law system as good as it gets.

C. The principles of “Eigenkapitalersatz”

The basic case of the doctrine of "Eigenkapitalersatz" is also a standard-problem of equitable subordination in the US: shareholder loans to undercapitalized corporations. Basically, the doctrine of "Eigenkapitalersatz" deals with shareholders rendering non-

\textsuperscript{104} German: "Oberste Gerichtshof".


equity performances such as loans or leases\textsuperscript{107} to their corporation at times when they should supply the corporation with more equity. This critical point in time, when "\textit{Eigenkapitalersatz}" comes in to affect normally perfectly legal contracts is called "crisis"\textsuperscript{108} and defined as the moment in time from which on the corporation would not be able to bargain for such loans or leases at arm's length.

In ensuing bankruptcy proceedings the shareholder's claims arising out of their performance of such loans or leases will be subordinated and are only to be satisfied after all other claims, i.e. the benefits of the loans or leases will be treated as equity. The reasoning behind that is that in a financial crises the shareholders have either to put more equity into the corporation or file for bankruptcy. If they don't, but render loans or leases to their corporation or leave their salaries dormant etc. they artificially keep a corporation alive that is clinically dead. The problem with that is that these insiders knew the condition of their company and therefore must not be treated as creditors who dealt at arm's length and in good faith. The creditor's didn't know that for example the newly acquired premises were rendered by a shareholder temporarily refraining from collecting the rent when they thought that the company was doing fine and still had resources.

Despite many similarities to the US doctrine of equitable subordination, the moral motives for subordinating claims differ between the US and Austria. US courts focus on inequity and to bringing justice to unjust situations. Austrian courts adapted the doctrine of "\textit{Eigenkapitalersatz}" to enforce the corporate insiders' financing responsibility. If

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\item German: "Krise".
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insiders decide to supply their struggling company with new money or new inventory etc., they must not do it on the risk of the creditors but on their own risk. If they don't want to take the risk, they have to file for bankruptcy. The doctrine of "Eigenkapitalersatz" also affects benefits which the company received in a good financial condition but were left dormant with the company while it entered a state of financial crisis.

It didn't take long until the Austrian Supreme Court began to further develop the Rules of "Eigenkapitalersatz". During the last ten years they were extended and applied not only to limited liability companies\textsuperscript{109} and shareholder loans, but also to shareholder's salary claims, share companies,\textsuperscript{110} controlling secured creditors,\textsuperscript{111} limited liability partnerships,\textsuperscript{112} and even associations\textsuperscript{113}.

D. \textit{Still no bill}

Interestingly enough there is not yet a statute in Austria providing for the application of the rules of "Eigenkapitalersatz". However section 21 of the Austrian Company Re-

\textsuperscript{109} \textit{German}: "Gesellschaft mit beschränkter Haftung".

\textsuperscript{110} \textit{German}: "Aktiengesellschaft ".


\textsuperscript{112} \textit{German}: so called "Personengesellschaften mit beschränkter Haftung" i.e. partnerships consisting of limited liability companies as partners and similar corporate structures. \textbf{See Austrian sources:} Koppensteiner GmbHG § 74 Rz 19; Jabornegg in Jabornegg, Kommentar zum HGB (1997) § 161 HGB Rz 59; Rebahn in Jabornegg § 187 HGB Rz 8; Karollus, Kapitalersetzende Leistungen, ÖBA 1997, 105 (107, 110, 116); Karollus, Verstärkter Kapitalschutz bei der GmbH & Co KG, ecolex 1996, 860 (861).

\textsuperscript{113} \textit{German}: "Vereine". \textbf{See Austrian Source:} Saria/Raoul Wagner, Verein und Eigenkapitalersatz, ecolex 1999, 31.
The doctrine of "Eigenkapitalersatz" has not only been acclaimed but also strongly criticized. The voices who deny the justification of "Eigenkapitalersatz" for example for its fragile statutory foundation were weakened by the fact that section 21 of the URG now fosters the doctrine of "Eigenkapitalersatz" by implicitly manifesting the consent of the Austrian Parliament to the existing case law. Unlike the US Congress, the Austrian Parliament intends to render a statutory regulation of "Eigenkapitalersatz". Already in 1997 the Austrian Parliament's Judicial Committee has formally asked the Austrian Attorney General to draft a bill providing for the statutory regulation of "Eigenkapitalersatz". Since then a workgroup in the Austrian Department of Justice has been established but no bill has yet been presented to the public. This might, to a large degree, be due to the fact that drafting language which is flexible enough to capture the doctrine of "Eigenkapitalersatz" is as much of an unfeasible task as it would be regarding the doctrine of equitable subordination.

Not long ago nobody in Austria thought that the so called Limited Liability Partnerships, i.e. a combination of the legal figures of the partnership and limited liability

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114 BGBL I 1997/114.
116 Austrian source: JAB 913 BlgNR XX. GP, 34.
117 German: so called "Personengesellschaften mit beschränkter Haftung" i.e. partnerships consisting of limited liability entities as partners and similar corporate structures. See Austrian sources: Koppensteiner GmbHG § 74 Rz 19; Jabornegg in Jabornegg, Kommentar zum HGB (1997) § 161 HGB Rz 59;
companies could be legal. Nowadays it is common place and accepted by the courts. Aggressive lending and venture capital are other examples of rapidly developing issues of corporate law which affect "Eigenkapitalersatz". As anywhere else, corporate (case-) law in Austria will develop rapidly together with new tax-provisions or financing instruments. Today's statute of "Eigenkapitalersatz" would be outdated tomorrow and could only be a basis for newly developing case law.

This rationale makes inevitable the question, why try at all to issue an "Eigenkapitalersatz"-Act. This question becomes even more important regarding the quality of the recently issued Austrian Bankruptcy Acts such as e.g. the URG\textsuperscript{118}, a set of provisions trying to provide for something similar to chapter 11 of the US Bankruptcy Code. The URG provided for a pre-bankruptcy procedure meant to help struggling corporations to reorganize and regain strength. Despite good intentions the Act lacks the necessary understanding of business practice and Austrian bankruptcy reality. Therefore since 1997 not one single URG-procedure has been opened. This is even more remarkable when regarding the fact that the URG provides for a personal liability of managing directors who don't file for a URG-procedure when some financial criteria are being went below and the situation finally leads to bankruptcy. Fortunately the legislative quality of the URG is also poor in a sense that it is technically possible to avoid this liability.\textsuperscript{119}

At last the Act did not achieve anything. No URG-procedure was opened and nobody was being held liable for not acting in the specified pre-bankruptcy situation.

\textsuperscript{118} The 1997 Company Reorganization Act, German: "Unternehmensreorganisationsgesetz".

\textsuperscript{119} See the entire Book RAOUl G. WAGNER, GESCHÄFTSFUHRERHAFTUNG UND URG, (Linde ed., Vienna/Austria 1999).

V. Why try at all to issue an "Eigenkapitalersatz"-Act?

Corporate insiders need guidelines in making advances to their corporations. However, it seems an impossible task to draft a one-fits-all set of provisions regulating all possible aspects of inequities in Austrian or US bankruptcy procedures. A comprehensive and complete checklist for corporate insiders most probably could never be drafted. This is among other things due to the fact that corporate finance is in constant and rapid flux and what was considered outrageous and illegal yesterday could well be a normal and accepted instrument of tomorrow’s corporate finance. Venture capital and aggressive lending are widespread today and need different minds to evaluate them than a simple inventory loan from a sole shareholder.

From a European’s point of view, systems of case law can be frightening for their lack of predictability, legal certainty and stability of the law, all of which are very precious to jurists from civil-law countries. But even in the civil law judges need to fine-tune statutory provisions before they can be applied to real life cases. In Austria for example the civil code ("ABGB") from 1811 is still the law of the land. It is an excellently written piece of legislature because it leaves the courts enough leeway to adapt the law to changes of a developing society. Attempts to provide for each and every possible case like e.g. the "Prussian Country Code" in what now is Germany in the 18th century failed because it was simply not feasible to handle a 15,000 section code.


121 German: Allgemeines Bürgerliches Gesetzbuch.

122 German: "das preussische Landrecht"
By passing 11 U.S.C. § 510, the US Congress wisely did not even attempt to establish statutory rules for equitable subordination. The complexity of the matter would have made it most likely that the courts would more or less have ignored such codified rules as not comprehensive. The German Federal Supreme Court did so by simply continuing to apply its case law regardless of the newly created provisions on "Eigenkapitalersatz". Both doctrines, "Eigenkapitalersatz" in Austria and Germany as well as equitable subordination in the US are yet far too developed to be squeezed into a statutory framework.

Another problem with a codification attempt is that the doctrines of equitable subordination and "Eigenkapitalersatz" are being applied when the complicated bankruptcy statutes of the US and Austria technically allow unjust results. It is very unlikely that a very complex codified set of rules could function as the necessary corrective for another very complex codified set of rules. The experience with the URG showed one thing: traditional Austrian lawmakers, i.e. government employees in the Austrian Department of Justice might be excellent legal generalists but do not have the necessary practitioner’s understanding of corporate finance and bankruptcy. Both fields are high-end legal niches where the best and most expensive business lawyers operate. It seems impossible for the mentioned lawmakers to keep up with the knowledge and understanding of these specialists. But there still is a way to render reasonable judgements in these areas of law:

The adversarial system of case-law allows these specialists on both sides of the dispute to participate in the law-making process and educate the judges at the time the decision is to be made so that their comprehension of the reasons for, effect of, and use of these techniques is sufficient for proper evaluation of the implications to a specific bank-
ruptcy case.\textsuperscript{123} The Austrian Parliament would therefore act wisely if it omitted any further actions towards creating a statute on "Eigenkapitalsatz".

\textbf{Conclusion}

Facing problems of undercapitalization, inequitable conduct, claims of management creditors etc. in bankruptcy proceedings, US courts developed the doctrine of \textit{equitable subordination}. The complexity of the underlying fact patterns and judgements such as whether a company was undercapitalized or not made it unfeasible - if not impossible - for US courts to determine one-for-all rules on when exactly to equitably subordinate claims in bankruptcy proceedings. US Congress recognized the difficulties of establishing rules in that field and decided to leave the formulation of these rules to the courts when it explicitly mentioned equitable subordination in the 1978 Bankruptcy Reform Act (Code) without issuing any guidelines on when and how to equitably subordinate.

Austrian courts faced similar problems. Once the Austrian Supreme Court saw itself confronted with the a scenario where US courts would have applied equitable subordination, it recognized the inequity and decided to act regardless of the fact, that the Austrian parliament had not yet even recognized the problems in that field of law. Now, a decade has passed and the Austrian Department of Justice has been working on a bill to codify rules on equitable subordination for more than three years. The amount of time that has passed without any bill being presented shows that the complexity of the field of equitable subordination is, to say the least, very hard to deal with by means

\textsuperscript{123} See also Andrew De Natale & Prudence B. Abram, \textit{The doctrine of equitable subordination as applied to nonmanagement creditors}, 4s0 BUS. LAW. 417, 447 (1985).
of codified law. The problems in the field of equitable subordination arise because under extreme circumstances such as bankruptcy, codified law can lead to unjust and unwanted results. It is hard to imagine that additional codification can be a remedy against the insufficiencies of codified law. Therefore the Austrian legislature would do wisely to follow the example of the US Congress and not issue a code on "Eigenkapitalersatz" in order to leave it to the courts to deal with situations which are beyond the frame of accuracy of codified law.