CORPORATE ASSISTANCE
Compliance Management for Business Owners

"Equitable Subordination" – The Creditor Shuffle in Veil Piercing Cases

Highlights

If you're like most privately held businesses, you took on a number of debts in order to get started. Some of these debts may be between your company and its owners. In many cases, business shareholders make personal loans to the business for working capital or to purchase equipment, or make personal guarantees to secure a line of credit from a lending institution. In other words, the owners become creditors of the corporation.

This article introduces the doctrine of "equitable subordination". Equitable subordination occurs when a court rearranges the relative positions of creditors. This is done when, in the court's view, a perceived injustice or unfairness needs to be addressed.

Simply put, the creditors of a business stand in a line. The first in line has the first (and strongest) claim to payment, and so on down the line. As part of a veil piercing action, courts can use equitable subordination to reshuffle the line of creditors. Corporate officers, directors, and shareholders who have loaned money to the business are often put at the end of the line, and can suffer financially as a result.

In an Alaska court case (Nerox Power Systems v. M-B Contracting Company, 54 P.3d 791), corporate veil piercing was the trigger for the court to perform an equitable subordination. In the Nerox case, the corporate veil was pierced and corporate insiders who had loaned millions of dollars to their business saw their claims pushed behind a host of other creditors.

This action effectively prevented them from receiving any repayment from the company, as the company had encountered financial difficulties and was unable to repay all its creditors.

Historically, equitable subordination was an action taken only in connection with a bankruptcy. The important lesson from the Nerox case is that veil piercing is shown to be a circumstance where courts perform equitable subordination, even where bankruptcy is not an issue. This is yet another reason for business owners to take special care that they are properly protecting their corporate veil.

Background - Nerox Power Systems

In November 1992, Nicholas Ross bought a controlling interest in a dormant parent corporation and its subsidiary corporation in the oil and gas industry. The parent and the subsidiary were renamed Nerox Energy and Nerox Power, respectively.

Over the course of several years, Ross personally loaned approximately $1.8 million to both companies to cover operating costs. Another corporate insider, William Artus, loaned $80,000 to the companies. Additionally, Artus was owed $70,000 for legal services performed before he became an insider. In April 1997, multiple trust deeds were filed on assets of the Nerox companies to secure the loans made by Nicholas Ross and William Artus.

In 1996, Nerox Power leased heavy equipment from M-B Contracting, Inc. for use in the development of a coal mine. A year later, M-B Contracting recorded a mechanic's lien against the Nerox companies for nonpayment of leasing fees. In 1998, M-B Contracting filed suit in Alaska to foreclose on its mechanic's lien.

Nerox Power v. M-B Contracting

There were two main issues in the Nerox case:

1. Whether the corporate veils of Nerox Power and Nerox Energy could be pierced, and thereby make Nicholas Ross personally liable for company debts;
2. Whether the April 1997 trust deeds (which had been filed before M-B Contracting's lien) could be subordinated to, or placed behind, the mechanic's liens filed by M-B Contracting and others.

In the legal proceedings, the superior court pierced the veils of both Nerox Energy and Nerox Power. The court further decided to subordinate Ross' and Artus' trust deeds to the liens of M-B Contracting and others.

The Legal Decision

The Alaska Superior Court found that both Nerox Energy and Nerox Power were "mere instrumentalities" of Nicholas Ross. The court's decision was based on six factors in Alaska law used to determine if a corporation is a "mere instrumentality" of one of its shareholders:

1. Whether the shareholder owns all or most of the stock - Ross owned 81% of the shares of Nerox Power, and a controlling interest in Nerox Energy.
2. Whether the shareholder subscribed to all of the capital stock or "caused the corporation" – by activating the dormant corporations and making large loans to them, Ross was central in "causing" the corporation.
3. Whether the corporation is grossly undercapitalized – the court found Nerox Energy's initial capitalization "grossly inadequate" and determined that Nerox Energy was "grossly undercapitalized during all relevant times".
4. Whether the shareholder uses the property of the corporation for his or her own benefit – Ross did not fail this test, but his failure of the others was sufficient to pierce the corporate veil.
5. Whether the directors of the corporation act independently of the shareholder – the court found that the various directors of Nerox Power "took their directions" from Ross personally, rather than fulfilling their obligation to act as independent directors. In this case, the directors acted as "yes men" to Ross, rather than acting for the good of the company.
6. Whether the "formal legal requirements of the corporation are observed" – The Nerox companies had no documentation for key loans with third parties and between the two companies. Additionally, financial reports on stock ownership were "exceedingly vague".

The Court's Decision Stuck

Stung by the veil piercing and equitable subordination actions of the superior court, Ross appealed the decision to the Alaska Supreme Court. In 2002, the Supreme Court decided to affirm the superior court's decision "in all respects".

A key finding of the Supreme Court was that equitable subordination is within the court's power outside of a bankruptcy context. This decision represents a significant expansion of the court's power to re-order creditor positions in a legal proceeding.

What This Means to You

Traditionally, a veil piercing action dissolves the distinction between business and personal assets. The result is to make business owners personally liable for business obligations. In the Nerox case, the result of the veil piercing was to weaken the business' obligation to repay a debt to one of its owners. Instead, the claim of a 3rd party creditor was given preferential treatment.

The Nerox case adds a new dimension to the veil piercing problem because it increases the magnitude of financial risk to the business owner. Not only can you be held personally liable for the business' debts, but other creditors may be put in line in front of you.

As always, the moral of this story is that proper corporate governance is essential.

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