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Part I

ARTICLES

A. Recharacterization of Debt to Equity: An Overview, Update, and Practical Guide to an Evolving Doctrine

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Introduction

When a bankruptcy court “recharacterizes” debt, it essentially causes such debt (or at least something the parties to the transaction characterized as debt) to be converted into equity. Unlike an equitable subordination analysis, in which courts determine whether a legitimate claim should be subordinated to that of other creditors due to a creditor’s inequitable conduct, a recharacterization analysis involves determining whether a debt actually exists. Therefore, in some ways, the risk of recharacterization is far more dangerous to a potential lender than the risk of equitable subordination because, unlike equitable subordination, recharacterization requires no finding of inequitable conduct. Moreover, equitable subordination results in a lower-priority claim debt only to the extent of the harm, while recharacterization converts a creditor’s entire claim to an equity interest.

While the Bankruptcy Code does not expressly provide for the recharacterization of debt to equity, the majority of bankruptcy courts that have considered the issue have determined they have the power to recharacterize what is ostensibly debt based on their equitable authority under Section 105 of the Bankruptcy Code. In contrast, a minority of courts have concluded that, because of the absence of a specific provision allowing recharacterization, no authority exists to provide such relief.

The seminal case on recharacterization is AutoStyle Plastics. In Auto-
Style Plastics, the Sixth Circuit engaged in a detailed examination of the debate among the courts and agreed with the bankruptcy court’s conclusion that while the facts of the case did not justify recharacterizing the investment as equity, recharacterization was within the court’s authority. In addition to its determination that bankruptcy courts have the power to recharacterize debt, AutoStyle Plastics provides guidance to future courts by setting forth certain factors to be considered in determining whether such relief is appropriate.

Although AutoStyle Plastics and its progeny have appeared to settle the issue in favor of courts having the authority to recharacterize debt, cases occasionally resurrect that debate. Moreover, even where courts agree that there is authority to recharacterize debt, the factors courts will likely consider in determining if recharacterization is warranted continue to evolve.

As an initial matter it must be remembered that equitable subordination and debt recharacterization are two distinct causes of action. Because of the similarities in the two causes of action, however, a meaningful discussion of debt recharacterization must address equitable subordination and how it differs from recharacterization. Once the limitations and distinct purpose of equitable subordination are understood, the role of debt recharacterization becomes clear.

Therefore, Section I of this article provides an overview of equitable subordination and debt recharacterization in order to distinguish the two causes of actions and separate analyses. Section II examines recent case law developments. Finally, Section III provides some practical tips to practitioners faced with avoiding, bringing, or defending recharacterization actions.

I. DEBT RECHARACTERIZATION COMPARED TO EQUITABLE SUBORDINATION

Although debt recharacterization and equitable subordination both involve the subordination of claims, they are distinct causes of actions requiring different analyses by courts. They also serve clearly different
functions. Recharacterization cases turn on whether a debt actually exists, not on whether the claim should be equitably subordinated.

In a recharacterization analysis, if the court determines that the advance of money is an equity investment rather than a loan, the claim will be recharacterized, and treated as an equity interest - resulting in total subordination of the claim because the corporation repays capital contributions only after satisfying all other obligations of the corporation. In an equitable subordination analysis, the court reviews whether a legitimate creditor engaged in inequitable conduct, in which case the remedy is subordination of the creditors' claim to that of other creditors, to the extent necessary to remedy the inequitable conduct.

If a “claim” is recharacterized and, therefore, the advance at issue is determined not to be a claim at all and the “creditor” who made the advance is not in fact a creditor, then equitable subordination never comes into play. Indeed, where shareholders have substituted debt for adequate risk capital, their claims are appropriately recast as equity regardless of satisfaction of the requirements of equitable subordination. Some of the confusion between the doctrines is caused by the fact that undercapitalization is a factor in an equitable subordination analysis and often is a factor in a recharacterization analysis as well. This has led some courts to equitably subordinate claims that other courts would recharacterize as equity contributions.

A. Equitable Subordination

Courts developed the doctrine of equitable subordination by using their equitable powers to ensure that claimants against a bankruptcy estate who have engaged in unfair or fraudulent conduct to the detriment of the debtor or other creditors are dealt with in a just and fair manner.

\[\text{References:}\]


The doctrine is now reflected in Section 510(c) of the Bankruptcy Code, which states that “a 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 a part of an allowed interest to all or a part of another allowed interest . . .”16

While Section 510(c) does not define the conduct that triggers equitable subordination, the majority of cases require that the following three criteria must be satisfied before a claim will be equitably subordinated: (1) the claimant engaged in some type of inequitable conduct; (2) the misconduct resulted in injury to the creditors of the debtor or conferred an unfair advantage on the claimant; and (3) equitable subordination of the claim will not be inconsistent with the provisions of the Bankruptcy Code.17

Where equitable subordination is warranted, courts generally tailor a remedy based on the principle that “a claim or 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 . . . [T]he exercise of the subordination power is governed by equitable principles . . . and equitable relief is remedial rather than penal.”18 In light of this principle, courts have tailored subordination to remedy the particular harms at issue, sometimes subordinating less than all of the holder’s claim19 or subordinating the claims to only a particular category of the remaining creditor group.20 The subordination power of bankruptcy courts is broad, and a court may even subordinate facially secured claims below all claims, even unsecured claims.21 Moreover, if conduct is so egregious that it affects the validity of the claim under applicable law, a court can disallow the claim in full as part of the claims

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15Matter of Mobile Steel Co., 563 F.2d 692, 700, 15 C.B.C. 1 (5th Cir. 1977); See also Pepper v. Litton, 308 U.S. 295, 305, 310, 60 S. Ct. 238, 84 L. Ed. 281 (1939) (claim of dominant and controlling shareholder disallowed where shareholder, among other things, schemed to hinder and delay a creditor).

1611 U.S.C. § 510(c).


avoidance process.\textsuperscript{22}

1. Inequitable Conduct

The initial requirement for the equitable subordination of a claim is that the claimant must have engaged in inequitable conduct.\textsuperscript{23} An inequitable result is not enough to meet this requirement.\textsuperscript{24} Unless this initial requirement can be shown, a court will not need to even consider the other criteria.\textsuperscript{25} Courts have divided the varieties of inequitable conduct into three broad categories: (1) fraud, illegality or breach of fiduciary duties; (2) undercapitalization; and (3) control of the debtor.

\textsuperscript{22}Matter of Mobile Steel Co., 563 F.2d 692, 699, 15 C.B.C. 1 (5th Cir. 1977).

\textsuperscript{23}Some courts have held or stated in dicta that claims may be subordinated even if the claim-holder did not engage in inequitable conduct. See e.g., U.S. v. Noland, 517 U.S. 535, 541-43, 116 S. Ct. 1524, 134 L. Ed. 2d 748, 28 Bankr. Ct. Dec. (CRR) 1331, 35 Collier Bankr. Cas. 2d (MB) 1, Bankr. L. Rep. (CCH) ¶ 76920, 96-1 U.S. Tax Cas. (CCH) ¶ 50252, 77 A.F.T.R.2d 96-2143 (1996) (reversing categorical subordination of all non-pecunary loss tax penalty claims and stating that it did not decide whether a bankruptcy court must always find misconduct before a claim must be equally subordinate); Matter of Lifschultz Fast Freight, 132 F.3d 339, 348-49, 31 Bankr. Ct. Dec. (CRR) 1103, 32 Collier Bankr. Cas. 2d (MB) 97, Bankr. L. Rep. (CCH) ¶ 77584 (7th Cir. 1997) (leaving no-fault subordination in certain limited circumstances as open question in the Seventh Circuit after Noland, but finding no-fault subordination inapplicable in that case). The parameters of no-fault subordination principles remain undefined. In Lifschultz Fast Freight, the Seventh Circuit stated that this theory is an exception to the normal rule that subordination requires inequitable conduct and that the other criteria for subordination (i.e., that the creditors must have been harmed and that subordination is consistent with the Bankruptcy Code) must still be found before subordination is appropriate. Matter of Lifschultz Fast Freight, 132 F.3d 339, 348-49, 31 Bankr. Ct. Dec. (CRR) 1103, 32 Collier Bankr. Cas. 2d (MB) 97, Bankr. L. Rep. (CCH) ¶ 77584 (7th Cir. 1997). Recently, the Tenth Circuit declined to extend no-fault equitable subordination beyond the subordination of tax penalty claims. See In re Hedged-Investments Associates, Inc., 380 F.3d 1292, 1301, Bankr. L. Rep. (CCH) ¶ 80151 (10th Cir. 2004)).


\textsuperscript{25}See Matter of Lifschultz Fast Freight, 132 F.3d 339, 344-345, 31 Bankr. Ct. Dec. (CRR) 1103, 32 Collier Bankr. Cas. 2d (MB) 97, Bankr. L. Rep. (CCH) ¶ 77584 (7th Cir. 1997) (finding that a secured loan to a company by an insider is not wrongful per se; Matter of Mobile Steel Co., 563 F.2d 692, 700, 15 C.B.C. 1 (5th Cir. 1977) (the mere ownership of all or most of the debtor’s stock or the existence of an insider or fiduciary relationship between a debtor and a creditor, without a showing of inequitable conduct, will not give rise to subordination of the insider’s claim). In re AutoStyle Plastics, Inc., 269 F.3d 726, 745, 45 U.C.C. Rep. Serv. 2d 964, 2001 FED App. 0378P (6th Cir. 2001) ("Claims involving insiders ‘are not automatically subordinated . . .’" (citations omitted)); See also, Matter of Missionary Baptist Foundation of America, 818 F.2d 1135, 1143, 16 Collier Bankr. Cas. 2d (MB) 1461, Bankr. L. Rep. (CCH) ¶ 71853 (5th Cir. 1987) ("The mere fact of a fiduciary relationship is insufficient to warrant subordination."); Frasher v. Robinson, 458 F.2d 492, 493 (9th Cir. 1972) ("Albeit inequitable conduct bona fide claims based upon loans from majority shareholders of a family business will not be subordinated to claims of other creditors.").
through use of the debtor as the creditor’s alter ego or instrumentality.\textsuperscript{26} At the outset it should be noted that courts impose a higher standard of conduct when reviewing an insider’s\textsuperscript{27} transactions with a debtor.\textsuperscript{28} Insider status, however, only determines the standard under which the creditor’s conduct is reviewed and does not, by itself, provide a sufficient basis for subordination.\textsuperscript{29} Where a creditor is a non-insider, the trustee must show that the creditor’s conduct was “egregious and severely unfair in relation to other creditors.”\textsuperscript{30} In the context of insiders, the standard is one of simple unfairness.\textsuperscript{31} Furthermore, insiders bear the burden of proof on the issue of inequitable conduct: while the party seeking equitable subordination must present material evidence of unfair conduct to rebut the prima facie validity of an insider’s claims, the insider can avoid subordination only by proving the good faith and


\textsuperscript{27}An “insider” of a debtor corporation includes: (i) an officer or director of the debtor; (ii) a person in control of the debtor; (iii) a partnership in which the debtor is a general partner; (iv) a general partner of the debtor; or (v) a relative of the general partner, director, officer or person in control of the debtor. See 11 U.S.C. § 101(31). Mere stock ownership, with nothing more, does not constitute an insider relationship to the debtor. A lender can also be an insider if it generally acted as a joint venturer or prospective partner with the debtor rather than an arm’s length creditor. See Pan Am Corp. v. Delta Air Lines, Inc., 175 B.R. 438, 500 (S.D. N.Y. 1994).


\textsuperscript{29}See In re Hyperion Enterprises, Inc., 158 B.R. 555, 562, 29 Collier Bankr. Cas. 2d (MB) 1281, 24 U.C.C. Rep. Serv. 2d 670 (D.R.I. 1993) (“The reason that transactions of insiders will be closely studied is because such parties usually have greater opportunity for such inequitable conduct, not because the relationship itself is somehow grounds for subordination.”); 3 Collier in Bankruptcy, ¶ 510.05 [3a] at 510-14 (reasoning that insider claims are not automatically subordinated because insiders are the persons most interested in restoring and reviving the debtor, and such bona fide effort should be viewed with approval).

\textsuperscript{30}In re Hyperion Enterprises, Inc., 158 B.R. 555, 562, 29 Collier Bankr. Cas. 2d (MB) 1281, 24 U.C.C. Rep. Serv. 2d 670 (D.R.I. 1993). See also In re Hedged-Investments Associates, Inc., 380 F.3d 1292, 1301, Bankr. L. Rep. (CCH) ¶ 80151 (10th Cir. 2004)) (“If the claimant is not an insider or fiduciary, however, the party seeking subordination must ‘demonstrate even more egregious conduct such as gross misconduct tantamount to fraud, misrepresentation, overreaching or spoliation.’”) (quoting In re Castletons, Inc., 990 F.2d 551, 28 Collier Bankr. Cas. 2d (MB) 991, Bankr. L. Rep. (CCH) ¶ 7522021 U.C.C. Rep. Serv. 2d 1062 (10th Cir. 1993)).

fairness of its dealing with the debtor.\textsuperscript{32}

Because inquiries about inequitable conduct are highly fact specific, there are few hard and fast rules. In many circumstances, courts recite their finding of facts and then announce in conclusory fashion that the circumstances were "inequitable."\textsuperscript{33} However, certain recurring fact patterns should be noted. For example, courts tend to deal harshly with creditors who take actions that may affect other creditors where they fail to fully disclose those actions in advance.\textsuperscript{34}

Courts have found an insider creditor's conduct fraudulent or a breach of fiduciary duty when the creditor: (a) encumbered all of a debtor's assets on the eve of bankruptcy solely to benefit herself;\textsuperscript{35} (b) made outright misrepresentations regarding forthcoming payments by debtor to trade creditors to induce delivery of goods;\textsuperscript{36} (c) engaged in a self-dealing scheme involving stock options and repurchase agreements that violated debentures with the debtor while the creditor was a director;\textsuperscript{37} or (d) raised insiders' salaries retroactively when bankruptcy was in prospect.\textsuperscript{38}

\textbf{a. Fraud, Illegality or Breach of Fiduciary Duties.}

In order for equitable subordination to be imposed based on fraud or breach of fiduciary duties, the bankruptcy court need not find actual fraud.\textsuperscript{39} Because fraudulent conduct cases often include elements of undercapitalization or self-dealing, it is difficult to place fraud based


\textsuperscript{33}See, e.g., In re N & D Properties, Inc., 799 F.2d 726, 731, 15 Bankr. Ct. Dec. (CRR) 254, 15 Collier Bankr. Cas. 2d (MB) 726 (11th Cir. 1986) (lending money to debtor was inequitable because no third party would make loan).

\textsuperscript{34}See Brown v. Presbyterian Ministers Fund, 484 F.2d 998, 1005 (3d Cir. 1973) (stating that a purchase of claims by an insider should be disclosed to the creditors).


\textsuperscript{36}In re Osborne, 42 B.R. 988, 11 Collier Bankr. Cas. 2d (MB) 1349, Bankr. L. Rep. (CCH) ¶ 70042 (W.D. Wis. 1984).


\textsuperscript{39}Heiser v. Woodruff, 327 U.S. 726, 732-33, 66 S. Ct. 853, 90 L. Ed. 970 (1946).
subordination cases in precise categories. A stockholder, even a dominant or majority stockholder, does not become a fiduciary to other stockholders “by reason of mere ownership of stock.”

Examples of fraudulent conduct warranting subordination of claims include when a creditor knowingly makes false statements regarding the debtor’s financial condition and when a creditor colludes with a debtor using its claim to defraud other creditors. There is, however, no clear test for fraud.

b. Undercapitalization.

Undercapitalization alone is insufficient to find inequitable conduct. When combined with inequitable conduct, undercapitalization may be sufficient to warrant equitable subordination. Furthermore, courts require a showing that the undercapitalization resulted in harm to other creditors and the corporation. This makes sense because, if courts subordinated claims solely based on a debtor’s undercapitalization, insiders would always be reluctant to lend money to a struggling entity.

As in the recharacterization context, adequacy of capitalization can

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40 See Nozemack, 56 Wash. & Lee L. Rev. 689, 700.
45 See Matter of Herby’s Foods, Inc., 2 F.3d 128, 24 Bankr. Ct. Dec. (CRR) 1116, 29 Collier Bankr. Cas. 2d (MB) 1375, Bankr. L. Rep. (CCH) ¶ 75446 (5th Cir. 1993) (in addition to undercapitalization, the court found additional evidence of inequitable conduct that included insider’s delay in perfecting a security interest in an attempt to lure a secured lender into making a loan to the debtor); See also In re Hyperion Enterprises, Inc., 158 B.R. 555, 29 Collier Bankr. Cas. 2d (MB) 1281, 24 U.C.C. Rep. Serv. 2d 670 (D.R.I. 1993) (court determined that even if a creditor is an insider, equitable subordination would not be imposed unless there was evidence showing that the creditor’s conduct was unfair to other creditors).
46 See 4 Lawrence P. King, Collier on Bankruptcy § 510.05 at 510-12 (15th ed. 1997).
be judged at the time of organization.\footnote{Matter of Mobile Steel Co., 563 F.2d 692, 702, 15 C.B.C. 1 (5th Cir. 1977)} However, courts have determined in recharacterization cases, that capitalization should also be viewed at the time the transfer was made.\footnote{In re AutoStyle Plastics, Inc., 269 F.3d 726, 751, 45 U.C.C. Rep. Serv. 2d 964, 2001 FED App. 0378P (6th Cir. 2001)} For the purposes of determining when the claims against the bankruptcy estate held by organizers or shareholders should be subordinated on the grounds of undercapitalization, adequate capitalization is that which a “reasonably prudent [person] with a general background knowledge of the particular type of business and its hazards would determine was reasonable capitalization in light of any special circumstances which existed at the time of the incorporation of the now defunct enterprise.”\footnote{Matter of Mobile Steel Co., 563 F.2d 692, 703, 15 C.B.C. 1 (5th Cir. 1977) (citing Norman Lattin, \textit{The Law of Corporations} §§ 15, 77 (2d ed. 1971)).} This suggests the following:

\begin{itemize}
\item[i.] Capitalization is not adequate 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 is capitalized; and
\item[ii.] Capitalization is inadequate, at the time when the advances were made, the bankrupt could not have borrowed a similar amount of money from the informed outside source.\footnote{In re Branding Iron Steak House, 536 F.2d 299, 302 (9th Cir. 1976) (“Before the legitimate claim of an officer, director, or shareholder of a bankrupt corporation may be subordinated to the claims of other creditors, not only must that person have the ability and intent to control the corporation, but he must in fact exercise that control to the detriment of other creditors”) (citing In re Brunner Air Compressor Corp., 287 F. Supp. 256, 265 (N.D. N.Y. 1968)).}
\end{itemize}

c. Control.

It is clear that domination and control can lead courts to equitably subordinate a claim. However, courts will not subordinate claims solely because of a parent or insider relationship; additional contributing factors must be present.\footnote{In re Kids Creek Partners, L.P., 212 B.R. 898, 929 (Bankr. N.D. Ill. 1997), decision aff’d, 233 B.R. 409 (N.D. Ill. 1999), aff’d, 200 F.3d 1070, 35 Bankr. Ct. Dec. (CRR) 123 (7th Cir. 2000) and decision aff’d, 239 B.R. 497 (N.D. Ill. 1999).} Control means “actual exercise of managerial discretion, or “usurping the power of the directors and officers to make business decisions.”\footnote{In re Mobile Steel Co., 563 F.2d 692, 701, 15 C.B.C. 1 (5th Cir. 1977); See also In re Branding Iron Steak House, 536 F.2d 299, 302 (9th Cir. 1976) (“Before the legitimate claim of an officer, director, or shareholder of a bankrupt corporation may be subordinated to the claims of other creditors, not only must that person have the ability and intent to control the corporation, but he must in fact exercise that control to the detriment of other creditors”) (citing In re Brunner Air Compressor Corp., 287 F. Supp. 256, 265 (N.D. N.Y. 1968)).} Control does not exist merely because the lender had bargaining power, otherwise this would always be true whenever the lender was on the brink of terminating the debtor’s operations. Control must be so overwhelming that there must be, “to some extent, a
merger of identity," or a domination of the will of the debtor. The creditor must use the debtor as an instrumentality or exercise such "total control over the [debtor] as to have essentially replaced its decision making capacity with that of [the debtor]." General factors analyzed in determining whether a lender is in control of a particular debtor include the following:

1. Stock ownership;
2. Interference with the operations of its borrowers;
3. Participation in management decisions;
4. Directing which creditors the debtor will pay;
5. Placement of lender employees as directors or officers of the debtor;
6. Hiring and firing personnel of a debtor;
7. Participation in shareholder meetings;
8. Participation in director meetings;
9. Participation in management meetings; and
10. Dealing with the debtor at arms-length.

2. Misconduct Must Have Resulted in Injury to Creditors or Conferred an Unfair Advantage on the Claimant.

The second requirement for equitable subordination of a creditor’s claim based on its inequitable conduct, is that the conduct must have resulted in unfair advantage to a misbehaving creditor and harm to the debtor or its other creditors. This involves a disjunctive test, requiring a showing of either unfair advantage to misbehaving creditors or harm to the debtor or its other creditors. The analysis of this element overlaps with the analysis of "inequitable conduct" because a determination of fraud, breach of fiduciary duty or other inequitable conduct frequently requires an assessment of the action’s impact on other creditors.

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The third prong of the test is that equitable subordination of the claim must not be inconsistent with the provisions of relevant bankruptcy law. This element of the test is a reminder to bankruptcy courts that they cannot adjust valid claims by good faith creditors simply because the court senses an inequitable result.\(^{58}\)

B. Recharacterization of Debt to Equity

While equitable subordination is a remedy for inequitable conduct and involves determining whether a legitimate creditor’s claim should be subordinated to the extent necessary to offset injury to other creditors, recharacterization requires no finding of inequitable conduct. Recharacterization involves a determination by a court that a debt (or at least something the parties characterized as debt) is actually a capital contribution and, therefore, should be treated as an equity interest.\(^{59}\)

Although no clear test exists for determining whether a court should recharacterize a transaction, courts have considered a number of factors, most of which have to do with whether the transaction bears the characteristics of an arm’s length bargain. Courts generally weigh the relevant factors as a group so that no single factor will result in recharacterization of an advance.\(^{60}\) Because many different factors are employed to determine whether to treat an alleged loan as a capital contribution, it is difficult for both lenders and corporate borrowers to

\(^{58}\) One court stated that the enactment of Section 510(c) rendered this prong of the test useless because now the Code clearly recognizes the court’s authority to equitably subordinate claims in bankruptcy. See Matter of Mobile Steel Co., 563 F.2d 692, 700, 15 C.B.C. 1 (5th Cir. 1977); See also Nozemack, 56 Wash. & Lee L. Rev. 689, 701.

\(^{59}\) Under the “Deep Rock” doctrine, shareholder loans to a corporation may be treated as capital contributions, and thus effectively subordinated, where there is “knowing undercapitalization and the attendant unfairness to the creditors of the corporation.” Matter of Mobile Steel Co., 563 F.2d 692, 702, 15 C.B.C. 1 (5th Cir. 1977); See also In re N & D Properties, Inc., 799 F.2d 726, 733, 15 Bankr. Ct. Dec. (CRR) 254, 15 Collier Bankr. Cas. 2d (MB) 726 (11th Cir. 1986) (“Shareholder loans may be deemed capital contributions in one of two circumstances: where the trustee proves initial undercapitalization or where the trustee proves that the loans were made when no other disinterested lender would have extended credit.”); Matter of Herby’s Foods, Inc., 2 F.3d 128, 132, 24 Bankr. Ct. Dec. (CRR) 1116, 29 Collier Bankr. Cas. 2d (MB) 1375, Bankr. L. Rep. (CCH) ¶ 75446 (5th Cir. 1993) (“[I]f an insider makes a loan to an undercapitalized corporation, the combination of undercapitalization and the insider loan may allow the bankruptcy court to recharacterize the loan as a capital contribution . . . ”); Matter of Fabricators, Inc., 926 F.2d 1458, 1469, 21 Bankr. Ct. Dec. (CRR) 809, 24 Collier Bankr. Cas. 2d (MB) 1489, Bankr. L. Rep. (CCH) ¶ 73875 (5th Cir. 1991) (“When an insider makes a loan to an undercapitalized corporation, a court may recast the loans as contributions to capital.”).

predict how a court will view individual transactions.\textsuperscript{61}

1. The AutoStyle Plastics Factors

On March 16, 1982 AutoStyle Plastics, Inc. (the “Debtor”) entered into a long-term credit facility with a lending institution (the “Lender”). The credit facility was secured by a perfected first-priority security interest in substantially all of Debtor’s assets. On March 28, 1985, AutoStyle, Inc. (the “Parent”), a newly created corporation, acquired the majority of Debtor’s outstanding stock. Participant A owned approximately 35% of Parent’s stock and Participant B owned approximately 16%.

Participant A and Lender subsequently entered into a participation agreement\textsuperscript{62} whereby Participant A paid $2 million to Lender, allowing Lender to fund additional borrowings by Debtor under the credit facility. The participation agreement granted Participant A a 100% subordinated participation in the credit facility: Participant A would receive payment only if Debtor paid Lender and only after Lender and other loan participants received payment for their shares of the loan. Participant B entered into a separate, but substantially similar, participation agreement with Lender whereby Participant B paid $935,252 in exchange for a position in the credit facility. On August 11, 1988, the participation agreement between Participant A and Lender was amended to increase Participant A’s participation from $2 million to $4.5 million.

Shortly after the release of a solvency opinion on November 29, 1988, Participant C purchased half of Parent’s common stock for $10 million and loaned Debtor another $26.8 million. On March 19, 1990, Lender and Participant C entered into a participation agreement similar to the agreements with Participants A and B, except that the agreement provided that Participant C would, on demand from Lender after Debtor’s default or at any time sooner at Participant C’s option, pay a $1.5 million participation interest in the credit facility. Also, on March 19, 1990, Participant A and Lender again amended their participation agreement.

\textsuperscript{61}In re Hillsborough Holdings Corp., 176 B.R. 223, 248 (M.D. Fla. 1994); In re Lane, 742 F.2d 1311, 1314-15, 84-2 U.S. Tax Cas. (CCH) ¶ 9817, 54 A.F.T.R.2d 84-6098 (11th Cir. 1984). Additionally, at least one court has stated that there must also be inequitable conduct for the recharacterization of debt to equity. In re Zenith Electronics Corp., 241 B.R. 92, 107, 35 Bankr. Ct. Dec. (CRR) 329, 43 Collier Bankr. Cas. 2d (MB) 206, 53 Fed. R. Evid. Serv. 523 (Bankr. D. Del. 1999). However, the Zenith case was viewing recharacterization as an equitable subordination and was decided prior to AutoStyle Plastics. See also Diasonics, Inc. v. Ingalls, 121 B.R. 626, 630-32, 24 Collier Bankr. Cas. 2d (MB) 1138 (Bankr. N.D. Fla. 1990)).

\textsuperscript{62}A participation is not a loan. To the contrary, a participation is a contractual arrangement between a lender and third party whereby the third party, labeled a participant, provides funds to the lender. In re AutoStyle Plastics, Inc., 269 F.3d 726, 736, 45 U.C.C. Rep. Serv. 2d 964, 2001 FED App. 0378P (6th Cir. 2001). The following four characteristics constitute a “true” loan participation agreement: (i) money is advanced by the participant to the lead lender; (ii) the participant’s right to repayment arises only when the lead lender is paid; (iii) only the lead lender can seek legal recourse against the borrower; and (iv) the document is evidence of the parties’ true intentions. In re AutoStyle Plastics, Inc., 269 F.3d 726, 736-37, 45 U.C.C. Rep. Serv. 2d 964, 2001 FED App. 0378P (6th Cir. 2001)
agreement to further increase Participant A's participation in the credit facility by $1.5 million. The terms of the amendment were similar to those of Participant C's participation agreement. Participants A and C each paid Lender $1.5 million under their respective agreements in October 1996, after Debtor filed for bankruptcy.

Previously, on September 30, 1988, Creditor executed a guarantee relating to a $4 million loan to Debtor to purchase certain equipment. Debtor entered into a security agreement granting Creditor a security interest in machinery and equipment, second in priority only to the lien in favor of Lender. Although Creditor acknowledged Lender's first-priority status, it argued, among other things, that the participation interests should be recharacterized as capital contributions or equitably subordinated to Creditor's junior secured claim.

In determining whether recharacterization was warranted, the Auto-Style Plastics court adopted an 11-factor test originally used in the Roth Steel Tube case to recharacterize tax claims. In applying these factors, the AutoStyle Plastics court noted that no one factor is controlling or decisive. The factors must be construed within the particular circumstances of each case. The factors are:

(1) *Names Given to the Instruments.* The absence of notes or other instruments of indebtedness is a strong indication that advances were capital contributions and not loans. Additionally, courts will examine the names given to the documents and whether or not the labels accurately reflect the nature of the document and the substance of the transaction.

(2) *Presence or Absence of a Fixed Maturity Date and Schedule of Payments.* The absence of a fixed maturity date and a fixed maturity date and a fixed

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63Roth Steel Tube Co. v. C.I.R., 800 F.2d 625, 86-2 U.S. Tax Cas. (CCH) ¶ 9676, 58 A.F.T.R.2d 86-5808 (6th Cir. 1986). The court in AutoStyle Plastics determined that the factors applied in Roth Steel provided a general framework for assessing recharacterization of tax claims that is also appropriate in the bankruptcy context for analyzing the recharacterization of a claim from debt to equity. See In re AutoStyle Plastics, Inc., 269 F.3d 726, 750, 45 U.C.C. Rep. Serv. 2d 964, 2001 FED App. 0378P (6th Cir. 2001). The court did, however, note that there is some disagreement as to whether the tax court recharacterization factors are appropriate for use in bankruptcy cases. See In re AutoStyle Plastics, Inc., 269 F.3d 726, 750, 45 U.C.C. Rep. Serv. 2d 964, 2001 FED App. 0378P (6th Cir. 2001).


65Additionally, the idea that no one factor is determinative, but that the analysis concerns a multi-factor approach is supported by the bankruptcy court as well as tax code analysis. See In re Hyperion Enterprises, Inc., 158 B.R. 555, 561, 29 Collier Bankr. Cas. 2d (MB) 1281, 24 U.C.C. Rep. Serv. 2d 670 (D.R.I. 1993).


obligation to repay is an indication that advances were capital contributions and not loans. The Bankruptcy Court in *Auto-Style Plastics* noted that the absence of a set schedule of repayment of principal weighs in favor of equity, but is not dispositive. The District Court, however, believed that the participation agreements’ use of demand notes as well as a fixed rate of interest and regular interest payments, was indicative of a loan. Moreover, the District Court stated that a rigid application of a rule that the lack of a fixed maturity date and fixed payment schedule is indicative of equity “would create a per se rule that use of a demand note by an insider would always be indicative of an equity contribution rather than a loan.” The Appellate Court agreed with the District Court and concluded that the use of the demand note with a fixed rate of interest and interest payment is more indicative of debt than equity.

(3) Presence or Absence of a Fixed Rate of Interest and Interest Payments. The absence of a fixed rate of interest and requirements for interest payments are strong indicators that the advance is for capital contributions rather than loans. In *Auto-Style Plastics*, the defendants provided for interest, but subsequently agreed to defer interest payments. At best, the Bankruptcy Court determined that an argument can be made that this factor cuts both ways since the deferral of interest payments indicates the possibility that during the course of the transaction the lender never expected to get repaid and converted it back to equity. The court stated, however, that it does not change the fact that initially at least, there was a fixed rate of interest and interest payments indicating that the transaction was originally intended to be debt and not equity. Moreover, the deferral of interest payments does not by itself mean that the parties converted a debt transaction to equity since the defendants still expected to be repaid.

(4) Source of Repayment. If the expectation of repayment depends solely on the success of the borrower’s business, the

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transaction has the appearance of a capital contribution.\textsuperscript{74} However, if various measures are taken to provide security for performance of the obligations, the repayment becomes less dependent on the success of the venture.\textsuperscript{75}

(5) \textit{Adequacy or Inadequacy of Capitalization}. Thin or inadequate capitalization is strong evidence that the advances are capital contributions rather than loans.\textsuperscript{76} The undercapitalization analysis is particularly relevant when “a corporation is started by the shareholders with a minimal amount of capital who then make a large loan of money to the newly formed corporation.”\textsuperscript{77} Capitalization is assessed not only at initial capitalization,\textsuperscript{78} but also at the time the transfer was made.\textsuperscript{79} Certain courts have determined when a debt is incurred by an undercapitalized debtor and the prospect for repayment is poor, such advances are a capital contribution and not a loan.\textsuperscript{80} However, the inquiry concerning undercapitalization is “highly factual and may vary substantially with the industry, company, size of the debt, accounting methods employed, and like factors.”\textsuperscript{81} Additionally, some other conduct must also be found for undercapitalization to constitute a basis for recharacterizing debt to equity lest insiders and others shy away from lending to a corporation in financial distress or a venture at higher than usual risk.\textsuperscript{82}

(6) \textit{Identity of Interest Between the Creditor and the Stockholder}.

\textsuperscript{74}In re AutoStyle Plastics, Inc., 269 F.3d 726, 751 (citing Roth Steel Tube Co. v. C.I.R., 800 F.2d 625, 631, 86-2 U.S. Tax Cas. (CCH) ¶ 9676, 58 A.F.T.R.2d 86-5808 (6th Cir. 1986)); See also In re Phase I Molecular Toxicology, Inc., 287 B.R. 571, 577, 49 Collier Bankr. Cas. 2d (MB) 1375 (Bankr. D. N.M. 2002).

\textsuperscript{75}Long Island Lighting Co. v. Bokum Resources Corp., 40 B.R. 274, 297 (Bankr. D. N.M. 1983); See also In re AutoStyle Plastics, Inc., 269 F.3d 726, 751, 45 U.C.C. Rep. Serv. 2d 964, 2001 FED App. 0378P (6th Cir. 2001) (source of repayment which was dependent on success of the company’s business was balanced to some extent by the security of a lien on all of the company’s assets).

\textsuperscript{76}In re AutoStyle Plastics, Inc., 269 F.3d 726, 751, 45 U.C.C. Rep. Serv. 2d 964, 2001 FED App. 0378P (6th Cir. 2001), (citing Roth Steel Tube Co. v. C.I.R., 800 F.2d 625, 630, 86-2 U.S. Tax Cas. (CCH) ¶ 9676, 58 A.F.T.R.2d 86-5808 (6th Cir. 1986)).


\textsuperscript{78}See In re Phase I Molecular Toxicology, Inc., 287 B.R. 571, 578, 49 Collier Bankr. Cas. 2d (MB) 1375 (Bankr. D. N.M. 2002).

\textsuperscript{79}In re AutoStyle Plastics, Inc., 269 F.3d 726, 751, 45 U.C.C. Rep. Serv. 2d 964, 2001 FED App. 0378P (6th Cir. 2001), (citing Roth Steel Tube Co. v. C.I.R., 800 F.2d 625, 630, 86-2 U.S. Tax Cas. (CCH) ¶ 9676, 58 A.F.T.R.2d 86-5808 (6th Cir. 1986)).

\textsuperscript{80}Matter of Transystems, Inc., 569 F.2d 1364, 1369-71 (5th Cir. 1978).


\textsuperscript{82}In re Kids Creek Partners, L.P., 212 B.R. 898, 931 (Bankr. N.D. Ill. 1997), decision aff’d, 233 B.R. 409 (N.D. Ill. 1999), aff’d, 200 F.3d 1070, 35 Bankr. Ct. Dec. (CRR) 123 (7th Cir. 2000) and decision aff’d, 239 B.R. 497 (N.D. Ill. 1999); See also In re Octagon Roofing, 157 B.R. 852, 858 (N.D. Ill. 1993) (stating that an analysis allowing equitable subordination for undercapitalization absent inequitable conduct “would discourage loans from insiders to companies facing financial difficulty and that would be unfortunate because it is the shareholders who are most likely to have the motivation to salvage a floundering
If stockholders make advances in proportion to their respective stock ownership, an equity contribution is indicated. On the other hand, a sharply disproportionate ratio between a stockholder’s percentage interest in stock and debt is indicative of a bona fide debt.

(7) Security for the Advances. The absence of a security for an advance is a strong indication that the advance is a capital contribution rather than a loan. The fact that a lender incurred the cost and invested the time to collateralize, and perfect, the advance makes the advance look more like a loan than equity.

(8) Corporation’s Ability to Obtain Outside Financing. When there is no evidence of the availability of other outside financing, the fact that no reasonable creditor would have acted in the same manner is strong evidence that advances were capital contributions rather than loans. However, a per se application of this factor alone would prevent any shareholder or insider from ever loaning money to a company experiencing distress. Accordingly, this factor must be viewed broadly and in the factual context in which it is being applied. In fact, the District Court in SubMicron (discussed infra) essentially stated: “Who else would invest funds in a distressed corporation than those who already have funds at stake?”

(9) Extent to Which Advances Were Subordinated to Claims of Outside Creditors. Subordination of advances to claims of all other creditors indicates that the loans were capital contribu-

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88See In re Octagon Roofing, 157 B.R. 852, 858 (N.D. Ill. 1993); See also In re Phase I Molecular Toxicology, Inc., 287 B.R. 571, 573, 49 Collier Bankr. Cas. 2d (MB) 1375 (Bankr. D. N.M. 2002).
tions and not loans.90

(10) Extent to Which Advances Were Used to Acquire Capital Assets. Use of advances to meet the daily operating needs of the corporation rather than to purchase capital assets is indicative of bona fide indebtedness.91 It should be noted, however, that at least one court found it persuasive that a debtor needed working capital. Specifically “necessary turnaround cash” to provide for payroll and other current expenses and that the company was on the verge of closing down or filing a chapter 11 petition.92 That court determined such a dire need of cash was persuasive in finding the obligation was a contribution to capital. However, the Transystems court clearly stated that “This court does not hold that the above circumstances preclude the possibility that [the] advance was a loan. However, taken in conjunction with the fact that there were no indicia of a loan presented [to the court], beyond the labels affixed to the documents themselves . . . [the shareholder’s] intent was to provide a contribution to capital.”93

(11) Presence or Absence of a Sinking Fund to Provide Repayments. The failure to establish a sinking fund for repayment is evidence that the advances were capital contributions rather than loans. The AutoStyle Plastics court noted that securing the loans by liens obviated any need for a sinking fund.94

2. Evolving Application of Factors Considered.

The evolution of additional factors to aid in the analysis of recharacterization claims is consistent with the development in common law as to the definition of conduct which triggers equitable subordination.95 In addition to the Autostyle Plastics factors, courts have considered other facts such as the intent of the parties to the transaction,” the manner

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92Matter of Transystems, Inc., 569 F.2d 1364, 1370 (5th Cir. 1978).
93Matter of Transystems, Inc., 569 F.2d 1364, 1370 (5th Cir. 1978).
95See 11 U.S.C. § 510(c) which allows for an action to equitably subordinate a claim, but does not define conduct which would warrant the remedy; See also Matter of U.S. Abatement Corp., 39 F.3d 556, 561, 26 Bankr. Ct. Dec. (CRR) 360, 32 Collier Bankr. Cas. 2d (MB) 761, Bankr. L. Rep. (CCH) ¶ 76208 (5th Cir. 1994) (noting that Section 510(c) does not specify the circumstances under which equitable subordination is imposed).
96Matter of Transystems, Inc., 569 F.2d 1364, 1367 (5th Cir. 1978); See also In re OMNE Partners II, 57 B.R. 703, 795 (Bankr. D. N.H. 1986) (court found support for the position that the intent of the parties must be closely examined when analyzing whether
and circumstances under which an advance was consummated, the degree of shareholder control, the treatment of obligation in business records, and the ratio of shareholder loans to capital. At least one court has eschewed weighing the factors set forth in *AutoStyle Plastics* by allowing recharacterization of debt into equity where the trustee can show either (1) that the debtor was initially undercapitalized or (2) that the advance was made at a time when no other disinterested lender would have extended credit. In either one of these scenarios, the purported lender will lose its claim even if every other factor points to bona fide indebtedness.

II. BEYOND AUTOSTYLE PLASTICS—RECENT CASE DEVELOPMENTS

As illustrated by the cases discussed in this section, recent cases generally focus on applying the legal standards discussed above to the facts of the particular cases rather than the threshold question of whether courts have the authority to recharacterize. *AutoStyle Plastics* and its progeny have seemingly settled this latter question. Our study of the cases reveals, however, that courts tend to be reluctant to exercise this authority. Although the cases do not generally say as much, we suspect that a policy concern may be at work. Namely, we believe that courts have generally followed the notion that equitable remedies should be applied sparingly when they conflict with seemingly legitimate contracts between sophisticated parties. This reluctance of courts to recharacterize debt to equity appropriately recognizes that companies and investors—sale leaseback transactions should be recharacterized); *Kassuba v. Realty Income Trust*, 562 F.2d 511 (7th Cir. 1977).

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97 See Matter of Transystems, Inc., 569 F.2d 1364, 1366 (5th Cir. 1978).
100 See Diasonics, Inc. v. Ingalls, 121 B.R. 626, 631, 24 Collier Bankr. Cas. 2d (MB) 1138 (Bankr. N.D. Fla. 1990) (stating that while other courts have acknowledged at least eleven separate determining factors in the recharacterization analysis, the Eleventh Circuit standard is that “shareholder loans may be deemed capital contributions in one of two circumstances: where the trustee proves initial undercapitalization or where the trustee proves that the loans were made when no other disinterested lender would have extended credit”) (quoting In re N & D Properties, Inc., 799 F.2d 726, 733, 15 Bankr. Ct. Dec. (CRR) 254, 15 Collier Bankr. Cas. 2d (MB) 726 (11th Cir. 1986)).
101 See In re United Medical Research, Inc., 12 B.R. 941, 24 C.B.C. 445 (Bankr. C.D. Cal. 1981) (stating in the context of marshalling that “It is poor policy for courts to upset legitimate business transactions because of some vague concept of equity. We tend to forget that these decisions affect future commercial transactions.”); In re San Jacinto Glass Industries, Inc., 93 B.R. 934, 938, Bankr. L. Rep. (CCH) ¶ 72539 (Bankr. S.D. Tex. 1988) (“equitable remedies . . . should be administered with temperance to prevent established commercial standards from being undermined in the process.”).
tors need predictability, and the flow of business and finance depends upon the law’s respect for, and protection of the parties’ reasonable expectations.


In July, 2002, the United States Bankruptcy Court for the District of Massachusetts ruled on an adversary proceeding brought by a Chapter 7 Trustee requesting to recharacterize a creditor’s claims as equity, or in the alternative, for equitable subordination of those claims. Relying on AutoStyle Plastics’ distinction between equitable subordination and debt recharacterization, the bankruptcy court stated that because recharacterization is a separate cause of action from equitable subordination, the court had the authority to recharacterize debt as equity “in a case in which a creditor has contributed capital to a debtor in the form of a loan, but the loan has the substance and character of an equity contribution.”

The Bankruptcy Court was persuaded that the advance made to the undercapitalized debtor, which was unable to secure financing from another source, was an equity investment despite being cast as a loan transaction, because, among other things, the terms and conditions of the “loan” gave the creditor who made the advance control of the operation of the debtor. The Bankruptcy Court’s discussion of the extensive testimony illustrates the incredible factually dependent nature of cases concerning claims for recharacterization of debt to equity. Some other facts which the Bankruptcy Court also found persuasive were the sophistication of the lender and the integrated set of loan documents which essentially compelled the debtor to treat the lender as if he were a substantial owner of the company rather than simply a lender. The Bankruptcy Court determined that evidence supported that the lender was also extremely involved in the daily operations of the debtor. Further, in the Bankruptcy Court’s view, “undercapitalization was by far the single most important cause of the debtor’s financial failure.”

Interestingly, in the AtlanticRancher case, the note and related agreements were properly documented with maturity dates and interest rates, used for working capital, and treated as debt on the debtor’s books. However, despite the proper documentation, the lender never made any effort to collect on the promissory note or foreclose on its collateral. In the Bankruptcy Court’s view, the lender knew that any attempt to exercise its rights as a secured creditor would have put the debtor out of business and, thus, the lender did not treat the convertible promissory note, and the rights contained therein, as a loan, but rather

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treated it as an investment. In quoting *Kids Creek*, the Bankruptcy Court stated that “the ultimate issue is whether the transaction had the substance and character of an equity contribution or loan.”

B. In re Phase-I Molecular Toxicology (Bankr. D. N.M. 2002)

In November, 2002, the United States Bankruptcy Court for the District of New Mexico concluded that the transaction before it was a loan and not an equity contribution. In *Phase-I*, the creditors filed a complaint for either equitable subordination of certain shareholders’ secured claims or recharacterization of the loans as capital contributions. Each of two shareholders extended a $150,000 loan to the debtor and each perfected a security interest in all or substantially all of the debtor’s assets. Prior to the granting of the loans, the two shareholders and other entities had already invested $10,000,000 as stockholders of the debtor. When the request for the loan was made, the debtor anticipated selling assets of a subsidiary and other assets which would generate significant cash sometime in the fall. The Bankruptcy Court, in determining that the transaction was a loan and not a contribution to capital, was persuaded by: (i) the title given to the instruments, specifically, “Senior Secured Demand Bridge Note”; (ii) that the security agreements were entered into at or near the time of the advances; (iii) significant assets were pledged for security of notes; (iv) that although the notes were payable on demand, and contained no fixed maturity date, they did include an interest charge; and (v) that the intended repayment of the loan was anticipated to be received from the sale of assets and was not completely dependent on the future success of the debtor’s business.

In quoting *AutoStyle Plastics*, the Bankruptcy Court stated “[i]f the expectation of repayment depends solely on the success of the borrower’s business, the transaction has the appearance of a capital contribution.” The Bankruptcy Court also found it persuasive that the expenses for the enforcement of the loan were included in the promissory notes and that there was no evidence that the other existing shareholders made contributions to the loan proportionate to their respective stock ownership. While the Bankruptcy Court engaged in some discussion concerning the undercapitalization of the company and the company’s inability to obtain a similar loan from outside sources, it noted that, for the purposes of recharacterizing an advance as a capital contribution.

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contribution rather than a loan, the undercapitalization factor is the initial capitalization, and not the capitalization at the time of the transfer. The Bankruptcy Court then found that the initial capitalization of the debtor was significant. The Bankruptcy Court stated that whether the debtor was undercapitalized at the time of the transfer is somewhat relevant, but that it is not determinative. Further, the Bankruptcy Court noted that while the fact that the debtor could not obtain a loan from any other disinterested lender weighs in favor of treating the advance as a capital contribution, that by itself does not "tip the scale." The Bankruptcy Court finished its discussion in reviewing that there was no evidence that the lenders were allowed to participate in the management of the debtor flowing from the transaction, or that the advanced funds were used to acquire capital assets. The Bankruptcy Court therefore concluded that the transaction constituted a loan.

C. In re Medical Software Solutions (Bankr. D. Utah 2002)

Also in November, 2002, the United States Bankruptcy Court District of Utah determined that identity of interests, without more, is insufficient to warrant the recharacterization of debt to equity. The Bankruptcy Court was asked to approve a proposed sale of substantially all of the assets outside the ordinary course of business, and before a Chapter 11 plan of reorganization and disclosure statement was proposed. The proposed buyers were insiders within the meaning of the Bankruptcy Code. As part of the bid, was included a "credit bid" of secured claims, including the claim of an insider/stockholder. Shareholders alleged that the proposed insider buyers secured claims should be recharacterized as equity and, thus, the buyers should be required to purchase the asset with new funds, rather than by offsetting the debt previously extended to the debtor.

The Bankruptcy Court concluded that recharacterization was a recognized cause of action in the Tenth Circuit and adopted the tax factors set forth in an unpublished Tenth Circuit Opinion. The Bankruptcy Court concluded that the testimony revealed that the obligation

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111 In re Phase I Molecular Toxicology, Inc., 287 B.R. 571, 578, 49 Collier Bankr. Cas. 2d (MB) 1375 (Bankr. D. N.M. 2002).
112 In re Phase I Molecular Toxicology, Inc., 287 B.R. 571, 578, 49 Collier Bankr. Cas. 2d (MB) 1375 (Bankr. D. N.M. 2002).
113 In re Medical Software Solutions, 286 B.R. 431 (Bankr. D. Utah 2002).
115 In re Medical Software Solutions, 286 B.R. 431, 442-43 (Bankr. D. Utah 2002). (citing In re Ruff Financial Services, Inc.; Segal v. Ledyard, 166 F.3d 348 (10th Cir. 1998)).
was a debt obligation and should not be recharacterized because only one of the factors, specifically, identity of interest, was present.

D. In re Internet Navigator, Inc. (Bankr. N.D. Iowa 2003)

In January, 2003, the United States Bankruptcy Court for the Northern District of Iowa refused to recharacterize a loan that a corporate debtor's principals had provided to the debtor prior to the commencement of the Chapter 11 case as a contribution to capital. In Internet Navigator, the Bankruptcy Court reiterated that the factors in cases such as AutoStyle Plastics and Cold Harbor, should be considered in light of the circumstances surrounding each case with no one factor given controlling or decisive weight. The Bankruptcy Court was persuaded that the intent of the debtor and the claimants was that they be paid wages and repaid for advances and expenses. The Bankruptcy Court looked to the minutes of the board that recognized the obligation as debt and which indicated an intent to issue “warrants” which were ultimately avoided. The Bankruptcy Court was not troubled that all the formalities were not followed in documenting the debts as it was a small, closely-held corporation.


In March, 2003, the United States District Court for the District of Delaware issued an opinion in which it affirmed the Bankruptcy Court’s decision and denied the request to recharacterize various pre-petition funding as equity contributions. In SubMicron, the District Court stated that the trial testimony was uncontradicted in that if the defendants had not made the 1999 funding to the debtor, the company would have been forced to close down and liquidate leaving nothing for the unsecured creditors. In a lengthy opinion, the District Court concluded that the 1999 fundings were properly characterized as secured debt because the parties intended the 1999 fundings to be secured debt, and the defendants were protecting their past investments (secured debt) by the additional loans. The District Court noted that while several factors leaned slightly toward equity, such as the absence of a sinking fund, the inadequacy of capitalization and collateral, the majority of the other factors weighed towards characterization as debt. The District Court concluded that the plaintiff failed to show that under the debtor’s financially distressed circumstances that the defendant’s 1999 fundings were irrational, improper or equity infusions disguised as debt.

Interestingly, the District Court was not troubled that some of the

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defendant’s 1999 fundings had notes, while others did not, since the record was clear the debtor’s accounting department had made numerous mistakes and errors when generating notes. The fact that the notes were generated for some fundings and not for others was not sufficient, in and of itself, in the District Court’s opinion, to recharacterize the 1999 fundings as equity. The District Court also took note that: (i) the plaintiff had not proven that the defendants or their designees controlled or dominated the debtor company in any way; and (ii) while undercapitalization lends itself for a court to be more skeptical of purported loans, undercapitalization of a loan is insufficient to justify the subordination of insider claims.

F. In re Outboard Marine Corp. (N.D. Ill. 2003)

In July, 2003, the United States District Court for the Northern District of Illinois, overturned the Bankruptcy Court, and determined that bankruptcy courts have the authority to hear recharacterization actions and that such actions are not in disharmony with equitable subordination. In Outboard Marine, one of the world’s largest boat manufacturers was struggling to stay afloat. In the Fall of 2000, Outboard Marine Corporation (“OMC”) and its lenders completed the tenth amendment to their loan and security agreement, creating an additional $25 million tranche of debt (“Tranche B”). Quantum Industrial Partners, LDC (“Quantum”), which over the course of two years had become the direct or beneficial owner of nearly 100% of OMC stock, immediately purchased a 100% participation interest in Tranche B. Quantum agreed with lead lender Bank of America that Tranche B would be subordinated to the $105 million Tranche A loan. Quantum also handed over to Bank of America all of its legal rights against OMC.

Two months later, OMC filed for chapter 11 protection and Bank of America brought an action to collect on all the secured loans. In a counterclaim, the trustee asked the Bankruptcy Court to use its equitable powers to decree that the Tranche B loan, allegedly owned to Quantum, did not give rise to a right to payment because it was not a loan at all, but merely an equity security.

The Bankruptcy Court declined the invitation to recharacterize the debt, however, observing from the bench that:

. . . there is no basis in bankruptcy law to recharacterize a debt as equity.

That bizarre concept arose from a serious misreading of a few tax cases

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123 In re SubMicron Systems Corp., 291 B.R. 314, 319 (D. Del. 2003) (“[t]his is because ‘any other analysis would discourage loans from insiders to companies facing financial difficulty and that would be unfortunate because it is the shareholders who are most likely to have the motivation to salvage a floundering company.’”) (quoting In re Octagon Roofing, 157 B.R. 852, 858 (N.D. Ill. 1993)).
... Somehow those very reasonable cases got read into the bankruptcy context into some sort of equitable doctrine... In my opinion no bankruptcy court has the power to do any such thing under the Bankruptcy Code.\textsuperscript{126}

As stated earlier, Judge Barliant’s view is in conflict with that of most courts that have considered the issue.\textsuperscript{127} On appeal, the District Court reversed, making the case in favor of recharacterization\textsuperscript{128} and holding that no “disharmony” necessarily existed between recharacterization and equitable subordination because equitable subordination, by definition, only becomes relevant if the court determines that the advance in question was not an equity contribution. Thus, the District Court remanded the case to the Bankruptcy Court, ordering it to exercise its authority to determine whether facts justified recharacterization. In making this determination, the Bankruptcy Court was urged to consider the eleven \textit{AutoStyle Plastics} factors and an additional two factors, which were adopted from the \textit{Hyperion}\textsuperscript{129} case: (i) the ratio of shareholder loans to capital; and (ii) the amount or degree of shareholder control.\textsuperscript{130}

\textbf{G. In re Abtox, Inc. (Bankr. N.D. Ill. 2003)}

Also in March, 2003, another judge sitting in United States Bankruptcy Court for the Northern District of Illinois determined that a cause of action for recharacterization should not be recognized under the United States Bankruptcy Code, based on Judge Barliant’s reasoning discussed above.\textsuperscript{131} Judge Doyle incorporated Judge Barliant’s views that “there is nothing anywhere in the Bankruptcy Code that authorizes

\textsuperscript{126}In re Outboard Marine Corporation, Case No. 00 B 37405 (2000).


converting a claim into an equity interest for any reason whatsoever.\textsuperscript{132}

In \textit{In re Micro-Precision Technologies, Inc.} (Bankr. D. N.H. 2003), the United States Bankruptcy Court for the District of New Hampshire was presented with a motion for disallowance of a claim or, in the alternative, for recharacterization of the claim as a junior preferred equity interest.\textsuperscript{133} The Bankruptcy Court ultimately determined that the obligation was a loan and should not be recharacterized as junior preferred equity. The Bankruptcy Court initially concluded that although the First Circuit had not yet addressed the issue whether or not bankruptcy courts may recharacterize debt as equity, two other courts in the First Circuit had addressed the issue and determined that bankruptcy courts had the authority to recharacterize debt as equity.\textsuperscript{134} The Court acknowledged the \textit{AutoStyle Plastics} factors and the discussion in \textit{Hyperion} and concluded that no one factor was controlling or decisive.

The obligation at issue in \textit{Micro-Precision} involved a fixed maturity date and a rate of interest under a promissory note. Evidence demonstrated that the debtor did not timely document reconversion on its balance sheet. However, there was no evidence presented to the Bankruptcy Court that the delay was deliberate or intended to mischaracterize the nature of the obligation. The debtor had made interest payments in 1999 and did not file bankruptcy until 2002. Although there was some evidence presented concerning the debtor’s difficulty in obtaining outside loans, no evidence was presented concerning capitalization. The Bankruptcy Court concluded that in order for the funds transferred by the lender to be recharacterized, the plaintiff would need to demonstrate some connection to capitalization. The Bankruptcy Court acknowledged that in recharacterization cases, the claims of creditors who were corporate insiders or had conducted their transactions with the debtors in some inequitable manner are closely scrutinized.\textsuperscript{135} There was, however, no allegation that the lender participated in the management of the debtor.\textsuperscript{136} The Bankruptcy Court also found it notable that the lender did not speak any English and never participated in any capacity in the corporate decision making or business operations of the debtor, nor had she intervened in any of the transactions between the debtor and its investors.

\textsuperscript{132}Outboard Marine, Case No. 00 B 37405 at 34.
III. PRACTICAL CONSIDERATIONS IN BRINGING AND DEFENDING RECHARACTERIZATION ACTIONS AS WELL AS PLANNING TO AVOID RECHARACTERIZATION CLAIM

A. Planning Issues Relative to Avoiding A Recharacterization Claim

A common scenario in which a recharacterization risk can be created is when an investor determines that an infusion of additional capital into a company is necessary to protect its original investment. For instance, an increasing number of private equity funds and other venture capitalists are being approached by their troubled portfolio companies for infusions of needed capital. Assuming an additional investment makes good business sense, the investor must consider how best to structure such an investment to protect itself to the greatest extent possible. Investors will generally structure such an infusion of capital into a troubled company as a loan rather than an equity investment because of the risks of a future bankruptcy. The investor still, however, faces the risk that its loan will be recharacterized as an equity investment in the event of bankruptcy. While the risk of recharacterization cannot be completely eliminated in this context, it can be minimized by appropriate legal structuring.

Perhaps one of the “safest” ways to structure an additional investment in a troubled company (outside of a DIP loan in a bankruptcy case) is demonstrated by AutoStyle Plastics itself. In AutoStyle Plastics, the Sixth Circuit held that the “true” participation interests of certain insiders in a lead lender’s credit facility were appropriately considered as debt. The participation by less than all of the shareholders resulted in the insiders’ participation interests not correlating with their equity interests, which, in turn, favored characterizing the interests as debt. Thus, the insiders’ participation interests, in a sense, were considered to be loans to other shareholders who did not have an interest in the credit facility. Moreover, the Sixth Circuit held that the insiders did not engage in any inequitable conduct warranting equitable subordination of their interests. In the absence of inequitable conduct, the Sixth Circuit found it irrelevant that the debtor was allegedly undercapitalized when the insiders obtained their participation interest. The Sixth Circuit held that to equitably subordinate an inside creditor’s claim, the inside creditor must actually have used its power to control the debtor to its own advantage or to the detriment of other creditors. The mere participation in a lead lender’s credit facility was not an act of controlling the debtor to the insiders’ own advantage or to the detriment of other creditors and, thus, did not constitute inequitable conduct.\(^{138}\)

A lead lender may be unwilling to negotiate a participation, and in

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\(^{138}\)Important to note is the fact that in the AutoStyle Plastics case, the participation interests in the credit facility were disclosed in general terms in the debtor’s audited financial statements. In re AutoStyle Plastics, Inc., 269 F.3d 726, 734, 45 U.C.C. Rep. Serv. 2d 964, 2001 FED App. 0378P (6th Cir. 2001).
some circumstances, may instead offer a right of subrogation. Under this arrangement, a lender pays the lead lender and then steps in the shoes of the lead lender in seeking repayment from the troubled company. A problem with this approach is that because subrogation is an equitable doctrine, a court proceeding is required for a right of subrogation to vest. In a bankruptcy proceeding, a court will uphold the right of subrogation only if it determines that the doctrines of equitable subordination and recharacterization are not applicable.

In some instances, an investor may determine that an additional capital infusion in a troubled company makes sense only if it is made in concert with an overall debt restructuring by the troubled company’s various creditors. This combination of a capital infusion by equity holders with a debt restructuring (commonly referred to as a “Shared Pain Restructuring”) can eliminate the recharacterization and equitable subordination risks as part of the overall business deal. A Shared Pain Restructuring may or may not require a bankruptcy proceeding to bind dissenting creditors and/or to take advantage of one or more of the other rights and powers afforded by the Bankruptcy Code.

A Shared Pain Restructuring is by no means always a creature of bankruptcy. Bankruptcy does, however, present certain advantages, most notably the ability to bind dissenting creditors. For example, even if 95% of the troubled company’s subordinated debenture holders agree to a proposal for the conversion of all debt to equity, the remaining 5% may retain their claims absent a bankruptcy. A bankruptcy proceeding enables a troubled company to bind dissenting creditors, thereby overcoming the classic free-rider problem faced when fewer than all creditors agree to the deal. These advantages must be weighted against the disadvantages of implementing a Shared Pain Restructuring through Chapter 11, foremost of which is the effect of bankruptcy on the business of the troubled company, which ranges from negative public opinion to statutory constraints imposed by the Bankruptcy Code.139

B. Litigation Analysis

It is clear that there are many instances involving recharacterization that never reach formal litigation. Moreover, even when claims for recharacterization are filed, they are rarely litigated to conclusion, and even more rarely, result in reported written decisions. Settlement seems to be the most likely result of most recharacterization claims, due in part to the time involved in litigating such a case to conclusion. Additionally, it has also become clear that practitioners are more creative with their use of recharacterization. For example, recharacterization issues have been raised in the context of securitization transactions, letters of credit, and in the provision and payment of guarantees. Recharacterization issues have also been raised in the context of bad

faith lending claims.

1. Procedural Aspects of Bringing a Recharacterization Action

An allegation of recharacterization, for purposes of negotiation, can be raised at any time in a case. However, because the Bankruptcy Code does not expressly provide for a cause of action recognizing recharacterization (unlike Section 510(c) of the Bankruptcy Code which provides an express cause of action for equitable subordination), the first obstacle for a part seeking such relief is a procedural one. Unlike, a claim for equitable subordination, which must be brought by an adversary proceeding and generally may be initiated only by a trustee or debtor-in-possession unless a bankruptcy court authorizes another party to initiate such a proceeding, no such guidelines exist for recharacterization actions. There are, however, several different ways recharacterization actions have been—and continue to be—brought.

Because Section 502 of the Bankruptcy Code deems proofs of claims or interests to be allowed unless an objection is filed, if a claim has already been filed in a case, then an objection can be filed including a counterclaim raising the recharacterization issues which will convert the objection to an adversary proceeding pursuant to Federal Bankruptcy Rules of Procedure 3007 and 7001. If no claim has been filed, however, it is unclear whether a separate adversary can be properly commenced solely on the basis of the exercise of power under Section 105 of the Code to recharacterize the claim. Another avenue is for an adversary to be commenced seeking a claims allowance determination under Section 502(f) of the Bankruptcy Code and Bankruptcy Rule 7001. Cases have also been filed using Section 510(c) seeking equitable subordination, or, in the alternative, recharacterization. However, given the disparate nature of recharacterization and equitable subordination, it is not clear whether a Section 510(c) action is the appropriate course to follow either.

Practically speaking, when preparing a “kitchen sink” pleading against a lender, many pleadings will seek a determination for recharacterization (where the entire obligation is recharacterized and subordinated) or, in the alternative, equitable subordination, where the claim is subordinated to the extent of the harm only. There are many other possibilities as well. In Outboard Marine, the lender filed an action seeking to compel payment and recharacterization was raised as a counterclaim. Certainly, the issue can be joined at the plan stage in connection with classification.

To date, there is no decision reported on a procedural challenge to these issues other than the overall propriety of the bankruptcy courts to

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141 An interesting point to think about perhaps is whether if there is a disagreement about the nature of the transaction, does Section 502 even apply at all?
hear the issues at all. However, it seems that there is much room for ingenuity when considering how to accomplish the recharacterization of an obligation from debt to equity and thought must be given as to how best to proceed, given the facts of the particular case.

2. Who Can Bring a Claim for Recharacterization?

When bringing an action for equitable subordination under Section 510 of the Bankruptcy Code, standing is an important issue. Generally, an action may be initiated only by a trustee or debtor-in-possession, unless a bankruptcy court authorizes another party to initiate such a proceeding. Creditors Committees generally have an implied qualified right to initiate, with bankruptcy court approval, proceedings in the name of the trustee or debtor in possession only when they unjustifiably fail to bring suit. There is one important exception to this general rule. When a trustee or DIP has not objected to a claim, or has no reason to object to a claim, a creditor may maintain a cause of action with the consent of the court under Section 510(c) of the Bankruptcy Code where the sole purpose of the action is to subordinate the claim to the objectant’s claim.

Because there is no express cause of action under the Bankruptcy Code for recharacterization, the question seems open as to who has proper standing to bring such actions. There are no reported cases in this area of standing to bring recharacterization actions. Practically speaking, Creditors Committees are the ones raising the issues and bringing the actions and there have been no challenges, that the authors have seen, to their standing to do so. Perhaps the bankruptcy courts will adopt the same analysis for standing as in equitable subordination cases, but arguments can be made that it should not involve the same analysis because standing decisions in equitable subordination cases rest on the express cause of action provided under the Bankruptcy Code and the cause of action in an equitable subordination case is based upon the conduct of a legitimate creditor, not the nature of the transaction. Consequently, in determining whether to bring a recharacterization action, consideration must be given to whether standing exists to bring such an action. There is also room for the possibility that a single creditor may have standing based upon the exception to the general rule adopted in equitable subordination cases. Of course, a fine line must be walked in bringing a suit for the purposes of exerting pressure on settlement negotiations and taking advantage of the bankruptcy court’s jurisdiction.

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3. How To Defend A Recharacterization Action.

If your client is one against which a recharacterization action has been brought or alleged, the first step is to get a complete understanding of the facts involved as soon as possible. The easiest way to assess the likelihood of success of any recharacterization action is to parse through each of the factors one by one as they relate to the facts. After reviewing the factors in light of the facts, as well as the intent of the parties, the factors must be balanced in light of the totality of the circumstances. As in any litigation analysis, it is likely that some factors will be more supportive of a successful defense than others. Nonetheless, given the big picture, what does the overall likelihood of success look like?

In the defense of an action for equitable subordination under Section 510 of the Bankruptcy Code, demonstrating that the lender was not an insider allows the defendant to gain an advantage. In recharacterization cases, insider status is merely a factor to be balanced, and although when an insider is involved it requires a greater level of scrutiny, no separate standards or burdens of proof with respect to insiders have been developed to date in the reported cases on these issues. Also, because there is no express cause of action under the Bankruptcy Code for recharacterization, the issue is open as to who has proper standing to bring such actions and can be raised as a means of challenging a recharacterization action. Perhaps the bankruptcy courts will adopt the same analysis used in determining standing to bring equitable subordination actions, but an argument can be made against such an analysis based upon the fact that the standing decisions in equitable subordination cases rest on the express cause of action provided under the Bankruptcy Code. As a defendant, therefore, check to see who is raising the action, for example, the creditors committee, and an argument, even for negotiation purposes, can be made that the action cannot be brought. Finally, a defense which can be raised in equitable subordination cases is that all the elements which are required have not been satisfied - due to the balancing approach of the factors in recharacterization cases this defense must be altered, but may be done in an effective way to downplay the “balancing” of various factors.

The difficulty in these cases is that there are not many reported decisions and the cases are incredibly factual in nature. Consequently, it is very difficult to predict with certainty what the outcome may be. More-

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146 As discussed earlier, different analyses and requirements are applied to insiders vs. non-insiders in determining inequitable conduct - generally, the standard applied to insiders is merely one of simple unfairness, while non-insiders are held to an “egregious” and “severely unfair” standard. See, e.g., Matter of Mobile Steel Co., 563 F.2d 692, 699, 15 C.B.C. 1 (5th Cir. 1977); U.S. v. Noland, 517 U.S. 535, 539, 116 S. Ct. 1524, 134 L. Ed. 2d 748, 28 Bankr. Ct. Dec. (CRB) 1331, 35 Collier Bankr. Cas. 2d (MB) 1, Bankr. L. Rep. (CCH) ¶ 76920, 96-1 U.S. Tax Cas. (CCH) ¶ 50252, 77 A.F.T.R.2d 96-2143 (1996); In re Medical Software Solutions, 286 B.R. 431 (Bankr. D. Utah 2002).

over, given that the bankruptcy court is a court of equity, be mindful of
the overlay of the total balancing approach the bankruptcy court will
bring to bear depending upon the facts of the case. It is very important
to keep an experienced bankruptcy lawyer involved in the case and not
totally hand the case off to litigators who can tend to focus on one par-
ticular fact or factor and lose sight of the big picture in the bankruptcy
court and the balancing nature of the cases. An advantage, however, to
the lack of reported decisions and the fact-dependent nature of the
cases, is that it is not difficult to digest the case law in this area quickly
and create a unique defense based upon the facts of the case.

Generally, when engaging in settlement discussions, be mindful of
the cost of a defense which is almost totally dependent upon the facts
which could involve extensive discovery, numerous depositions and
voluminous document production, including electronic communications.
Additionally, you will find that in many cases, the testimony is so self
serving it may not be given much weight.

CONCLUSION

While the common law applicable to recharacterization actions
continues to evolve, it appears that the bankruptcy courts have, for
now, settled the questions of whether recharacterization exists as a
distinct cause of action. Further, recharacterization of claims as equity
has emerged as a tool de jour in the trustee and creditors committee
toolboxes of late. The thirteen recognized factors from AutoStyle Plas-
tics148 as supplemented by Outboard Marine149 provide a roadmap by
which to navigate an analysis of a recharacterization claim, although
all of the cases are consistent in their emphasis that no one factor is
decisive and that all the facts must be viewed in light of the circum-
stances surrounding each case with no one factor given controlling or
decisive weight.

It is also clear that any recharacterization claim is incredibly factu-
ally dependent and that discovery and testimony can be extensive and
expensive. Accordingly, given the recent developments in the case law,
a claim for recharacterization as a contribution to capital should not be
brought without investigation and sufficient facts to support the allega-
tion by a preponderance of the evidence. Bankruptcy practitioners must
be careful about the procedural posture of the case and in conducting
the appropriate analysis whether to bring a claim for recharacterization
or how to successfully defend such a claim efficiently and economically.

148In re AutoStyle Plastics, Inc., 269 F.3d 726, 45 U.C.C. Rep. Serv. 2d 964, 2001 FED
App. 0378P (6th Cir. 2001).
149In re Outboard Marine Corp., 50 Collier Bankr. Cas. 2d (MB) 931, n.5, 2003 WL
21697357 (N.D. Ill. 2003).