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Alert

Divided Tenth Circuit Reverses Recharacterization and Equitable Subordination of Insider Secured Loan

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The claim of an insider lender ("L") who invested "in a venture with substantial risk" and who loaned it additional funds on a secured basis to salvage its business should not be recharacterized as equity or subordinated on equitable grounds, held the U.S. Court of Appeals for the Tenth Circuit on June 12, 2015. *In re Alternate Fuels, Inc.*, 2015 WL 3635366 (10th Cir. June 12, 2015) (2-1) ("*AFI*"). Reversing the bankruptcy court and the Bankruptcy Appellate Panel, the court found that L's loans did "not meet our criteria for either recharacterization or equitable subordination." Moreover, L had "satisfied his burden of proof as to the validity and amount of his claim." *Id.* at *1. The *AFI* decision shows how and why courts have reached inconsistent results in deciding whether to recharacterize secured loans.

Relevance

Secured lenders such as financial institutions or corporate insiders are routinely threatened by bankruptcy trustees or creditors' committees with the recharacterization or subordination of their claims. Just as often, these threats are based on the lender's having made a so-called "rescue loan" and can generate years of litigation. *See e.g.*, *In re Sentinel Management Group Inc.*, 2014 WL 6990322 (N.D. Ill. Dec. 10, 2014) ("*Sentinel IV*") (bank making "rescue loan" did not engage in "egregious conduct" sufficient to subordinate its lien on equitable grounds; also, because of bank's good faith, corrupt borrower's fraudulent pledging of customer funds as collateral for loan cannot be voided as fraudulent transfer). *See In re Sentinel Management Group, Inc.*, 728 F.3d 660 (7th Cir. 2013) ("*Sentinel III*") (remanding case to district court for further litigation because of that court's "inconsistencies," Seventh Circuit found that debtor manager's "pledges of segregated funds as collateral for loans" was likely a fraudulent transfer based on its "actual intent to hinder, delay or defraud" creditors under Bankruptcy Code ("Code") Section 548 (a)(i)(A)).[1]

Facts

The debtor, Alternate Fuels Inc. ("AFI"), had been "engaged in surface coal mining operations." It filed a Chapter 11 petition in 1992, emerged to continue its mining operations, later stopped operating, and then abandoned its assets to creditors in 1996. An individual ("W") bought the stock of AFI and formed Cimarron Energy LLC "to handle the mining operations for which AFI still held permits." W provided the state of Missouri with "reclamation bonds" secured by cash of $1.4 million, to assure the state "that AFI would restore permitted mining sites to their original condition." 2015 WL 3635366, at *1. Cimarron later acquired AFI's assets but "AFI remained liable for debts not addressed in the 1992 bankruptcy."

[1] For an analysis of *Sentinel III* and *Sentinel IV*, see our May 22, 2015 *Alert*, "Court Validates Rescue Loan, Rejecting Equitable Subordination and Fraudulent Transfer Claims."

L bought W's interest in AFI during 1999 for $549,000, not to operate the entity or "to resume mining operations." Instead, L believed, "through his political connections," that he could fulfill AFI's remaining reclamation obligation. L intended to obtain the proceeds of the certificates of deposit pledged by AFI and the proceeds from the sale of Cimarron's mining equipment. *Id.*

L received the stock of AFI and Cimarron plus "the assignment of the 24 certificates of deposit" W had pledged to secure AFI's recognition bonds. AFI also signed notes to L, who expected to receive "the proceeds of the release of the certificate of deposits on the completion of reclamation, his only anticipated source of future payment." *Id.* at *2. L advanced further funds to AFI and received "replacement notes" totaling at least $2.4 million to evidence his loans. When AFI later recovered $5 million on a judgment against a third party, it filed a second bankruptcy petition to resolve its creditors' competing claims. L filed a claim against the AFI estate for $4.3 million, which included $3.8 million for three notes plus interest, secured by AFI's assignment of $3 million from the judgment proceeds.

The Lower Courts

The bankruptcy court recharacterized L's claim as equity. Alternatively, it held that L's claim was invalid because of a lack of "sufficient documentation." The bankruptcy court also held, in the alternative, that L's claim had to be subordinated on equitable grounds "to the level of an unsecured claim on par with the other unsecured claims, accompanied by the transfer of [L's] interest in the" AFI money judgment. *Id.* at *4. The Bankruptcy Appellate Panel for the Tenth Circuit affirmed.

Tenth Circuit

Recharacterization, according to Tenth Circuit precedent, is an equitable remedy and "essential to a court's ability to properly implement the priority scheme of the Bankruptcy Code." When a court "recharacterizes putative debt as equity, it 'effectively ignore[s] the label attached to the transaction at issue and instead recognize[s] its true substance.'" *Id.* at *5, citing *In re Hedged-Investments Assocs., Inc.*, 380 F.3d 1292, 1297 (10th Cir. 2004). Instead of being treated as a loan, the funds advanced are "treated as a capital contribution … In this way, recharacterization ensures that 'controlling equity owners of a troubled corporation [do not] jump the line of the bankruptcy process and thwart the company's outside creditors' and investors' priority rights.'" *Id.*

Source of Recharacterization Power

The Tenth Circuit rejected L's "contention that a court's power to recharacterize arises solely from the disallowance provision of [Code] § 502(b), rather than from [Code] § 105(a)." *Id.* at *7. In its view, "disallowance [of a claim] and recharacterization require different inquiries and serve different functions … . Recharacterization … is an inquiry into the true nature of a transaction underlying a claim … [,] part of a long tradition of courts applying the 'substance over form' doctrine." *Id.* at *6, citing *Pepper v. Litton*, 308 U.S. 295, 305-06 (1939). In short, reasoned the court, because the Code does not prohibit recharacterization, it still had to determine the "proper priority" of L's claims by closely reviewing their "true substance." *Id.* at *7.

Methodology for Recharacterization

Recharacterization of L's loans to AFI was not warranted, held the court. It stressed that any court applying Code Section 105(a) to recharacterize debt "as camouflaged equity must apply a thirteen-factor test." *Id.*, citing *Hedged-Investments*, 380 F.3d at 1298. Applying that "highly fact-dependent" criteria to the AFI dispute, it explained at the outset that L "was engaged in a venture with substantial risk: he purchased equity in a struggling business with the singular goal of completing reclamation and receiving

the proceeds of the certificates of deposit. When the business needed additional financial support to reach its goal, [L] provided advances. [There was] nothing inherently improper about this arrangement." *Id.*

Evidence of Debt
The Tenth Circuit first agreed with the bankruptcy court that L held promissory notes "evidencing [AFI's] indebtedness." *Id.* at *8. Although the notes were on a "preprinted form" and the acceleration provisions were inapplicable, "no rule [requires] that all portions of a standardized form must be complete for a document … to be deemed a promissory note." Nor were the notes invalid or unenforceable under applicable Kansas law. Although there was some dispute over the precise amount of L's loans, L's promissory notes "roughly reflected" the funds he had advanced to AFI. *Id.*

No Increase in Debtor's Management
Nothing in the record showed that L had "increased his participation in the management of AFI as a result of his advances." According to the court, the bankruptcy court "erred when it proceeded to discount this clear finding." Also found to be "irrelevant" was AFI's use of L's loans "to fund operating expenses rather than to purchase capital assets." In fact, AFI had "incurred no expenses other than the funding of reclamation operations," consistent with AFI's "narrow objectives." *Id.* at *9.

Mere Stock Ownership Not Enough
Nor did the Tenth Circuit believe L's ownership of AFI's stock supported recharacterization. It rejected the bankruptcy court's reliance on "identity of interest between the creditor and stockholder" to suggest characterization of L's loans as equity, stating, "We see no reason to assume that all funds transferred to a business owned by a single stockholder must be in the nature of equity." Indeed, because "one cannot own more than all of a company's stock," L would not invest more funds "in exchange for no additional equity." *Id.*

Notes Enforceable
L's notes lacked a fixed maturity date, but the Tenth Circuit rejected the bankruptcy court's deeming this to be an indicator of a capital contribution. Each note expressly required the payment of principal plus accrued interest no later than five years from the date of execution, and if payment was not made then, it required full payment when AFI's certificates of deposit were released. The notes were thus enforceable. Merely because L had not yet exercised his contractual right to enforce the notes had no significance. *Id.* at *10.

Undercapitalization Not Dispositive
AFI's undercapitalization was also not dispositive. In the words of the court, "placing too heavy an emphasis on undercapitalization [in this context] … would create an 'unhealthy deterrent effect,' causing business owners to fear that, should their 'rescue efforts' fail, a court will 'give disproportionate weight to the poor capital condition of their failing companies and thus too quickly refuse to treat their cash infusions as loans.'" *Id.*, citing *Hedged-Investments*, 380 F.3d at 1298 n.1. Because of the large amount invested by L for his interest in AFI and his later efforts to save the business, it was hardly surprising "that he would seek notes in return." *Id.* Moreover, although AFI had been undercapitalized for a coal mining business, it "was not engaged in coal mining"; its business activity was instead limited to meeting its "reclamation obligations to the State of Missouri." *Id.*

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Repayment Expected
L also "intended the notes to be satisfied" upon Missouri's releasing of the "reclamation bond," according to the precise language of the notes. The court, therefore, rejected the bankruptcy court's finding that L "never intended the loans to be repaid by AFI." *Id.* In the words of the court of appeals, "the evidence is abundantly clear that [L] expected repayment of debt in accordance with the terms of the notes … ." *Id.* at n.5.

Cautious Approach to Recharacterization
Most important, although certain facts arguably supported recharacterization, the court "exercise[d] caution … ." It had "previously declined to hold broadly that 'a dominant shareholder may not loan money to a corporation in which he is the principal owner and himself become a secured creditor.'" *Id.* at *11, quoting *In re Mid-Town Produce Terminal, Inc.*, 599 F.2d 389, 392 (10th Cir. 1979). The court did not want to "discourage owners from trying to salvage a business" by requiring "all contributions to be made in the form of equity capital." As the court acknowledged, "owners may often be 'the only party willing to make a loan to a struggling business,' … and needlessly punishing their efforts is neither 'desirable as social policy' nor required by our precedent." *Id.* (citations omitted).

No Harm Warranting Equitable Subordination
The Tenth Circuit also rejected the bankruptcy court's equitable subordination of L's claim. Whether L was an insider or a non-insider was irrelevant because, in the court's view, "under either equitable subordination standard, … the [bankruptcy] court erred in finding that [L had] engaged in unfair or inequitable conduct." *Id.* at *13. First, there was no finding that L had "engaged in any fraud or illegality" when obtaining the notes from AFI or in taking the assignment of the judgment proceeds. Moreover, L's stated purpose of operating AFI to secure the release of the certificates of deposit for his personal benefit was not a breach of fiduciary duty. As the court reasoned, "helping AFI fulfill obligations owed to the State of Missouri does not constitute a breach of those [fiduciary] duties." AFI was "no longer engaged in active mining operations, and its only pursuit was to reclaim permitted lands." *Id.*

No Mere Instrumentality
Nor had L used AFI as "an instrumentality or mere alter ego … ." *Id.* The Tenth Circuit refused "to hold broadly that a company becomes the alter ego of its majority shareholder simply because that shareholder funds a project that will ultimately benefit him." *Id.* at *14.

No Unfair Lending
The court further rejected the bankruptcy court's finding that L had "unfairly" loaned funds to AFI when he should have been investing equity. Again, the court stressed that L had not acted "unfairly when executing the promissory notes [because] AFI would not have been able to complete reclamation without the funds advanced by [L]." *Id.*

In sum, the court of appeals stressed that "equitable subordination is an extraordinary remedy to be employed by courts sparingly" because any legal uncertainty would create an unnecessary risk that a court might "refuse to honor an otherwise binding agreement on amorphous grounds of equity." *Id.* at *13, quoting *In re Lifschultz Fast Freight*, 132 F.3d 339, 347 (7th Cir. 1997). L had not engaged in any form of inequitable conduct and had not harmed or taken advantage of AFI's other creditors. The court therefore reversed the lower courts' equitable subordination of L's claim.

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The Dissent
The dissent accepted the bankruptcy court's recharacterization of L's loan as an equity investment. Rejecting the majority's description of L's loans as an attempt "to keep a struggling business afloat," it called the loans "a business gamble" made solely for L's "financial benefit and not AFI's." *Id.* at *15.

According to the dissent, L "knew" that "AFI had no ability to pay the debts when due." *Id.* at *20. Although the dissent agreed that "heavily emphasizing [AFI's] 'undercapitalization … would create an unhealthy deterrent effect,'" it believed L was not attempting to "rescue" AFI. *Id.* at *19. Indeed, in its view, L was "in no way lending to sustain or revive a struggling business." *Id.* at *21. It reasoned that the "object" of L's loans "was not repayment, but instead was to protect" L's claims and to acquire "secured status." *Id.* at *20.

Comments
Federal or State Law. The Tenth Circuit, in *AFI*, apparently relied on a federal common law of recharacterization and its own precedent. *In re Hedged-Investments Associates, Inc.*, 380 F.3d 1292, 1298 (10th Cir. 2004); *In re Autostyle Plastics, Inc.*, 269 F.3d 726, 748 (6th Cir. 2001) (court had power to recharacterize claim under 11-factor test derived from federal tax law to determine the propriety of recharacterization). Like some other courts, it believed that a bankruptcy court has the power to recharacterize claims based on its "general equitable powers under" Code Section 105(a). 2015 WL 3635366, at *4. *See In re Submicron Sys.*, 432 F.3d 448, 454 (3d Cir. 2006) (court has equitable power to recharacterize debt depending on whether it is more like equity); *In re Dornier Aviation*, 453 F.3d 225, 231 (4th Cir. 2006); *In re Autostyle Plastics*, 269 F.3d at 748. The Fifth and Ninth circuits recognize a bankruptcy court's power to recharacterize purported debt but stress that recharacterization of a debtor's obligation turns on "state law principles." *In re Fitness Holdings International, Inc.*, 2013 WL 1800000, at *4 (9th Cir. 2013); *In re Lothian Oil, Inc.*, 650 F.3d 539, 544 (5th Cir. 2011) (courts must define "claim" under state law; "Texas law controls the agreements underlying [the] claims in this case"; purported debt may be equity when state law would treat it as such).

There is probably some overlap between a federal law of recharacterization and applicable state law. *Hedged-Investments* and *Autostyle* established criteria that are superficially similar to those applied by many states. Delaware state courts, for example, have considered the following criteria to determine whether a debtor-creditor relationship was created: (1) the name given to the instrument; (2) the right to enforce payment of principal and interest; (3) the presence or absence of a fixed maturity date; and (4) the presence or absence of a right to share in profits or participate in management. *Moore v. American Fin. & Secs. Co.*, 73 A.2d 47, 48 (Del. Ch. 1950) (held, holders of certificates should be treated as stockholders and not creditors because of lack of definite maturity date). Massachusetts state courts, too, will recharacterize debt in "exceptional cases," particularly when an insider has acted inequitably by inadequately capitalizing an entity at its formation or by defrauding creditors. *See, e.g.*, *Albert Richards Co. v. The Mayfair Inc.*, 191 N.E. 430, 433-34 (Mass. 1934) (voided corporate debtor's mortgage to insider as fraudulent transfer); *SFB Corp. v. Cambridge Automatic, Inc.*, 2002 WL 31481078 (Mass. Super. Ct. Oct. 1, 2002) (no recharacterization of insider debt; no fraud; no facts showing inequitable conduct).

The Wisconsin Supreme Court also held an insider's debt to be enforceable in *In re Mader's Store for Men, Inc.*, 254 N.W.2d 171, 189 (Wis. 1977). So long as (1) the debtor was adequately capitalized at its formation and (2) the insider was not guilty of inequitable conduct, the insider's rescue loan was enforceable. *Id.* at 188-89. *See generally* J.M. Wilson & S. Moeller-Sally, "Debt Recharacterization Under State Law," 62 Bus. Lawyer 1257 (2007) ("Wilson").

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State Law More Predictable. The Tenth Circuit in *AFI* referred to applicable Kansas state law in its opinion but relied on its *Hedged-Investments* precedent and the bankruptcy court's equitable powers to deny characterization. The problem with the court's approach is its unpredictability. Which of the court's articulated 13 criteria will be considered most important is anybody's guess. Of the seven judges reviewing the facts in *AFI*, only two (the majority of the Tenth Circuit panel) recognized L's secured claim.

According to the U.S. Supreme Court, though, the "basic federal rule in bankruptcy is that state law governs the substance of claims." *Raleigh v. Ill. Dept of Revenue*, 530 U.S. 15, 20 (2000). The Fifth and Ninth circuits, in *Lothian* and *Fitness Holdings*, also agreed that state law governs. As two commentators persuasively argue, "application of state law [will] reconcile conflicting and inconsistent federal case law and support capital markets by restoring predictability in the enforcement of insider debt." Wilson, at 1280. Because the Code provides no statutory basis for deciding recharacterization disputes and because of ample Supreme Court precedent, the issue should turn on state law, not some vague federal equitable law.

Equitable Subordination a Different Remedy. The recharacterization remedy here is different from equitable subordination. Code Section 510(c) authorizes a bankruptcy court to subordinate a claim "to all or part of another allowed claim … under principles of equitable subordination … ." Although subordination and "recharacterization [may be] based on the same facts," they "are directed at different conduct and have different remedies." *Lothian*, 650 F.3d at 543; *In re Winstar Commc'ns., Inc.*, 554 F.3d 382, 414 (3d Cir. 2009). Equitable subordination is remedial, not punitive, meaning that the remedy is available only to the extent necessary to repair the harm suffered by the debtor and its creditors. *Wooley v. Faulkner* (*In re SI Restructuring, Inc.*), 532 F.3d 355 (5th Cir. 2008) (subordination "inappropriate" when trustee failed to prove harm from insider loans). In *AFI*, the lack of harm to creditors was one reason why the Tenth Circuit reversed the bankruptcy court's equitable subordination of L's claim. Nevertheless, the bankruptcy court recognized the difference between recharacterization and equitable subordination. Its recharacterization of L's loan deemed it to be equity, below the claims of all creditors. In its alternative equitable subordination of L's claim, it only subordinated the claim to other secured creditors, subordinating it "to the level of an unsecured claim on par with the other unsecured claims … ." 2015 WL 3635366, at *4.

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