

## ALERTS

## Ninth Circuit Allows Bankruptcy Courts to Recharacterize Loans as Equity, Applying State Law

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The Ninth Circuit held on April 30, 2013 that a bankruptcy court “has the authority to determine whether a transaction creates a debt or an equity interest for purposes of [Bankruptcy Code] § 548, and that a transaction creates a debt if it creates a ‘right to payment’ under state law.” *In re Fitness Holdings International, Inc.*, 2013 WL 1800000, \*1 (9<sup>th</sup> Cir. April 30, 2013). The court agreed with five other circuits, but explicitly followed the reasoning of the Fifth Circuit’s recent *In re Lothian Oil, Inc.* decision. 650 F.3d 539, 543-44 (5<sup>th</sup> Cir. 2011) (looked to state law to “distinguish between debt and equity”).

The debtor in *Fitness* had made a pre-bankruptcy transfer of cash to its sole shareholder in repayment of a purported loan. Although the lower courts held they lacked the power to go behind the loan documentation, the court of appeals remanded for further litigation, holding that the bankruptcy court, in fact, had the power to recharacterize the transaction. Essentially, the Ninth Circuit interpreted the bankruptcy trustee’s claim “as a request for a determination that [the debtor’s payment] to [its shareholder] was not made in repayment of a ‘debt’ as that term is defined in the Code.” *Id.* at \*2, n.4. If the payment was, in substance, a dividend when the debtor was insolvent, the insider shareholder would have received a fraudulent transfer under Code § 548.

### Relevance

Creditors regularly scrutinize a debtor's payment to insiders such as a sole shareholder. Whether and how recharacterization is a weapon in the creditors' arsenal has troubled the lower courts. *Fitness* shows that the courts of appeals are now coalescing on how to treat repayment of insider "loans." *Lothian*, moreover, held that "recharacterization extends beyond insiders and is part of the bankruptcy courts' authority to allow and disallow claims under [Code] § 502." 650 F.3d at 542.

## Facts

A bank and the debtor's sole shareholder in *Fitness* had provided the debtor with "significant funding." *Id.* at \*1. The shareholder's loan to the debtor was unsecured, and the shareholder had also guaranteed the debtor's obligations to the bank. *Id.* The bank later loaned additional sums to the debtor for the purpose of paying off the shareholder's unsecured loan, while also releasing the shareholder from its guaranty to the bank. Within the following year, the debtor filed a Chapter 11 petition. The creditors' committee sought to "recover the payments made to [the shareholder] as a result of the refinancing transaction with" the bank, asking the court to "characterize the financing [the shareholder] provided to [the debtor] ... as equity investments, ... rather than extensions of credit." *Id.* Thus, reasoned the committee, the cash payment to the shareholder was a "constructively fraudulent" transfer. *Id.*

## Analysis

The district court affirmed the bankruptcy court's dismissal of the claims against the shareholder prior to conversion of the case to a Chapter 7 liquidation. *Id.* at \*2. In affirming the bankruptcy court, the district court held that the shareholder's "advances to [the debtor] were loans and, as a matter of law, it was barred from recharacterizing such loans as equity investments." *Id.*, relying on *In re Pacific Express*, 69 B.R. 112, 115 (B.A.P. 9<sup>th</sup> Cir. 1986). *Id.* According to the court of appeals, the "district court erred in holding it was bound by a decision of the Bankruptcy Appellate Panel," citing *Bank of Maui v. Estate Analysis, Inc.*, 904 F.2d 470, 472 (9<sup>th</sup> Cir. 1990) ("As Article III courts, the district courts must always be free to decline to follow BAP decisions and to formulate their own rules within their jurisdiction."). *Id.*, n.3.

Whether the sole shareholder had a “right to payment constituting a ‘claim’” under the Code, explained the Ninth Circuit, turns on “state law.” *Id.* at \*3. “. . . [T]he basic federal rule in bankruptcy is that state law governs the substance of claims, Congress having generally left the determination of property rights and the assets of a bankrupt estate to state law.” *Id.*, quoting *Travelers Cas. & Sur. Co. of Am. v. Pacific Gas & Elec. Co.*, 549 U.S. 443, 450 (2007). Thus, “when the Bankruptcy Code uses the word ‘claim’ — which the Code itself defines as a ‘right to payment’ — it is usually referring to a right to payment recognized under state law.” *Id.* at \*3, quoting *Travelers*, 549 U.S. at 451.

The Code defines debt as “liability on the claim,” § 101(12), and defines “value” as including “satisfaction or securing of a . . . debt.” Code § 548(d)(2)(A). Thus, reasoned the court, in the fraudulent transfer context, “a transfer is for ‘reasonably equivalent value’ for purposes of § 548(a)(1)(B)(1) (i) if it is made in repayment of a claim, i.e., a ‘right to payment’ under state law.” *Id.* at \*4.

The Ninth Circuit in *Fitness* dealt with the trustee’s request for recharacterization of the purported debt to the sole shareholder as follows: “[I]f any party claims that the transfer constituted the repayment of debt (and thus was a transfer for ‘reasonably equivalent value’), the court must determine whether the purported ‘debt’ constituted a right to payment under state law.” *Id.* “If it [was not a right to payment as a debt], the court may recharacterize the debtor’s obligation to the transferee under state law principles.” *Id.* In reaching this conclusion, the court explicitly rejected the BAP’s holding in *Pacific Express* that the Code “did not authorize courts to characterize claims as equity or debt.” *Id.* Finding that the Code gives a bankruptcy court “the authority to recharacterize claims in bankruptcy [cases],” the Ninth Circuit joined other circuits reaching the same conclusion. *Id.* at \*5. It agreed “with the approach adopted by the Fifth Circuit in *In re Lothian Oil, Inc.*, 650 F.3d 539, 543 (5<sup>th</sup> Cir. 2011), which is consistent with the [Supreme Court’s] *Butner* principle.” *Id.* at \*5. *Butner v. United States*, 440 U.S. 48, 54 (1979) (“Congress has generally left the determination of property rights in the assets of a bankrupt’s estate to state law.”). Thus, “in order to determine whether a particular obligation owed by the debtor is a ‘claim’ for purposes of bankruptcy law, it is first necessary to determine whether that obligation gives the holder of the obligation a ‘right to payment’ under state law.” *Id.* If there is no debt under state law, the bankruptcy court has the power to recharacterize the purported loan as equity.

## Remand

For the trustee in *Fitness* to state a claim, he “was required to plausibly allege that the interest created by [the sole shareholder’s] agreements with the [the debtor] constituted equity investments (rather than debt) under applicable state law, and that therefore [the sole shareholder] had no ‘right to payment’ . . . from [the debtor].” *Id.* at \*6. The trustee could therefore “claim that [the debtor’s] transfer was not for reasonably equivalent value,” an essential material allegation of a constructively fraudulent claim under Code § 548(a)(1)(B). *Id.* The district court, therefore, had mistakenly held that it was “barred from considering whether the complaint plausibly alleged that the [sole shareholder’s] promissory notes could be recharacterized as creating equity interests rather than debt . . . .” *Id.* Instead of ruling on the merits, the Ninth Circuit vacated the lower courts’ dismissal of the trustee’s fraudulent transfer claim, and remanded the matter to them for further disposition. *Id.*

## Limited Consensus Among Appellate Courts

At least five other circuits had agreed that bankruptcy courts could recharacterize claims. *Lothian, supra*, 650 F.3d at 544 (5<sup>th</sup> 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); *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 (4<sup>th</sup> Cir. 2006); *In re Hedged-Investments Associates, Inc.*, 380 F.3d 1292, 1298 (10<sup>th</sup> Cir. 2004); *In re Autostyle Plastics, Inc.*, 269 F.3d 726, 748 (6<sup>th</sup> Cir. 2001) (court had power to recharacterize claim under 11-factor test derived from federal tax law). Nevertheless, despite different methodologies among the circuits, the Ninth Circuit found the approach taken by the Fifth Circuit in *Lothian* to be “more consistent with Supreme Court precedent [i.e., *Butner*].” *Id.* at \*5.

## Delaware and New York Case Law On Recharacterization

Under Delaware state law, for example, the “question of whether or not the holder of a particular instrument is a stockholder or a creditor depends

upon the terms of his contract.” *Wolfensohn v. Madison Fund, Inc.*, 253 A.2d 72, 75 (Del. 1969) (when preferred stock holders received debentures and certificates to eliminate arrearage in corporate debt, issuance of debentures and certificates created a debtor-creditor relationship). Delaware courts have considered numerous facts to determine whether a debtor-creditor relationship was created, including: (1) the name given to the instrument; (2) the right to enforce payment of principal and interest; (3) presence or absence of a fixed maturity date; and (4) presence or absence of right to share in profits or participate in management. *Moore v. American Fin. & Secs. Co.*, 73 A.2d 47, 47-48 (Del. Ch. 1950) (*held*, holders of certificates should be treated as stockholders and not creditors because of lack of definite maturity date).

Bankruptcy courts in New York follow the Sixth Circuit test when doing a recharacterization analysis: “Courts analyzing recharacterization claims balance the factors laid out by the Sixth Circuit in [*Bayer Corp. v. MascoTech, Inc. (In re Autostyle Plastics, Inc.)*, 269 F.3d, 726, 749-50 (6th Cir. 2001)]: (1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a fixed maturity date and schedule of payments; (3) the presence or absence of a fixed rate of interest and interest payments; (4) the source of repayments; (5) the adequacy or inadequacy of capitalization; (6) identity of interest between creditor and stockholder; (7) the security, if any, for the advances; (8) the corporation’s ability to obtain financing from outside lending institutions; (9) the extent to which the advances were subordinated to the claims of outside creditors; (10) the extent to which the advance was used to acquire capital assets; and (11) the presence or absence of a sinking fund to provide repayments.” *In re BH&S Holdings LLC*, 420 B.R. 112, 157 (Bankr. S.D.N.Y. 2009) (dismissing recharacterization claim for failure to plead facts supporting the *AutoStyle* factors). See also *In re Adelphia Communications Corp.*, 365 B.R. 24, 73-74 (Bankr. S.D.N.Y. 2007) (same); *In re General Motors Corp.*, 407 B.R. 463, 498-99 (Bankr. S.D.N.Y. 2009) (prepetition debt was, in fact, debt and should not be recharacterized as equity).

## Recharacterization Different From Equitable Subordination

Code § 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. See, e.g., *Wooley v. Faulkner (In re SI Restructuring, Inc.)*, 532 F.3d 355 (5<sup>th</sup> Cir. 2008) (subordination “inappropriate” when trustee failed to prove harm from insider loans).

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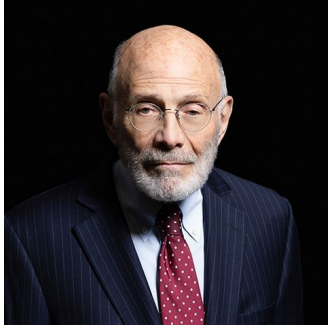
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