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## Codification and Clarity: Debt Recharacterization

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# CODIFICATION AND CLARITY: DEBT RECHARACTERIZATION

## ABSTRACT

*Judicial recharacterization is a judge-made doctrine that allows a court to recharacterize a creditor's claim as an equity investment. Courts use judicial recharacterization as a mechanism to reorder the priority of payments if the judge believes that the true nature of the transaction has the characteristics of an equity relationship from the outset, despite being classified as a loan.*

*When a corporate entity files for bankruptcy, the court will follow a statutorily prescribed order by which creditors are entitled to receive payments. Only after all the creditors have been paid back will any remaining funds be distributed among the equity holders. By recharacterizing a debt transaction under the doctrine, a creditor's purported loan will be transformed into an equity investment. The judge's decision to recharacterize will push that creditor to the back of the line, making it unlikely that the party will receive any payout.*

*Recent debate has centered around the unwieldy and unpredictable nature of these recharacterizations. Creditors often face dramatic differences in the outcome of litigation depending on the jurisdiction in which their claim arises.*

*While analyzing a question of judicial recharacterization, jurisdictions that recognize the doctrine will confront three major considerations: (1) whether the Bankruptcy Code gives judges the authority to recharacterize debt as equity, absent an express provision; (2) what factors a judge with proper authority may utilize when recharacterizing a purported loan as equity; and (3) what standard of review a judge's recharacterization decision should be given.*

*Courts facing questions of judicial recharacterization have analyzed these aspects in dramatically different ways creating a split among the circuit courts on all three aspects. Without a Code provision directly addressing recharacterization, such splits among the circuits will only deepen and cause more confusion. Since recharacterization in a bankruptcy proceeding is the difference between receiving payment or receiving nothing at all, policy and equity considerations mandate a more uniform approach. This Comment argues for the codification of the doctrine of judicial recharacterization.*

## INTRODUCTION

A bankruptcy court has the ability to reorder the priority of claims by imposing the doctrine of equitable subordination<sup>1</sup> or judicially recharacterizing a debt as equity.<sup>2</sup> These doctrines are used under different circumstances to recharacterize investors' loans as equity, pushing them to the bottom of the payout.<sup>3</sup> The effect of a bankruptcy court's recharacterization is similar to equitable subordination because in both cases the claim is subordinated below that of other creditors.<sup>4</sup> However, these two doctrines arise under different scenarios. Section 510(c) of the Bankruptcy Code (the Code) codifies the doctrine of equitable subordination allowing courts to push a bad acting investor's loan to the bottom of the payout scheme.<sup>5</sup> At the other end, judicial recharacterization of debt as equity is another mechanism courts often use to achieve the same end, absent misconduct.<sup>6</sup> Although this doctrine is not codified, when recharacterized, the loan is transformed into equity which has the effect of being subordinated below the other creditors of the corporation. Such recharacterization adversely changes the creditor's payout point in the priority scheme in bankruptcy.

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<sup>1</sup> 11 U.S.C. § 510 (2012)

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

- (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or
- (2) order that any lien securing such a subordinated claim be transferred to the estate.

<sup>2</sup> The Third, Fourth, Fifth, Sixth, Seventh, Ninth, Tenth and Eleventh Circuit's have faced the question of recharacterization. *See* Cohen v. KB Mezzanine Fund II, LP (*In re* SubMicron Sys. Corp.), 432 F.3d 448, 453–54 (3d Cir. 2006); Fairchild Dornier GMBH v. Off. Comm. of Unsecured Creditors (*In re* Dornier Aviation (N. Am.), Inc.), 453 F.3d 225, 234 (4th Cir. 2006); Grossman v. Lothian Oil Inc. (*In re* Lothian Oil Inc.), 650 F.3d 539, 542 (5th Cir. 2011); Bayer Corp. v. MasoTech, Inc. (*In re* Autostyle Plastics, Inc.), 269 F.3d 726 (6th Cir. 2001); Nelson v. Welch (*In re* Repository Techs., Inc.), 601 F.3d 710, 716 (7th Cir. 2010) (addressing an appeal of a bankruptcy court's refusal to recharacterize a loan, although not discussing the source of authority or ability of the court to hear a recharacterization claim); *In re* Pacific Express, Inc., 69 B.R. 112, 113 (B.A.P. 9th Cir. Cal. 1986); *In re* Fitness Holdings Int'l, Inc., 714 F.3d 1141, 1148 (9th Cir. 2013); Sender v. Bronze Grp., Ltd. (*In re* Hedged-Investments Assocs.), 380 F.3d 1292, 1297 (10th Cir. 2004); Stinnett's Pontiac Serv., Inc. v. Comm'r, 730 F.2d 634, 638 (11th Cir. 1984). The First, Second, and Eighth Circuits have not faced the question of debt-to-equity recharacterization yet.

<sup>3</sup> *See In re* SubMicron Sys. Corp., 432 F.3d at 454.

<sup>4</sup> *See In re* Autostyle Plastics, Inc., 269 F.3d at 748.

<sup>5</sup> *See* 11 U.S.C. § 510 (2012).

<sup>6</sup> *See In re* SubMicron Sys. Corp., 432 F.3d at 454–55.

For the purposes of comparison between equitable subordination and recharacterization, it is important to note that courts can “subordinate a claim only to another claim, or an equity interest to another equity interest. If a court equitably subordinates a claim as deeply as possible, that is, beneath all other claims, the subordinated claim must be satisfied in full before any distribution can be made to equity holders.”<sup>7</sup>

As currently practiced, judicial recharacterization can be unpredictable and its application varies greatly across circuits that recognize it. Hence, there needs to be a more uniform standard for judicial recharacterizations. Such uniformity will result in more predictability for potential investors and may dissuade the upward trend in bad-acting institutions issuing those loans. While recognizing recharacterization may allow courts to subordinate an otherwise improper claim, absent misconduct, courts have construed their equitable powers too broadly due to the lack of statutory authority to recharacterize debt as equity under their general powers of equity.

Consider the following two scenarios when determining the relationship between judicial recharacterization, equitable subordination, and their respective impacts on the priority scheme mandated by the Code.

Scenario One, a vendor makes a “loan” to a troubled borrower and agrees to accept repayment *only* when the borrower begins making money again. Here, the entire amount of the “loan” would be ripe for recharacterization (from an unsecured debt claim to an equity interest) because the parties in fact treated the transfer as an equity investment (recovery dependent on company’s performance) rather than a loan (payment due at stated maturity).

In Scenario Two, a major equity holder sitting on a debtor’s board of directors obtained confidential information that claims will be paid at a higher rate under the debtor’s plan of reorganization than the market generally perceives. He then surreptitiously purchases claims against the debtor in order to enhance his or her own recovery. His claims will remain what they were—claims—but they may be equitably subordinated to other claims if his acts are found to have been both inequitable and harmful to debtor or creditors.<sup>8</sup>

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<sup>7</sup> Lawrence V. Gelber & James T. Bentley, *How Unsecured Creditors Push Ahead of Lenders Who in Fact Invested, Part III – Equitable Subordination v. Recharacterization*, COMMERCIAL BANKRUPTCY INVESTOR (January 2014), [www.dailydac.com/commercialbankruptcy/investors/articles/how-unsecured-creditors-push-ahead-of-lenders-who-in-fact-invested-part-iii-equitable-subordination-vs-recharacterization](http://www.dailydac.com/commercialbankruptcy/investors/articles/how-unsecured-creditors-push-ahead-of-lenders-who-in-fact-invested-part-iii-equitable-subordination-vs-recharacterization).

<sup>8</sup> *Id.*

These scenarios highlight the differences between the two doctrines that will be explained below and raise questions under what circumstances may each doctrine apply and how to apply them.

This Comment argues Congress should codify the concept of judicial recharacterization to promote more uniformity across courts by determining the most common circumstances for recharacterizing a loan. This Comment will also propose a proper federal recharacterization test and standard of review in the event of an appeal. Additionally, this Comment proposes a five-factor approach to federal recharacterization based on the most substantive factors the circuit courts have considered in their analyses. Finally, this Comment provides reasons for rejecting the remaining elements the circuits have considered.

Proponents of judicial recharacterization attempt to tie its power to the Code by either § 105(a), the general equitable provision, or § 502(b), the claim allowance provision.<sup>9</sup> However, no circuit considers recharacterization under § 510(c). Section 510(c), the provision of the Code that permits equitable subordination, is an independent claim from recharacterization. Although often invoked in the same proceeding, courts do as they should; separate the claims and analyze them independently.

The most recognized mechanism to move a claim lower on the priority ladder is equitable subordination. However, equitable subordination is only triggered by “misconduct that causes injury to creditors (or shareholders) or confers an unfair advantage on a single creditor at the expense of others.”<sup>10</sup> In many instances, there is insufficient misconduct to trigger § 510(c), as the scenarios above highlight. In that event, the door is left open for those in a debtor-creditor relationship to manipulate the terms of the loan such that the true nature of the loan should have been classified as an equity transaction.

The first cases regarding recharacterization emerged in the late 1980’s, meaning this not a novel issue. However, the lack of a specific Code provision surrounding the nearly thirty years of diverging case law has made this an unavoidable problem with a clear solution: codification.

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<sup>9</sup> See *In re Lothian Oil Inc.*, 650 F.3d 539 (authorizing judicial recharacterization under § 502(b)); *In re Dornier Aviation (N. Am.), Inc.*, 453 F.3d at 231 (authorizing judicial recharacterization under § 105(a)).

<sup>10</sup> Mark G. Douglas, *Creditors’ Committee Lacks Standing to Seek Equitable Subordination*, JONES DAY (December 2007) <http://www.jonesday.com/creditors-committee-lacks-standing-to-seek-equitable-subordination>.

## I. BACKGROUND

### A. *The Bankruptcy Code's Priority Scheme Affected by Judicial Recharacterization and Equitable Subordination*

First, to understand the necessity for clarity of the law regarding recharacterization, it is essential to understand how the priority scheme in bankruptcy works. Where a creditor's transaction falls within the priority scheme will often dictate if and how much they will be paid back.<sup>11</sup> In a bankruptcy proceeding, a priority scheme exists for the distribution of the debtor's assets.<sup>12</sup> For this reason, creditors prefer their claims to be higher on the payout ladder.<sup>13</sup>

Congress included § 726 of the Code to determine the priority scheme, which requires all debt creditors to be paid before equity holders.<sup>14</sup> However, with the codified authority from § 510(c), a bankruptcy court may alter the priority of an allowed claim via equitable subordination; that is, the court may reduce the priority of all or part of an allowed claim if it finds that the creditor engaged in inequitable conduct.<sup>15</sup>

Judicial recharacterization affects the statutorily prescribed priority scheme in the same way by moving a creditor's claim to the bottom of the payout, where it is likely they will receive no payments from the now-bankrupt corporation.

### B. *Equitable Subordination*

Courts use the doctrine of equitable subordination to “remedy misconduct that causes injury to creditors (or shareholders) or confers an unfair advantage on a single creditor at the expense of others.”<sup>16</sup> Section 510(c) of the Code states, “the court may . . . under principles of equitable subordination, subordinate for purposes of distribution . . . an allowed claim to . . . another allowed claim or . . . an allowed interest to all or part of another allowed interest.”<sup>17</sup> In order for

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<sup>11</sup> See 11 U.S.C. § 726 (2012).

<sup>12</sup> See *In re Dornier Aviation (N. Am.), Inc.*, 453 F.3d at 230.

<sup>13</sup> See John D. Ayer, Michael Bernstein & Jonathan Friedland, *Priorities*, KIRKLAND & ELLIS, [https://www.kirkland.com/siteFiles/kirkexp/publications/2392/Document1/Friedland\\_Priorities.pdf](https://www.kirkland.com/siteFiles/kirkexp/publications/2392/Document1/Friedland_Priorities.pdf) (analogizing the payout scheme to a ladder, where “the claims standing on the highest rung must be paid in full before any claims on the next rung can be paid anything.”).

<sup>14</sup> See 11 U.S.C. § 726 (2012).

<sup>15</sup> See *Id.* § 510 (2012).

<sup>16</sup> Douglas, *supra* note 10.

<sup>17</sup> 11 U.S.C. § 510 (2012).

a claim to be equitably subordinated, most courts follow the analysis set forth in *Benjamin v. Diamond* (*In re Mobile Steel Corp.*):<sup>18</sup> (1) “the claimant must have engaged in some type of inequitable conduct;”<sup>19</sup> (2) “the misconduct must have resulted in injury to the creditors or conferred an unfair advantage on the claimant;”<sup>20</sup> and (3) “equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Code.”<sup>21</sup>

Although *In re Mobile Steel* was decided before Congress’ 1978 codification of equitable subordination found at § 510(c), the Supreme Court still uses the *Mobile Steel* analysis to determine whether a claim should be equitably subordinated pursuant to the Code.

Courts will consider the inequitable conduct element as a primary indicator of the need to subordinate a claim. It is possible for the inequitable conduct “to warrant subordination of a claim irrespective of whether it was related to the acquisition or assertion of that claim.”<sup>22</sup> When determining whether inequitable conduct has occurred sufficient to satisfy the first element, courts will consider three categories of inequitable conduct.<sup>23</sup> The categories, which are independently sufficient to satisfy the first element are: “(1) fraud, illegality, and breach of fiduciary duties; (2) undercapitalization; or (3) claimant’s use of the debtor as a mere instrumentality or alter ego.”<sup>24</sup>

If a transaction satisfies this test, it “does not mean that a court is required to equitably subordinate a claim, but rather that the court is permitted to take such action.”<sup>25</sup> Thus, a court may determine when such subordination is appropriate.

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<sup>18</sup> See *Benjamin v. Diamond* (*In re Mobile Steel Corp.*), 563 F.2d 692, 699 (5th Cir. 1977); *In re SubMicron Sys. Corp.*, 432 F.3d at 460 (3d Cir. 2006); 11 U.S.C. § 510.

<sup>19</sup> *In re Mobile Steel Co.*, 563 F.2d at 700 (citing *Comstock v. Group of Institutional Investors*, 335 U.S. 211, 229, (1948); *Spach v. Bryant*, 309 F.2d 886, 889 (5th Cir. 1962); *Frasher v. Robinson*, 458 F.2d 492, 493 (9th Cir. 1972), *cert. denied*, 409 U.S. 1009, (1972)).

<sup>20</sup> *In re Mobile Steel Co.*, 563 F.2d at 700 (citing *Comstock*, 335 U.S. at 229; *In re Branding Iron Steak House*, 536 F.2d 299, 302 (9th Cir. 1976); *In re Brunner Air Compressor Corp.*, 287 F. Supp. 256, 265 (N.D.N.Y.1968); see *Wages v. Weiner*, 381 F.2d 667, 670 (5th Cir. 1967)).

<sup>21</sup> *In re Mobile Steel Co.*, 563 F.2d at 700 (citing *Luther v. United States*, 225 F.2d 495, 499 (10th Cir. 1955), *cert. denied*, 350 U.S. 947 (1956); *In re Columbia Ribbon Co.*, 117 F.2d 999, 1002 (3d Cir. 1941); see *American Mutual Life Ins. Co. v. City of Avon Park, Florida*, 311 U.S. 138, 145 (1940), (quoting *SEC v. United States Realty & Improvement Co.*, 310 U.S. 434, 455 (1940)); *In re Texas Consumer Fin. Corp.*, 480 F.2d 1261, 1265 (5th Cir. 1973)).

<sup>22</sup> *In re Mobile Steel Co.*, 563 F.2d at 699 (5th Cir. 1977).

<sup>23</sup> See *Redmond v. Jenkins* (*In re Alternate Fuels, Inc.*), 789 F.3d 1139, 1154–55 (10th Cir. 2015).

<sup>24</sup> *Id.*

<sup>25</sup> *In re Autostyle Plastics, Inc.*, 269 F.3d at 744 (quoting *In re Octagon Roofing*, 157 B.R. 852, 857 (N.D. Ill. 1993)).

Additionally, the first element of inequitable conduct requires several other considerations; including a requirement that a court must establish whether the lender is an inside lender or an outside lender, in order to determine the level of review given to the transaction.<sup>26</sup> Section 101(31)(B) of the Code states that “an insider of a debtor corporation may be either a director, an officer or another person in control of the debtor.”<sup>27</sup>

Transactions involving insider claimants must withstand higher standards than those involving outside creditors.<sup>28</sup> These transactions are analyzed under a higher standard because “insiders ‘usually have greater opportunities for . . . inequitable conduct’” due to their proximity to the corporation and inside information.<sup>29</sup> While an outsider claimant will require a showing of “egregious conduct such as fraud, spoliation, or overreaching,” an insider claimant requires “evidence of less egregious conduct” to support an equitable subordination claim.<sup>30</sup>

The party “seeking to equitably subordinate the claims of an insider must demonstrate ‘unfair dealing.’”<sup>31</sup> Evidence of an unfair dealing causes the burden to shift to the insider to prove that it upholds the requisite “good faith and fairness”<sup>32</sup> in the transaction. The court will assess, “whether a plaintiff

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<sup>26</sup> See *In re Alternate Fuels, Inc.*, 2015 WL 3635366 at \*34.

<sup>27</sup> 11 U.S.C. § 101(31)(B) (2012).

While a structural analysis of the debtor may reveal whether a lender has de jure control, a court considers the extent of the lender’s actual, managerial control when assessing allegations of de facto control. Nonetheless, control does not exist simply because bargaining power was greatly skewed in favor of the lender or because the lender and debtor share a close relationship. Rather, the lender’s control must be so overwhelming that there must be, to some extent, a merger of identity or a domination of the debtor’s will. For example, the lender must exercise sufficient authority so as to dictate corporate policy and the disposition of assets.

See *Matrix IV, Inc. v. Am. Nat’l Bank & Tr. Co. (In re S.M. Acquisition Co.)*, No. 05 C 7076, 2006 U.S. Dist. LEXIS 58960, at \*17 (N.D. Ill. Aug. 7, 2006) (stating courts will also consider de jure and de facto control to determine whether a lender is an insider of a bankruptcy court debtor).

<sup>28</sup> See *Bayer Corp. v. MasoTech, Inc. (In re Autostyle Plastics, Inc.)*, 269 F.3d 726 (6th Cir. 2001).

<sup>29</sup> *Id.* (quoting *In re Fabricators*, 926 F.2d 1458, 1465).

<sup>30</sup> See *In re Alternate Fuels, Inc.*, 789 F.3d at 1158; *Waslow v. MNC Commercial Corp. (In re Paoella)*, 161 B.R. 107, 118 (E.D. Pa. 1993) (finding that debtor’s misrepresentations of reasons for nonrenewal to creditors did not rise to the level of gross or egregious misconduct); *Grede v. Bank of N.Y. Mellon*, 441 B.R. 864, 885 (N.D. Ill. 2010) (finding that defendants’ lien on the debtor’s estate issue was valid and not subject to equitable subordination because their lack of care in verifying the source of collateral does not rise to the level of egregious misconduct necessary for equitable subordination).

<sup>31</sup> *In re S.M. Acquisition Co.*, 2006 U.S. Dist. LEXIS 58960, at \*22 (quoting *In re Kreisler*, 331 B.R. 364, 381 (Bankr. N.D. Ill. 2005)).

<sup>32</sup> *In re S.M. Acquisition Co.*, 2006 U.S. Dist. LEXIS 58960, at \*22.

adequately pled unfair dealing by an insider that, if proven and not dispelled by the insider, could potentially warrant equitable subordination.”<sup>33</sup>

Previously, lower courts have tried to impose an automatic subordination of insider loans merely because the creditor was an insider.<sup>34</sup> However, appellate courts have frequently reversed this trend.<sup>35</sup> In such a case, the Tenth Circuit reversed a district court’s decision to equitably subordinate a loan “on the grounds that the loan was made by an ‘insider’ at a time when the borrower corporation was badly undercapitalized.” The Tenth circuit reasoned that an automatic subordination of insiders’ loans would “discourage owners’ efforts to salvage a troubled business.”<sup>36</sup> Thus, the existence of an insider relationship alone is insufficient to permit subordination.<sup>37</sup> If sufficient allegations of misconduct are shown, the insider claimant must establish that “each . . . challenged transaction with the debtor had all the earmarks of an arm’s length bargain.”<sup>38</sup>

Historically, courts primarily considered the claimant’s insider status and the undercapitalization of the now-bankrupt corporation to determine if the doctrine of equitable subordination should be applied.<sup>39</sup> An analysis of undercapitalization considers whether there were insufficient capital contributions made to a corporation. If a corporation was undercapitalized at the time of a purported loan, courts are increasingly skeptical of the loan because “they may, in reality, be infusions of capital.”<sup>40</sup>

However, today a more comprehensive analysis exists where undercapitalization alone is insufficient to justify the subordination of an insider claim.<sup>41</sup> Just as courts moved away from using the insider status as a primary factor, courts have moved away from using undercapitalization as a dispositive factor because it discourages “loans from insiders to companies facing financial

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<sup>33</sup> *Id.*

<sup>34</sup> *See Sender v. Bronze Grp., Ltd. (In re Hedged-Investments Assocs.)*, 380 F.3d 1292, 1297 (10th Cir. 2004).

<sup>35</sup> *Id.*

<sup>36</sup> *Id.* (citing *In re Mid-Town Procedure Terminal, Inc.*, 599 F. 2d 389, 393–94 (10th Cir. 1979)).

<sup>37</sup> *See In re Alternate Fuels, Inc.*, 789 F.3d at 1158.

<sup>38</sup> *In re Pacific Express, Inc.*, 69 B.R. at 115.

<sup>39</sup> *See In re Autostyle Plastics, Inc.*, 269 F.3d at 746.

<sup>40</sup> *Id.*

<sup>41</sup> *See id.*

difficulty and that would be unfortunate because it is the shareholders who are most likely to have the motivation to salvage a floundering company.”<sup>42</sup>

Undercapitalization is also a factor in the recharacterization analysis, creating confusion between the two doctrines and even causing “some courts to equitably subordinate claims that other courts would recharacterize as equity contributions.”<sup>43</sup> This blurred line between the doctrines and unpredictable outcomes highlights the need for clarity and codification in this area of law.

Courts “use great caution in applying this remedy”<sup>44</sup> to subordinate claims under their equitable powers;<sup>45</sup> recognizing that “equitable subordination is an unusual remedy which should be applied in limited circumstances.”<sup>46</sup> The Tenth Circuit has been intentionally careful to ensure that owners may finance their struggling business in the way they see fit, since they may be the only party willing to make a loan to a corporation on the verge of bankruptcy.<sup>47</sup> Since the effects of equitable subordination are to reorder the priority of an otherwise valid transaction, courts should use it sparingly.<sup>48</sup> Interestingly, while most courts recognize the implications of equitable subordination and the legitimate reasons for limiting the doctrine, they nonetheless give themselves the broad and expansive authority to subordinate claims using recharacterization.

For the purposes of comparison between equitable subordination and recharacterization, it is important to note that courts may subordinate “a claim only to another claim, or an equity interest to another equity interest. If a court equitably subordinates a claim as deeply as possible, that is, beneath all other claims, the subordinated claim must be satisfied in full before any distribution can be made to equity holders.”<sup>49</sup> Congress expressly codified a bankruptcy court’s authority to subordinate a claim when equity “demands that the payment

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<sup>42</sup> *Id.* at 726 (quoting *In re Octagon*, 157 B.R. at 858)).

<sup>43</sup> *Id.* (quoting Matthew Nozemack, *Making Sense out of a Bankruptcy Courts’ Recharacterization of Claims: Why Not Use § 510(c) Equitable Subordination?* 56 WASH. & LEE L. REV. 689 (1999)).

<sup>44</sup> *Id.* at 744.

<sup>45</sup> See *In re Alternate Fuels, Inc.*, 789 F.3d at 1152.

<sup>46</sup> *In re Autostyle Plastics, Inc.*, 269 F.3d at 726.

<sup>47</sup> See *In re Alternate Fuels, Inc.*, 789 F.3d at 1158 (“We have been careful not to ‘discourage owners from trying to salvage a business’ by requiring ‘all contributions to be made in the form of equity capital.’ Indeed, 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.”) (internal citations omitted).

<sup>48</sup> See *id.* at 1154.

<sup>49</sup> Gelber & Bentley, *supra* note 7.

priority of claims of an otherwise legitimate creditor be changed to fall behind those of other claimants” at § 510(c) of the Code.<sup>50</sup>

### C. Judicial Recharacterization

Although recharacterization has not been codified, most circuit courts that addressed this issue have held a judge may order the recharacterization of debt as equity pursuant to either § 105(a) or § 502(b).<sup>51</sup> When a loan is recharacterized as equity, courts “effectively ignore the label attached to the transaction at issue and instead recognize its true substance.”<sup>52</sup> The funds in question are no longer considered a loan, but rather are treated as equity. However, some find use of the term “recharacterization” to be misleading. Conversely, they prefer to think of recharacterization in terms of whether, at the onset of the transaction, a debt or equity relationship was created; instead of changing the transaction from debt to equity.<sup>53</sup>

Presently, the logistics of recharacterization are unpredictable, but judicial recharacterization plays an important role in our bankruptcy courts. Specifically, courts note important policy considerations for permitting judicial recharacterization, “if the court were required to accept the representations of the claimant, then an equity investor could label its contribution a loan and guarantee itself higher priority—and a larger recovery—should the debtor file for bankruptcy.”<sup>54</sup>

Although historically considered a single claim,<sup>55</sup> courts now hold that recharacterization and equitable subordination are separate doctrines, serving different functions, and contain different subordination processes.<sup>56</sup> The court in *Sender v. Bronze Grp., Ltd* articulated this distinction in stating:

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

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<sup>50</sup> Cohen v. KB Mezzanine Fund II, LP (*In re SubMicron Sys. Corp.*), 432 F.3d 448, 454 (3d Cir. 2006).

<sup>51</sup> See *Daewoo Motor Am., Inc. v. Daewoo Motor Co.* (*In re Daewoo Motor Am., Inc.*), 471 B.R. 721 (C.D. Cal. 2012).

<sup>52</sup> *Sender v. Bronze Grp., Ltd.* (*In re Hedged-Investments Assocs.*), 380 F.3d 1292 (10th Cir. 2004).

<sup>53</sup> See *In re Cold Harbor Assocs. L.P.* 204 B.R. 904, 915 (Bankr. E.D. Va. 1997).

<sup>54</sup> *In re Dornier Aviation (N. Am.), Inc.*, 453 F.3d at 231.

<sup>55</sup> *In re SubMicron Sys. Corp.*, 432 F.3d at 455 (citing *Aquino v. Black* (*In re AtlanticRancher, Inc.*), 279 B.R. 411, 433 (Bankr. D.Mass. 2002) (stating that “while once considered solely in conjunction with the doctrine of equitable subordination, bankruptcy courts now consider recharacterization a separate cause of action”).

<sup>56</sup> See *In re Hedged-Investments Assocs.*, 380 F.3d at 1296.

money is equity and not debt, the claim is recharacterized and the effect is subordination of the claim as a proprietary interest because the corporation repays capital contributions only after satisfying all other obligations of the corporation. In an equitable subordination analysis, the court is reviewing whether a legitimate creditor engaged in inequitable conduct, in which case the remedy is subordination of the creditor's claim to that of another creditor only to the extent necessary to offset injury or damage suffered by the creditor in whose favor the equitable doctrine may be effective.<sup>57</sup>

As a result, courts now consider equitable subordination and judicial recharacterization as separate causes of action, causing confusion in the bankruptcy courts. This confusion stems from uncertainty over how to impose the doctrine of judicial recharacterization, absent explicit congressional guidance from the Code.<sup>58</sup>

Claims from both insiders and non-insiders are subject to recharacterization in jurisdictions that follow the recharacterization doctrine.<sup>59</sup> In *Grossman v. Lothain Oil Inc.*, the Fifth Circuit reversed the district court's decision, which refused to extend debt recharacterization to a non-insider creditor. In reversing, the Fifth Circuit stated, "because insiders and non-insiders alike could mischaracterize their claims in contravention of state law, the court declined to limit recharacterization to insider claims."<sup>60</sup> Thus, a "per se rule to prohibit bankruptcy courts from recharacterizing contributions from anyone but corporate insiders" is not appropriate.<sup>61</sup>

Finally, there may also be a temporal requirement when asserting a claim of recharacterization.<sup>62</sup> At least in a scenario of reorganization, a creditor runs the risk of losing the ability to assert a recharacterization claim if they file after the claim objections deadline.<sup>63</sup> In a chapter 11 or chapter 13 reorganization case, a bankruptcy court must approve a debtor's proposed reorganization plan.<sup>64</sup> The confirmed plan will set the terms and limitations of reorganization and repayment to the creditors.<sup>65</sup>

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<sup>57</sup> *In re Hedged-Investments Assocs.*, 380 F.3d at 1297.

<sup>58</sup> *See id.*

<sup>59</sup> *See id.* at 1301.

<sup>60</sup> *Grossman v. Lothain Oil Inc. (In re Lothain Oil Inc.)*, 650 F.3d 539, 544.

<sup>61</sup> *Id.* at 541–42.

<sup>62</sup> 11 U.S.C. § 502 (2012).

<sup>63</sup> *Id.*

<sup>64</sup> 11 U.S.C. § 1129 (2012); 11 U.S.C. § 1325 (2012).

<sup>65</sup> *Id.*

The Sixth Circuit, in *Official Comm. of Unsecured Creditors of Russell Cave Co. v. Gen. Elec. Capital Corp.*, affirmed the bankruptcy and district court's holding that the joint liquidation plan of reorganization's definition of "claim objections" was inclusive of recharacterization.<sup>66</sup> According to the confirmed plan that was binding on all the parties, creditors were given a specific date (120 days after the plan confirmation) to file all claim objections.<sup>67</sup> Because the creditor filed its recharacterization claims nine months after the deadline for claim objections, the objections were clearly time-barred under the plan.<sup>68</sup> Therefore, if a committee files a recharacterization claim after the deadline for claim objections, the objection may be time-barred under the plan.<sup>69</sup>

Recharacterization is most typically used as "a cause of action against corporate insiders and fiduciaries . . . who advance funds to a financially struggling corporation."<sup>70</sup> Critics of the doctrine argue that despite being labeled an "equitable remedy . . . recharacterization fails to produce an outcome in accordance with the broad equitable mandate of" the Code.<sup>71</sup> However, since this power is not expressly given to bankruptcy courts, the question arises: If it exists at all, where does a judge get authority to recharacterize debt into equity? The answer to this question varies greatly by jurisdiction.

## II. ANALYSIS

Congress should codify the concept of judicial recharacterization to promote more uniform standards across courts to determine the most common circumstances for recharacterizing a loan. Currently, there are three major splits among circuit courts regarding the narrow topic of judicial recharacterization of debt to equity. First, courts disagree on which provision of the Code, if any, authorizes a court to recharacterize a loan into equity. This split is significant because without a proper source of authority, courts lack the jurisdiction to make these changes to the creditor's purported loans.

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<sup>66</sup> Official Comm. of Unsecured Creditors of Russell Cave Co. v. Gen. Elec. Capital Corp. (In re Russell Cave. Co.), 107 F. App'x 449, 452 (6th Cir. 2004).

<sup>67</sup> *Id.* at 449–50.

<sup>68</sup> *Id.* at 449–52.

<sup>69</sup> *Id.*

<sup>70</sup> Hilary A. Goehausen, *You Said You Were Going to Do What to My Loan? The Inequitable Doctrine of Recharacterization*, 4 DEPAUL BUS. & COM. L.J. 117, 128 (2005) (citing Matthew Nozemack, *Making Sense Out of Bankruptcy Courts' Recharacterization of Claims: Why Not Use § 510(c) Equitable Subordination?*, 56 WASH. & LEE. REV. 689, 706.

<sup>71</sup> *Id.*

Assuming there is a proper source of authority, courts are split—and use different tests—to determine whether recharacterization is necessary, due to the true nature of the transaction. The use of different tests for federal recharacterization among the circuits creates confusion for creditors. Additionally, it creates open grounds for an appeal based on a “misapplication of the factors” since there is no uniformity or instructions. But when these appeals are filed, courts are split as to which standard of appeal to apply to a lower courts determination that judicial recharacterization was proper.

To resolve some of these conflicts, this Comment proposes a statutory solution. It includes a uniform five-factor approach to federal recharacterization based on the most substantive factors the circuit courts have considered in their analyses. Additionally, my proposed statutory solution provides the standard of review. In this case, the new statute will become the source of authority for the bankruptcy court’s power to recharacterize transactions.

A. *Circuit Splits Over the Source of Authority, Federal Recharacterization Test, and Standard of Review for Judicial Recharacterization*

1. *Source of Authority*

a. *Federal Courts Do Not Have Authority to Recharacterize Debt as Equity*

The concept of judicial recharacterization is generally recognized by courts who have faced the issue, but is not yet universally accepted.<sup>72</sup> Numerous circuits and the Supreme Court have not yet faced this question and Congress

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<sup>72</sup> The Third, Fourth, Fifth, Sixth, Seventh, Ninth, Tenth and Eleventh Circuits have faced the question of recharacterization. See *In re SubMicron Sys. Corp.* 432 F.3d at 454; *In re Dornier Aviation (N. Am.), Inc.*, 453 F.3d at 225; *In re Lothian Oil Inc.*, 650 F.3d at 542–44; *In re Autostyle Plastics, Inc.*, 269 F.3d at 726; *In re Repository Techs., Inc.*, 601 F.3d at 710 (addressing an appeal of a bankruptcy court’s refusal to recharacterize a loan, although not discussing the source of authority or ability of the court to hear a recharacterization claim); *In re Pacific Express, Inc.*, 69 B.R. 112 (B.A.P. 9th Cir. Cal. 1986); *In re Fitness Holdings Int’l, Inc.*, 714 F.3d at 1148–49.; *In re Hedged-Investments Assocs.*, 380 F.3d at 1297 (10th Cir. 2004); *Stinnett’s Pontiac Serv.*, 730 F.2d at 638. The First, Second, and Eighth Circuits have not faced the question of debt-to-equity recharacterization yet.

has not addressed it by statute.<sup>73</sup> Several bankruptcy courts<sup>74</sup> and B.A.P courts<sup>75</sup> have determined there is no basis in bankruptcy law to recharacterize a debt as equity.

The argument, framed around a lack of basis to recharacterize debt as equity, lies rooted in a statutory interpretation of § 510(c), “because a claim can be subordinated to other claims under the doctrine of equitable subordination”<sup>76</sup> is expressly codified, the fact that “recharacterization is not explicitly codified but would produce a similar result” triggers “the principle of *inclusion uno, exclusio alterus*” to suggest “that Congress did not intend bankruptcy courts to have authority to recharacterize a debt.”<sup>77</sup> Stated another way, “where there is a specific provision governing these determinations, it is inconsistent with the Code to allow such determinations to be made under different standards through the use of a court’s equitable powers.”<sup>78</sup>

This argument is particularly compelling when one considers the enormous effect of recharacterization on a lender. To understand the implications of a recharacterization of a lender’s claim, consider the case of *Fairchild Dornier GMBH v. Official Comm. Of Unsecured Creditors*.<sup>79</sup> In this case, creditors alleged they were owed \$146,000,000 from a now bankrupt subsidiary.<sup>80</sup> Considering a list of eleven factors, with no explanation of the weight given to each one, the court determined that \$139,525,000 of that debt should be recharacterized as an equity contribution.<sup>81</sup> This judicial recharacterization left the lender paying a fraction of what the creditor was expecting to be repaid. Recognizing that there may very well be good policy considerations for allowing courts to subordinate claims, absent inequitable conduct, if Congress had

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<sup>73</sup> For compilation of recharacterization cases, see *supra* note 72.

<sup>74</sup> *Moglia v. Quantum Indus. Partners, LDC (In re Outboard Marine Corp.)*, 2003 U.S. Dist. LEXIS 12564 (N.D. Ill. Jul. 21, 2003) (District Court for Northern District of Illinois, reversing the bankruptcy court’s decision to dismiss a recharacterization claim due to lack of authority); *In re Autostyle Plastics, Inc.*, 269 F.3d at 726 (Sixth Circuit affirm district court’s reversal of bankruptcy court’s ruling that it did not have the authority to review Bayer’s recharacterization claim). Note that it is interesting that the bankruptcy courts, tasked specializing in interpretation and explanation of the Code, find they don’t have authority to recharacterize claims, and it is the district courts or circuit courts that reverse and give them this sweeping authority.

<sup>75</sup> *In re Pacific Express, Inc.*, 69 B.R. 112 (B.A.P. 9th Cir. Cal. 1986).

<sup>76</sup> *In re Outboard Marine Corp.*, 2003 U.S. Dist. LEXIS 12564 at \*7.

<sup>77</sup> *Id.* at \*7–8.

<sup>78</sup> *In re Pacific Express, Inc.*, 69 B.R. at 115.

<sup>79</sup> *In re Dornier Aviation (N. Am.), Inc.*, 453 F.3d at 225.

<sup>80</sup> *Id.* at 230.

<sup>81</sup> *Id.* at 225.

intended for courts to have this power to alter payments by hundreds of millions of dollars, it seems that they would have codified it.

While one might argue that Congress simply failed to include recharacterization specifically, it seems clear Congress knows how to codify claim subordination sections, and the fact that recharacterization was not included means Congress did not intend for it to be included. Therefore, since Congress has failed to specifically highlight this incredible power,<sup>82</sup> courts have construed their authority too broadly,<sup>83</sup> and they do not, in fact, have the authority to make these recharacterizations. More specifically, the fact that § 510(c) creates a provision for the subordination of a claim, courts against recharacterization argue judges may not achieve this same end through different means.

There may be an argument for judicial recharacterization based on a competing canon of construction: legislative acquiescence. This canon is based on the relationship between judicial action and legislative inaction. If a court interprets a statute in a certain way over many years, proponents argue that by not changing or codifying the statute in question, the legislature is silently agreeing with the court's interpretation. Essentially, when the legislature has been silent in the face of judicial action a presumption arises that the legislature approves of the judicial action.

However, this canon requires the bold assumption that legislatures are following every court decision. This canon also further assumes that they monitor and know when an interpretation of a statute or code reaches beyond the plain reading. This assumption is especially bold in the context of bankruptcy law as it is such a specific and sometimes complicated code to understand. It seems just as likely that the legislature's silence comes from lack of knowledge, not specific intent to acquiesce the interpretation.

A Minnesota Bankruptcy Court judge faced a recharacterization issue and stated: "the remedy invoked here is extraordinary, judicially created, and potentially sweeping in its application."<sup>84</sup> Additionally, the court addresses the different interpretations on the "statutory authorization to impose the remedy."<sup>85</sup>

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<sup>82</sup> *Id.*

<sup>83</sup> *In re Pacific Express, Inc.*, 69 B.R. at 115.

<sup>84</sup> *Duke & King Mo., LLC v. Nath Cos., (In re Duke & King Acquisition Corp.)*, 508 B.R. 107, 155 (Bankr. D. Minn. 2014).

<sup>85</sup> *Id.* at 157.

Regarding the use of §105(a) for recharacterization the court states, “it is hornbook law that the bankruptcy courts are not to use the vesting of equitable powers under § 105(a) as a warrant to create new remedies that would be at marked odds with other, specific provisions of the Bankruptcy Code.”<sup>86</sup>

*b. The Bankruptcy Code’s General Equitable Provision, § 105(a), As Source of Authority*

The Code gives courts general powers of equity, which are codified at § 105(a).<sup>87</sup> This section states that a “court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Code].”<sup>88</sup>

The Fourth Circuit reasons “recharacterization is well within the broad powers afforded to a bankruptcy court in § 105(a) and facilitates the application of the priority scheme laid out in § 726.”<sup>89</sup> In upholding the district court’s affirmation of the bankruptcy court’s recharacterization, the Court relies on § 105(a) to authorize the bankruptcy court’s actions because they “carry out the provisions of this title.”<sup>90</sup> The Court finds that to ensure the proper priority scheme is met, a court may recharacterize debt as equity.<sup>91</sup> The Court rejects petitioner’s argument that this action “violates the principle that a bankruptcy court may not use its equitable powers ‘to alter the substantive rights of the parties.’”<sup>92</sup>

In addition to the Fourth Circuit, the Third, Sixth, and Tenth Circuits agree that a court’s recharacterization authority is vested within the general provisions of § 105(a).<sup>93</sup> However, not all circuits agree that this is the proper analysis. Some judges argue that bankruptcy courts “are not to use the vesting of equitable powers under § 105(a) as a warrant to create new remedies that would be at

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<sup>86</sup> *Id.*

<sup>87</sup> 11 U.S.C. § 105(a) (2012).

<sup>88</sup> *In re SubMicron Sys. Corp.*, 432 F.3d at 448; 11 U.S.C. § 105(a) (2012).

<sup>89</sup> *In re Dornier Aviation (N. Am.), Inc.*, 453 F.3d at 231.

<sup>90</sup> *Id.*

<sup>91</sup> *Id.*

<sup>92</sup> *Id.*

<sup>93</sup> *In re SubMicron Sys.*, 434 F.3d at 454; *Fairchild Dornier GmbH v. Off. Comm. of Unsecured Creditors (In re Dornier Aviation (N. Am.), Inc.)*, 453 F.3d 225, 231 (4th Cir. 2006); *Bayer Corp. v. MasoTech, Inc. (In re Autostyle Plastics, Inc.)*, 269 F.3d 726, 748 (6th Cir. 2001); *Sender v. Bronze Grp., Ltd. (In re Hedged-Investments Assocs.)*, 380 F.3d 1292, 1298 (10th Cir. 2004).

marked odds with other, specific provisions of the Bankruptcy Code.”<sup>94</sup> Furthermore, § 105(a) does not allow a bankruptcy court to “recognize substantive rights that do not exist under non-bankruptcy law.”<sup>95</sup>

A bankruptcy court in Wisconsin held that “recharacterization under § 105(a) is never appropriate because the Code and Rules have established a framework for subordinating claims to one another, and using § 105(a) to achieve the same result circumvents that framework.”<sup>96</sup>

Distinctively, the Fifth and Ninth Circuits do not rely on § 105(a) as a source of authority to recharacterize putative debt. The Fifth and Ninth Circuits instead hold that, “to determine whether a particular obligation owed by the debtor is a ‘claim’ for purposes of bankruptcy law, a court must simply determine whether that obligation gives the holder of the obligation a ‘right to payment’ under state law.”<sup>97</sup>

In strong opposition to creating new federal recharacterization tests pursuant to § 105(a) authority, the Ninth Circuit in *Off. Comm. of Unsecured Creditors v. Hancock Park Capital II, L.P.* declared that federal courts adopting such tests are doing so in violation of Supreme Court precedent by relying “on § 105(a) and federal common law rules ‘of their own creation’ to determine whether recharacterization is warranted.”<sup>98</sup> Although recharacterization is never mentioned in the *Travelers Cas. & Surety Co. of America v. Pac. Gas & Electric Co.*, the Supreme Court states, “we generally presume that claims enforceable under applicable state law will be allowed in bankruptcy unless they are expressly disallowed.”<sup>99</sup>

The Court further states that federal courts “cannot create a separate legal standard for the enforceability of insider debt in bankruptcy and should follow the state law of debt recharacterization.”<sup>100</sup> Courts following this approach look

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<sup>94</sup> *In re Duke & King Acquisition Corp.*, 508 B.R. at 157 (Bankr. D. Minn. 2014) (citing *Law v. Siegel*, 134 S. Ct. 1188 (2014); *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988)).

<sup>95</sup> *Id.* (citing *Johnson v. First Nat. Bank of Montevideo*, 719 F.2d 270, 274 (8th Cir. 1983)).

<sup>96</sup> *In re Airadigm Communs., Inc.*, 376 B.R. 903, 913 (Bankr. W.D. Wis. 2007).

<sup>97</sup> *Redmond v. Jenkins (In re Alternate Fuels, Inc.)*, 789 F.3d 1139, 1148 (10th Cir. 2015) (citing *In re Fitness Holdings Int’l, Inc.*, 714 F.3d 1141, 1148–49 (9th Cir. 2013) and *In re Lothian Oil, Inc.*, 650 F.3d 539, 542–44 (5th Cir. 2011)).

<sup>98</sup> *In re Fitness Holdings Int’l, Inc.*, 714 F.3d at 1149 (citing *Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Electric Co.* 549 U.S. 443, 451 (2007)).

<sup>99</sup> *Travelers Cas. & Surety Co. of America v. Pac. Gas & Electric Co.*, 549 U.S. 443, 452 (2007).

<sup>100</sup> *In re Fitness Holdings Int’l, Inc.*, 714 F.3d at 1149. (quoting M. Wilton & Stephen Moeller-Sally, *Debt Recharacterization Under State Law*, 62 BUS. LAW. 1257, 1278 (Aug. 2007)).

to state law since “property interests are created and defined by state law” and “unless some federal interest requires a different result, there is no reason why such interest should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.”<sup>101</sup>

An additional problem with using the general equitable provision as the source of authority is a concern about the limits to § 105(a) authority. It remains unclear if a bankruptcy court may do anything they deem “equitable” and attribute it to this power. In its reasoning for rejecting § 105(a) as the source of authority for recharacterization, the Fifth Circuit states they take a “cautious view of § 105(a).”<sup>102</sup> Just as other courts have decided to broadly construe their § 105(a) power to authorize bankruptcy courts to punish civil contempt, the Fifth Circuit held that § 105(a) “does not authorize bankruptcy courts to punish criminal contempt committed outside of the court’s presence.”<sup>103</sup> In this view, they are viewing acts pursuant to § 105(a) much like congressional action pursuant to the commerce clause which must be carried out by a specific enumerated power.

This indicates that some Circuits are rightfully cautious when determining the limits to § 105(a), while other Courts use it as an over-reaching justification when there is no statute on point. The Fifth Circuit’s cautionary and limited view of § 105(a) provides the most rational and consistent application of the Code.<sup>104</sup> Courts should be wary to use § 105(a) as the only source of authority for their actions because stretching the application of the general authority provision to encompass niche areas of laws was not Congress’s intention in drafting the Code.

Additionally, there is a concern if courts give themselves this power under § 105(a) at what point will that statute be limited.<sup>105</sup> If the courts continue pointing to this all-encompassing equitable provision of the Code for unbounded authority, many more problems will unfold, outside the world of recharacterization.

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<sup>101</sup> *In re Fitness Holdings Int’l, Inc.*, at 1146.

<sup>102</sup> *In re Lothian Oil Inc.*, 650 F.3d at 543.

<sup>103</sup> *Id.*

<sup>104</sup> *Id.*

<sup>105</sup> *Id.*

The many advocates of § 105(a) should consider the caution proffered by Judge Barliant of the Northern District of Illinois.<sup>106</sup> Judge Barliant held that nothing in the Code authorizes recharacterization and that specifically the use of § 105(a)'s power may only be used to carry out provisions of the Code. Since there is no provision in the code authorizing recharacterization, § 105(a) cannot be a means for bankruptcy courts to justify debt-to-equity recharacterizations.<sup>107</sup> Finally, “§ 105(a) does not permit courts to create substantive rights or expand the entitlements of creditors that are not already established under the Code or non-bankruptcy law.”<sup>108</sup>

Despite the most reasonable interpretation of § 105(a), a majority of circuits handling recharacterization cite § 105(a) as their source of authority to hear the claim and to reclassify debt as equity.

*c. The Bankruptcy Code's Claim Disallowance Provision, § 502(b), As Source of Authority for Recharacterization*

The Fifth Circuit instead permits judicial recharacterization through § 502(b), the claim allowance and disallowance provision.<sup>109</sup> Section 502(b) states that when a creditor files a timely claim, “the court, after notice and a hearing shall determine the amount, of such claim . . . and shall allow such claim in such amount, except to the extent that (1) such claim is unenforceable against the debtor and property of the debtor, under any agreement or applicable law.”<sup>110</sup> In *Butner v. United States*, the Supreme Court determined that the applicable law was state law.<sup>111</sup>

Although never mentioning the concept of recharacterization or equitable subordination, *Butner* stands for the proposition that when a bankruptcy court is faced with an objection to a claim under § 502, “state law determines whether, and to what extent, a claim is ‘unenforceable against the debtor and property of the debtor, under any agreement or applicable law.’ ‘Taken together,’ the court

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<sup>106</sup> *Moglia v. Quantum Indus. Partners, LDC (In re Outboard Marine Corp.)*, 2003 WL 21697357 at \*8 (N.D. Ill. July 21, 2003) (citing *In re Kids Creek Partners, L.P.*, 212 B.R. 898, 931–33 (Bankr. N.D. Ill. 1997).

<sup>107</sup> *Id.*

<sup>108</sup> *Supra* note 70.

<sup>109</sup> *In re Lothian Oil Inc.*, 650 F.3d at 539.

<sup>110</sup> 11 U.S.C. § 502(b) (2012); *In re Lothian Oil Inc.*, 650 F.3d at 543.

<sup>111</sup> *Butner v. United States*, 440 U.S. 48, 54 (1979); *See also In re Lothian Oil Inc.*, 650 F.3d at 543; *In re Fitness Holdings Int'l, Inc.*, 714 F.3d at 1146–47 (The Fifth and Ninth Circuit look to this holding when determining that they must look to Supreme Court precedent when considering the source of authority for recharacterization).

reasoned, ‘Butner and § 502(b) support the bankruptcy courts’ authority to recharacterize claims.’”<sup>112</sup> The Fifth Circuit first faced the question of whether a bankruptcy court has authority to recharacterize debt as equity in *Grossman v. Lothian Oil Inc.*<sup>113</sup> In that case, the court held that “a bankruptcy court’s ability to recharacterize debt as equity is part of the court’s authority to allow and disallow claims, and the remedy is not limited to claims asserted by corporate insiders.”<sup>114</sup>

By using § 502(b) as authority, the Fifth Circuit believes using § 105(a) as a source of authority is “unnecessary.”<sup>115</sup> Furthermore, the Court addresses the concerns raised by using § 105(a)’s general equitable power of authority to recharacterize claims. The Fifth Circuit notes that it has traditionally taken a “cautious view” of the reach of § 105(a) authority.<sup>116</sup> Additionally, the Fifth Circuit argues that promulgating recharacterization authority under § 502(b) eliminates the need for the statutory interpretation of a court’s subordination powers because subordination and claim disallowance are separate rights, both expressly given to bankruptcy courts in the Code.<sup>117</sup>

Although, the Fifth and Ninth Circuit’s interpretation of the claim allowance provision to control judicial recharacterization has its flaws, it helps eliminate the statutory confusion between § 105(a) and § 510(c). While the Fifth and Ninth Circuit’s interpretation of § 105(a) seems accurate, their stance on authority from § 502(b) still raises many questions. However, § 502(b) seems to be a better source of authority for recharacterization since § 105(a) clearly does not apply to such overarching authority.

### *B. Federal Recharacterization Tests*

Assuming proper authority exists, the question then becomes under what circumstances a court will recharacterize the loan as equity, and which test they should apply. Despite the Circuits’ broad agreement that the Code authorizes

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<sup>112</sup> Mark G. Douglas, *First Impressions: Fifth Circuit Rules That Noninsider Claims Can Be Recharacterized as Equity*, JONES DAY (September/October 2011) <http://www.jonesday.com/first-impressions-fifth-circuit-rules-that-noninsider-claims-can-be-recharacterized-as-equity-10-01-2011> (quoting Butner, 440 U.S. at 48.).

<sup>113</sup> *In re Lothian Oil Inc.*, 650 F.3d at 539 (Although historically, Texas courts have used a multi-factor federal tax test in determining if debt should be recharacterized as equity.)

<sup>114</sup> Douglas, *supra* note 112.

<sup>115</sup> *In re Lothian Oil Inc.*, 650 F.3d at 543–45.

<sup>116</sup> *Id.*

<sup>117</sup> *Id.* at 543.

courts to recharacterize claims, the courts take different approaches in identifying the legal framework for this recharacterization.<sup>118</sup>

Circuits have developed various and confounding answers to this question by creating complex, ambiguous, multi-factor tests that vary depending on the jurisdiction. The Eleventh, Fifth, and Tenth Circuits use a multi-factor test to determine if debt should be recharacterized as equity.<sup>119</sup>

The Eleventh, Fifth, and Tenth Circuits have identified the following thirteen factors: (1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a fixed maturity date; (3) the source of payments; (4) the right to enforce payment of principal and interest; (5) participation in management flowing as a result; (6) the status of the contribution in relation to regular corporate creditors; (7) the intent of the parties; (8) “thin” or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) source of interest payments; (11) the ability of the corporation to obtain loans from outside lending institutions; (12) the extent to which the advance was used to acquire capital assets; and (13) the failure of the debtor to repay on the due date or to seek a postponement.<sup>120</sup>

The Eleventh Circuit has also applied an objective test to recharacterization. The Court stated that “shareholder loans may be deemed capital contributions in one of two circumstances: where the trustee proves initial under-capitalization or where the trustee proves that the loans were made when no other disinterested lender would have extended credit.”<sup>121</sup>

The Sixth Circuit also employs a multi-factor test.<sup>122</sup> They have identified the following eleven factors: (1) the names given to the instruments, if any,

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<sup>118</sup> *In re Fitness Holdings Int’l, Inc.*, 714 F.3d at 1148.

<sup>119</sup> *In re Lothian Oil Inc.*, 650 F.3d at 544; *Stinnett’s Pontiac Serv., Inc. v. Comm’r*, 730 F.2d 634, 638 (11th Cir. 1984); *Sender v. Bronze Grp., Ltd (In re Hedged-Investments Assocs.)*, 380 F.3d 1292, 1298 (10th Cir. 2004).

<sup>120</sup> *Stinnett’s Pontiac Serv., Inc.*, 730 F.2d at 638 (citing *Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972)); *In re Hedged-Investments Assocs.*, 380 F.3d at 1297–98.

<sup>121</sup> *Compare In re N & D Properties, Inc.*, 799 F.2d 726, 728 (11th Cir. 1986), with *Duke & King Mo., LLC v. Nath Cos.*, (*In re Duke & King Acquisition Corp.*), 508 B.R. 107, 158 (Bankr. D. Minn. 2014) (expressly rejecting *In re N & D Properties, Inc.* by stating “the Eleventh Circuit test is not binding precedent in this jurisdiction. In its brevity and in its arrogation of broad judicial power to adjust after the fact, it stands alone among the appellate courts that have addressed recharacterization in the context of bankruptcy. It cites no precedent for its holding. Its test seems particularly rigid—much at odds with the weighing-and-balancing essence of equity. It simply is not the rule to apply.”).

<sup>122</sup> *Roth Steel Tube Co. v. Comm’r of Internal Revenue*, 800 F.2d 625, 630 (6th Cir. 1986); *Bayer Corp. v. MasoTech, Inc. (In re Autostyle Plastics, Inc.)*, 269 F.3d 726, 749 (6th Cir. 2001).

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) the identity of interest between the creditor and the 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 advances were used to acquire capital assets; and (11) the presence or absence of a sinking fund to provide repayments.<sup>123</sup>

The Third Circuit upheld the District Court's use of a seven-factor test.

Those factors are: (1) the name given to the instrument; (2) the intent of the parties; (3) the presence or absence of a fixed maturity date; (4) the right to enforce payment of principal and interest; (5) the presence or absence of voting rights; (6) the status of the contribution in relation to regular corporate contributors; and (7) certainty of payment in the event of the corporation's insolvency or liquidation.<sup>124</sup>

In considering the recharacterization framework, the Third Circuit finds the intent of the parties to be a crucial factor for determination. To help frame their analysis, the Court states, "that intent may be inferred from what the parties say in their contracts, from what they do through their actions, and from the economic reality of the surrounding circumstances. Answers lie in facts that confer context case-by-case."<sup>125</sup>

Historically, federal judicial recharacterization tests originated from the comprehensive tests used in tax law cases.<sup>126</sup> In 1979, before wide adoption of the multi-factor tests, the Tenth Circuit analyzed recharacterization under a fact-specific three-factor inquiry considering (1) the initial operating capital, (2) the length of time the business was in operation at the time of the loan, and (3) whether the parties treated the transaction as a loan or as a capital investment.<sup>127</sup>

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<sup>123</sup> Roth Steel Tube Co., 800 F.2d at 630; *In re Autostyle Plastics, Inc.*, 269 F.3d at 750.

<sup>124</sup> Cohen v. KB Mezzanine Fund II, LP (*In re SubMicron Sys. Corp.*), 432 F.3d 448, 445 n.8 (3d Cir. 2006).

<sup>125</sup> *In re SubMicron Sys. Corp.*, 432 F.3d at 456 (3d Cir. 2006).

<sup>126</sup> *In re Autostyle Plastics, Inc.*, 269 F.3d at 749 & n.12 (6th Cir. 2001); *cf. In re Hedged-Investments Assocs.*, 380 F.3d 1292, 1298 (10th Cir. 2004) (Tenth circuit credits tax courts for the comprehensive framework but also acknowledges that the tax-court-created framework was consistent with a previous and more general framework approved by the Tenth Circuit in *In re Mid-Town Produce Terminal, Inc.*, 599 F.2d 389 (10th Cir. 1979)).

<sup>127</sup> See *In re Mid-Town Produce Terminal, Inc.*, 599 F.2d 389, 393 (10th Cir. 1979).

However, the court later expanded their criteria to impose a thirteen-factor test to the issue of recharacterization in 2004,<sup>128</sup> noting that recent tax law cases in other circuits<sup>129</sup> have created “a more extensive set of criteria to judge whether funds advanced to a now-bankrupt entity were true loans or camouflaged equity investments.”<sup>130</sup>

To apply the same reasoning Judge Posner applied in a Seventh Circuit tax case, many multi-factor tests are “redundant, incomplete, and unclear[,]”<sup>131</sup> and the circuits’ various recharacterization tests are no exception. Judge Posner’s major problem with the multi-factor test in *Exacto Spring* was that it was nondirective; the test failed to indicate how the factors were to be weighed “in the event they don’t all line up on one side.”<sup>132</sup>

The Tenth Circuit believes that the use of a multi-factor test would actually encourage investments from insiders of struggling enterprises to keep the business from falling into bankruptcy.<sup>133</sup> The Tenth Circuit argues that the three-factor test in *Mid-Town* emphasized undercapitalization too much and predicts that would have an “unhealthy deterrent effect”<sup>134</sup> on insider investments, compared with the view that the multi-factor test will have a deterrent effect on potential investors due to the uncertainty in this area of law.<sup>135</sup>

Uniform standards in federal recharacterization tests would create more predictability for the investors, attorneys, and the courts. If the legal standard

<sup>128</sup> *In re Hedged-Investments Assocs.*, 380 F.3d at 1298.

<sup>129</sup> *Id.* The court specifically noted the decision in *In re Autostyle Plastics, Inc.*, where the Sixth Circuit applied such a multi-factor test from the tax cases to a bankruptcy recharacterization inquiry. *In re Autostyle Plastics, Inc.*, 269 F.3d at 749–50 (6th Cir. 2001)

<sup>130</sup> *In re Hedged-Investments Assocs.*, 380 F.3d at 1298.

<sup>131</sup> *Exacto Spring Corp. v. Comm’r*, 196 F.3d 833, 835 (7th Cir. 1999) (quoting *Palmer v. Chicago*, 806 F.2d 1316, 1318 (7th Cir. 1986).

<sup>132</sup> *Id.*

<sup>133</sup> *In re Hedged-Investments Assocs.*, 380 F.3d 1292, n.1. stating:

Use of a more comprehensive set of criteria also serves one of our main concerns identified in *Mid-Town*—that excessive suspicion about loans made by owners and insiders of struggling enterprises would discourage legitimate efforts to keep a flagging business afloat. Too heavy an emphasis on undercapitalization produces just such an unhealthy deterrent effect. Undercapitalization certainly remains an important factor to consider, but under the multi-factor approach we adopt today business owners need not fear, should their rescue efforts fail, that the bankruptcy court would give disproportionate weight to the poor capital condition of their failing companies and thus too quickly refuse to treat their cash infusions as loans.(internal citation omitted).

<sup>134</sup> *Id.*

<sup>135</sup> *Id.*

becomes clearly articulated, it might reduce litigation from the start, or in the event of a decision, reduce the number of appeals.

### C. *Standard of Review Analysis*

After a court recharacterizes debt as equity it is likely the investor will appeal the decision. Courts are split again as to the standard of review applied to determinations of judicial recharacterization.<sup>136</sup> In any case, “[t]he proper standard of review is a question of federal procedure and is therefore governed by federal law.”<sup>137</sup> However, since recharacterization emerged from judge-made law, no clear standard was announced and the circuits are mixed as to which standard of review to apply.

Circuits have developed their federal recharacterization tests to determine when a loan should be recharacterized as an equity contribution from the tax courts.<sup>138</sup> Tax courts are split over whether, for tax purposes, a contribution should be treated as debt or equity.<sup>139</sup> Since these tax courts lay the foundation for the legal theory of recharacterization, it is clear that the same issues translate into the bankruptcy court since they have not been expressly codified.

In tax cases addressing whether a contribution should be treated as debt or equity, courts are split on the standard of review.<sup>140</sup> For example, “the Sixth and Ninth Circuits have concluded the issue is one of fact to be reviewed for clear error.”<sup>141</sup> Alternatively, “[t]he Fifth and Eleventh Circuit Courts of Appeals” hold that the issue is “primarily one of law subject to *de novo* review.”<sup>142</sup>

Differing standards of review among the circuits for the same issue create problems with an equal administration of the law. Two creditors with similar claims that have been recharacterized as equity may face different outcomes

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<sup>136</sup> *In re* SubMicron Sys. Corp., 432 F.3d at 456; *In re* Lane, 742 F.2d at 1315; *Estate of* Mixon v. United States, 464 F.2d 394, 402–03, n.13 (5th Cir.1972); *In re* Hedged-Investments Assocs., 380 F.3d at 1297.

<sup>137</sup> United States Courts for the Ninth Circuit, [http://cdn.ca9.uscourts.gov/datastore/uploads/guides/stand\\_of\\_review/I\\_Definitions.html](http://cdn.ca9.uscourts.gov/datastore/uploads/guides/stand_of_review/I_Definitions.html) (citing *Freund v. Nycomed Amersham*, 347 F.3d 752, 762 (9th Cir. 2003)).

<sup>138</sup> *In re* Autostyle Plastics, Inc., 269 F.3d at 749 n.12; *cf. In re* Hedged-Investments Assocs., 380 F.3d at 1298. The tenth circuit credits tax courts for the comprehensive framework but also acknowledges that the tax-court-created framework was consistent with a previous and more general framework approved by the Tenth Circuit in *In re* Mid-Town Produce Terminal.

<sup>139</sup> *In re* SubMicron Sys. Corp., 432 F.3d at 463.

<sup>140</sup> *Id.* at 456.

<sup>141</sup> *Id.* (citing *Roth Steel Tube Co. v. Comm’r*, 800 F.2d 625, 629 (6th Cir. 1986); *Bauer v. Comm’r*, 748 F.2d 1365, 1367 (9th Cir. 1984)).

<sup>142</sup> *In re* SubMicron Sys. Corp., 432 F.3d at 456 (citing *In re* Lane, 742 F.2d 1311, 1315 (11th Cir. 1984); *Estate of* Mixon, 464 F.2d at 402–03, n.13).

after an appeal depending on the jurisdiction in which they fall. This discrepancy runs afoul of general bankruptcy provisions, which require similar claims to be treated equally.<sup>143</sup>

The different standards of review may also create an incentive for forum shopping since potential investors, or even potential debtors, may realize they will benefit from by bringing their claim in different forums. More specifically, “[t]he concern surrounding forum shopping stems from the fear that a plaintiff will be able to determine the outcome of a case simply by choosing the forum in which to bring the suit.”<sup>144</sup> This creates a “fear that applying the law sought by a forum-shopping plaintiff will defeat the expectations of the defendant or will upset the policies of the state in which the defendant acted (or from which the defendant hails).”<sup>145</sup>

### 1. *Clear Error*

The Third Circuit adopted the reasoning of the Ninth and Sixth Circuits, finding that the standard of review for a recharacterization determination is clear error.<sup>146</sup> An appellate court, under a clear error standard, reviews the trial court’s findings of fact.<sup>147</sup> Under this standard special deference is given to the trial court because they are in the best position to make factual determinations since they preside over the evidentiary hearings regarding the factual issues of the case.<sup>148</sup>

Under a clear error standard of review, an investor whose loan has been recharacterized faces the most difficult standard of review. While their appeal may be triumphant under a *de novo* or even mixed question of law and fact, it will be very difficult for an investor to overcome the heavy burden of proof a standard of review requires to reverse a trial courts determination of recharacterization.

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<sup>143</sup> See 11 U.S.C. §§ 726, 1123(a)(4), 1126, 1322(a)(3) (2012).

<sup>144</sup> *Sheldon v. PHH Corp.*, 135 F.3d 848, 855 (2d Cir. 1998) (citing *Olmstead v. Anderson*, 400 N.W.2d 292, 303 (Mich. 1987)).

<sup>145</sup> *Id.*

<sup>146</sup> *In re SubMicron Sys. Corp.*, 432 F.3d at 456.

<sup>147</sup> FED. R. CIV. P. 52(a)(6) (“Findings of fact, whether based on oral or other evidence, must not be set aside unless clearly erroneous, and the reviewing court must give due regard to the trial court’s opportunity to judge the witnesses’ credibility.”).

<sup>148</sup> See *United States Courts for the Ninth Circuit*, *supra* note 137; *Anderson v. Bessemer City*, 470 U.S. 564, 573 (1985); *McClure v. Thompson*, 323 F.3d 1233, 1240–41 (9th Cir. 2003).

Here, the Third Circuit frames their analysis simply by reasoning the relevant inquiry is the “intent of the parties as it existed at the time of the transaction.”<sup>149</sup> Viewing it as a question of the intent of the parties, the Third Circuit holds that this is a question of fact subject to clear error review.<sup>150</sup> In finding that the district court’s determination was not clearly erroneous, the Third Circuit deferred to the numerous findings of fact that supported the district court’s recharacterization decision.<sup>151</sup>

Since “the District Court found ample evidence to support a debt characterization and little evidence to support a characterization of equity infusion[,]”<sup>152</sup> the Third Circuit upheld their judicial recharacterization even though the specific weight of the factors was not discussed. The Court of Appeals deferred wholly to the factual findings of the district court.

## 2. *De Novo* Review

The Fifth and Eleventh Circuits hold that a district court’s determination of whether a transaction is debt or equity is subject to a *de novo* review.<sup>153</sup> An appellate court reviewing a case *de novo* gives no deference to the district court’s decision of whether the loan should have been classified in the first instances as equity.<sup>154</sup> Instead, the appellate court must consider “the matter anew, as if no decision previously had been rendered.”<sup>155</sup>

The Eleventh Circuit reasoned that while the basic facts are subject to a clearly erroneous standard the “ultimate characterization of the transactions as debt or equity receives no such protection” and since “[t]his evaluation presents primarily a question of law,” the “district court’s determination of the issue is thus subject to a *de novo* review by this court.”<sup>156</sup>

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<sup>149</sup> *In re* SubMicron Sys. Corp., 432 F.3d at 456–57.

<sup>150</sup> *Id.* [T]his is a question of fact that, ‘once resolved by a district court, cannot be overturned unless clearly erroneous.’” (quoting *A.R. Lantz Co. v. United States*, 424 F.2d 1330, 1334 (9th Cir. 1970)).

<sup>151</sup> *Id.* at 456.

<sup>152</sup> *Id.*

<sup>153</sup> *In re* Lane, 742 F.2d 1311, 1315 (11th Cir. 1984); *Estate of Mixon*, 464 F.2d at 402–03, n.13; *Cf. Grossman v. Lothian Oil Inc. (In re Lothian Oil Inc.)*, 650 F.3d 539, 541 (5th Cir. 2011) (“In reviewing a bankruptcy appeal from the district court, [appellate courts apply] the same standard to the bankruptcy court’s findings of fact and conclusions of law that the district court applied. That standard reviews findings of fact for clear error and conclusions of law *de novo*.”) (internal quotations and citations omitted).

<sup>154</sup> *See Freeman v. DirecTV, Inc.*, 457 F.3d 1001, 1004 (9th Cir. 2006).

<sup>155</sup> *Id.*

<sup>156</sup> *In re* Lane, 742 F.2d at 1315 (citing *Estate of Mixon*, 464 F.2d at 402–03).

### 3. *Mixed Question of Law and Fact*

The Tenth Circuit finds that the question of whether a transaction labeled as a loan should be recharacterized as an equity investment is a mixed question of law and fact, deferring to the bankruptcy court's finding of facts and reviewing them with a clearly erroneous standard.<sup>157</sup> However, the application of the legal test for recharacterization is reviewed *de novo*.<sup>158</sup>

## D. *Codification Analysis*

### 1. *Recharacterization Statute Proposal*

To resolve the ambiguities and inconsistent outcomes caused by a lack of uniform guidelines, a recharacterization clause must be added to the Code. Since the concept is generally recognized by courts that have faced the question, codification of the concept would not disturb a majority of the current federal interpretations, but would merely provide clarity and direction to an already well-recognized tool for bankruptcy courts.

The recharacterization statute should be proposed as an addition to §510, the “Subordination” section of the Code, because a recharacterization effectively subordinates the claim.<sup>159</sup> Despite the similar effective results, the purpose of equitable subordination is to subordinate a claim as a remedy for a creditor's inequitable conduct, while the purpose of recharacterization is to reclassify a money advance from debt to equity, which has the effect of subordination.<sup>160</sup> Therefore, since they both involve subordinating claims but under different circumstances, it is appropriate for both statutes to reside in the “subordination” sections but under distinct provisions. The following is an example of a proposal for the judicial recharacterization statute, with the remaining sections explaining the details of the provision:

#### **Proposal: 11 U.S.C. § 510 - Subordination.**

##### **(d) Judicial recharacterization:**

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<sup>157</sup> *Sender v. Bronze Grp., Ltd. (In re Hedged-Investments Assocs.)*, 380 F.3d 1292, 1297 (10th Cir. 2004) (citing *Phillips v. White (In re White)*, 25 F.3d 931, 933 (10th Cir. 1994)).

<sup>158</sup> *Id.* (citing *Gullickson v. Brown (In re Brown)*, 108 F.3d 1290, 1292 (10th Cir. 1997)); *Redmond v. Jenkins (In re Alternate Fuels, Inc.)*, 789 F.3d 1139 (10th Cir. 1997).

<sup>159</sup> *See Moglia v. Quantum Indus. Partners, LDC (In re Outboard Marine Corp.)* 2003 U.S. Dist. LEXIS 12564 \*9–12 (N.D. Ill. July 21, 2003) (citing *In re Pacific Express, Inc.*, 69 B.R. 112, (B.A.P. 9th Cir. 1986) (Recharacterization achieves the same result as equitable subordination, but without explicit statutory permission, which may result in inconsistent standards under the bankruptcy code.).

<sup>160</sup> *In re Hedged-Investments Assocs.*, 380 F.3d at 1297 (quoting *In re Autostyle Plastics, Inc.*, 269 F.3d at 748–49).

(1) In the absence of misconduct, the court may review the proper characterization in the first instance of funds advanced as either debt or equity by applying the following test:

If a majority of the factors indicate the true nature of the loan is equity, a court may recharacterize the loan as such, considering

- intent of the parties;
- presence/absence of a fixed maturity date/schedule of payment;
- source of payment;
- presence/absence of fixed interest payments; and
- the security interest for the advances.

(2) Standard of review: In the event of an appeal the standard of review shall be clear error.

Thus, this statute addresses the circuit splits by creating a statutory source of authority, standardizing the federal recharacterization test, and providing a standard of review.

#### *E. Federal Recharacterization Test Proposal*

Multi-factor tests have the tendency to be “redundant, incomplete, and unclear.”<sup>161</sup> The confusion surrounding multi-factor tests stems from a failure to indicate “how the factors are to be weighed in the event they don’t all line up on one side.”<sup>162</sup> Predictably, a test that lists thirteen factors with no standard on how to classify or consider the factors will undoubtedly yield erratic results when applied across circuits.<sup>163</sup>

The ambiguity in federal recharacterization tests is central to the need for codification and direction on how to apply the factors. Not only does every circuit facing the issue apply a different test, no circuit gives an explanation for the strength of the factors or how to apply each respective test. Under the current test, a case where a minority of the factors are met may be recharacterized, while

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<sup>161</sup> *Exacto Spring Corp. v. Comm’r*, 196 F.3d 833, 835 (7th Cir. 1999) (quoting *Palmer v. Chicago*, 806 F.2d 1316, 1318 (7th Cir.1986).

<sup>162</sup> *Id.* at 833.

<sup>163</sup> See David A. Skeel & Georg Krause-Vilmar, *Recharacterization and the Nonhindrance of Creditors*, 7 EUR. BUS. ORG. L. REV. 259, 265 (2006).

[Courts] seem uncertain how to determine when debt should be recharacterized. A useful gauge of the uncertainty is the steady proliferation of factors courts try to take into account. After surveying the previous case law, the leading case compiled a list of eleven factors; a subsequent case concluded that eleven was not enough, and added two more.

a case in which a majority of the factors are weakly met could be refused recharacterization. While understanding the recharacterization analysis is often a fact-specific inquiry, courts need more direction than a list of six, seven, eleven, or thirteen unweighted factors.

As currently practiced, each circuit's test is followed with a general disclaimer, stating that no single factor is dispositive in this balancing test, and the significance of the factors may vary depending on the facts of a case.<sup>164</sup> Courts justify this at the expense of the investor, reasoning that "some cases are easy (*e.g.*, a document titled a 'Note' calling for payments of sums certain at fixed intervals with market-rate interest and these obligations are secured and are partly performed, . . .)" while "others are hard (such as a 'Note' with conventional repayment terms yet reflecting an amount proportional to prior equity interests and whose payment terms are ignored)."<sup>165</sup> However, it is possible to create a uniform, comprehensive test that has the ability to be factually specific, yet far less unpredictable and arbitrary than current law. Codifying the federal recharacterization factors with an instruction on how to apply them would achieve this goal without compromising the factual specific inquiry.

The bankruptcy courts have based their recharacterization tests off factors used in federal tax inquiries to answer whether advances to a corporation are loans or capital contributions.<sup>166</sup> One court adopting the tax factors stated the tax factors "provide a general framework for assessing recharacterization claims that is also appropriate in the bankruptcy context" but recognize there is a "disagreement" regarding the appropriateness of tax court recharacterization factors in a bankruptcy proceeding.<sup>167</sup> While the adoption of the federal tax factors has been common practice, it has created unwieldy and unpredictable tests, creating a system where lenders, attorneys, and even bankruptcy court judges cannot ascertain the outcome of a transaction.

*Recharacterization and the Nonhindrance of Creditors*, by David A. Skeel, Jr. and Georg Krause-Vilmar, considers the issue in terms of an "ambiguous loan

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<sup>164</sup> *In re Autostyle Plastics, Inc.*, 269 F.3d at 750; *In re Outboard Marine Corp.*, 2003 U.S. Dist. LEXIS 12564, at \*15; *In re Hedged-Investments Assocs.*, 380 F.3d at 1298, n.1; *Stinnett's Pontiac Serv., Inc. v. Comm'r*, 730 F.2d 634, 638 (11th Cir. 1984).

<sup>165</sup> *See* *Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Sys. Corp.)*, 432 F.3d 448, 456 (3d Cir. 2006).

<sup>166</sup> *Bayer Corp. v. MascoTech, Inc. (In re Autostyle Plastics, Inc.)*, 269 F.3d 726, 749, n.12 (6th Cir. 2001).

<sup>167</sup> *Id.*

problem.”<sup>168</sup> In the ambiguous loan problem, the author argues that cash infusions could be misconstrued as equity when they were intended to be loans, merely because the parties failed to make formal loan agreements.<sup>169</sup> The author aptly argues that when making an agreement between an insider and the corporation, the documentation may omit key terms such as interest rates and a mandated repayment schedule.<sup>170</sup> The author raises three factors that bankruptcy courts use in federal recharacterization tests that speak directly to this “ambiguous loan” issue: (1) “the names given to the instruments,” (2) “presence or absence of a fixed maturity date and payment schedule,” and (3) “presence or absence of fixed interest payments.”<sup>171</sup>

It appears that individuals conducting business with close friends or trusted corporations often leave out important formalities, which allows a court to unjustly recharacterize their loan as equity. For the reasons stated below, the factor “names given to the instrument” should not be its own federal recharacterization factor included in the codification. However, the other three ambiguous loan factors; presence/absence of a fixed maturity date; fixed interest payments; and a payment schedule, are simple ways for those in a creditor-debtor relationship to transcribe the terms of their agreement and ensure it will not be unjustly recharacterized. These two factors are highly indicative of the true nature of the agreement.

In an effort to highlight the most important factors, this Comment suggests by codifying recharacterization, bankruptcy courts consider these as the primary and most heavily weighted factors: (1) intent of the parties; (2) presence/absence of a fixed maturity date/schedule of payment; (3) source of payment; (4) presence/absence of fixed interest payments; and (5) the security interest for the advances. If a cognizable question of recharacterization is raised, the court should consider these factors. If a majority of these factors clearly weigh in favor of a certain classification, a court should have the discretion to recharacterize the transaction.

At the very least, courts should require a majority of the relevant factors to be present in order to provide some basic guidelines for the analysis. The qualification of the majority factors is important because there are certain transactions that will not deal with some of the factors in the test applied. In those cases, a court could cross out the non-applicable factors and require a

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<sup>168</sup> Skeel and Vilmar, *supra* note 163, at 259–85.

<sup>169</sup> *Id.* at 268.

<sup>170</sup> *Id.*

<sup>171</sup> *Id.* 277.

majority of the applicable factors to lean towards an equity classification before a court may consider recharacterization a loan.

Additionally, for the reasons stated below, courts should no longer consider undercapitalization, whether an outside lender would give a loan, the name given to the instrument, and whether advances were used to acquire capital assets as factors in the federal recharacterization test. Many of these factors are duplicative, shallow, and do not help a court truly discern whether a transaction should have been classified as debt or equity from the outset.

Most note-worthy is that the test will be discretionary. The language of the proposed statute shall read: *if a majority of the factors indicate the true nature of the loan is equity, a court may recharacterize the loan as such.*<sup>172</sup> To begin, the equitable subordination test under § 510(c) is a discretionary test.<sup>173</sup> Because the debt-to-equity recharacterizations are often so fact-specific, it is important the power remains with a judge to apply the facts of the case to determine if recharacterization is proper under the circumstances of the case. By imposing a discretionary standard, the power remains with the judge and the proposed statute provides courts with more guidance.

### *1. Factors Indicative of Debt or Equity Transaction*

#### *a. Intent*

The intent of the parties should be the primary consideration in determining whether a loan should be recharacterized as equity.

The objective intentions of the parties can provide valuable insight into the purpose of the transaction which will allow a proper classification of the loan. However, determining the objective intent of the parties in the transaction can be difficult. To determine intent courts may infer “from what the parties say in their contracts, from what they do through their actions, and from the economic reality of the surrounding circumstances. Answers lie in facts that confer context case-by-case.”<sup>174</sup>

Additionally, the subjective intent of the parties can provide valuable insight into the transaction. While some circuits hold that subjective intent of the parties

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<sup>172</sup> See discussion *infra* Section (B)(I) (setting forth a proposed federal recharacterization statute).

<sup>173</sup> 11 U.S.C. § 510(c) (2012).

<sup>174</sup> *In re* SubMicron Sys. Corp., 432 F.3d at 456.

“will not alter the relationship or duties created by an otherwise objectively indicated intent”<sup>175</sup> this proposal suggests analyzing the subjective intent of the parties may be beneficial. In fact, under current federal recharacterization tests, courts consider subjective intent factors.

For example, a factor considering the name given to the instrument does not need to be a factor on its own, because the name of the instrument may represent the intent of the parties. Therefore, considering this factor under the intent analysis simplifies the analysis, instead of complicating the recharacterization test with factors that can fit within other factors.

The Third Circuit is the only court to provide any insight on how to analyze the factors in the recharacterization determination. While advocating for a seven-factor test, the court held “the determinative inquiry in classifying advances as debt or equity is the intent of the parties as it existed at the time of the transaction.”<sup>176</sup>

Considering both what a reasonable person would have done to create a creditor-debtor relationship, and what the parties in question have done to create a creditor-debtor question, will be vital to the recharacterization analysis.

*b. Presence or Absence of a Fixed Maturity Date/Schedule of Payment*

The fixed maturity date is the date on which the loan is to be repaid. In *Stinnett's Pontiac Serv., Inc. v. Comm'r*,<sup>177</sup> the court stated, “no one factor is controlling” but “the presence of a definite maturity date and a definite obligation to repay is[] ‘a highly significant feature[] of the debtor-creditor relationship.’ . . . [T]he absence of a fixed maturity date is indicative of an equity advance.”<sup>178</sup>

In the event a transaction occurs absent a schedule of payment or an end term, it should be strongly indicative that the transaction was a capital

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<sup>175</sup> *Stinnett's Pontiac Serv., Inc.*, 730 F.2d at 639. (The court found that although the subjective intent of the parties was to create a loan, the circumstances surrounding the advances in question were indicative of a capital contribution. A holding that the subjective intent of the parties prevails over their objective intent would be “to ignore the plan [sic] facts and to elevate form over substance.”) (quoting *Tyler v. Tomlinson*, 414 F.2d 844, 850 (5th Cir. 1969)).

<sup>176</sup> *In re SubMicron Sys. Corp.*, 432 F.3d at 457.

<sup>177</sup> *Stinnett's Pontiac Serv., Inc.*, 730 F.2d at 634.

<sup>178</sup> *Id.* at 638 (quoting *Dillin v. United States*, 433 F.2d 1097, 1101 (5th Cir. 1970)).

contribution rather than a loan, regardless of whether the parties named the instrument a “loan agreement.”<sup>179</sup>

The Sixth Circuit raises a logical concern regarding a rigid application of this factor. If the “lack of a fixed maturity date and fixed repayment schedule was indicative of equity” there arises a fear that a per se rule would emerge that “use of a demand note by an insider would always be indicative of an equity contribution rather than a loan[]” by virtue of them lacking a fixed maturity date and schedule of repayment.<sup>180</sup>

To address this concern, it should be noted that form may not trump substance of the transaction.<sup>181</sup> Therefore, while valid, the Sixth Circuit’s concern of a “per se rule” emerging is unfounded due to the other safeguards proposed in the federal recharacterization test. As long as courts consider this factor in conjunction with the four other factors, it will never be the single determinative factor. Additionally, if an instrument, such as a demand note, details a fixed maturity date and schedule of repayment that is never met or followed, a court shall not consider that in favor of a loan simply because the parties put the proper words on the agreement. The actions flowing from the agreement must follow the terms required to determine the transaction as a loan or capital contribution. Or said in another way, the form of the transaction will not trump the substance.

*c. Presence/absence of fixed interest payments*

While this factor is sometimes considered in conjunction with the presence/absence of a fixed maturity date/schedule of payment, courts should consider them separately. It is possible for a transaction to contain a fixed maturity date, but no requirement of interest payments, or vice versa.

This factor is important because “[a] true lender is concerned with interest.”<sup>182</sup> Because of this, the absence of a fixed interest rate on the purported loan is a “strong indication that the advances were capital contributions rather than loans.”<sup>183</sup>

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<sup>179</sup> *In re Autostyle Plastics, Inc.*, 269 F.3d at 750.

<sup>180</sup> *See id.* at 726.

<sup>181</sup> *See id.* at 747–50.

<sup>182</sup> *Stinnett’s Pontiac Serv., Inc.* 730 F.2d at 640. (quoting *Curry v. United States*, 396 F.2d 630, 634 (5th Cir. 1968)).

<sup>183</sup> *In re Autostyle Plastics, Inc.*, 269 F.3d at 750.

As with the presence or absence of a fixed maturity date and schedule of payment, interest payments cannot just be in theory. To address this concern, courts may consider if the notes required interest payments, but none were actually made.<sup>184</sup> However, there should be a distinction between deferral of payments and complete lack of payments, “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.”<sup>185</sup>

*d. Source of Payment*

The source of payment factor questions whether the payment depends on the corporation’s earnings. Many of the loans considered for recharacterization were tied to the success of the corporation. For example, the terms of an agreement may only require repayment of a purported loan once a near-bankrupt corporation was profitable again.<sup>186</sup> The Eleventh Circuit determined “[t]he importance of the source of the payments, ‘is that if repayment is possible only out of corporate earnings, the transaction has the appearance of a contribution of equity capital, but if repayment is not dependent upon earnings, the transaction reflects a loan to the corporation.’”<sup>187</sup>

*e. The Security Interest for the Advances*

A security interest emerging from the transaction in question indicates the advances are a loan, not a capital contribution.<sup>188</sup> A creditor’s interest, as a secured creditor of the debtor, cuts very favorably in favor of a loan. While this factor may seem small in comparison to the other considerations, it is highly indicative of the true nature of the loan. Additionally, determining whether a purported creditor holds a security interest in the debtor-corporation is a relatively simple question that weighs heavily in favor of a loan transaction.

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<sup>184</sup> See *Stinnett’s Pontiac Serv., Inc.*, 730 F.2d at 640.

<sup>185</sup> *In re Autostyle Plastics, Inc.*, 269 F.3d at 751.

<sup>186</sup> *Cf. Stinnett’s Pontiac Serv., Inc.*, 730 F.2d at 638 (corporate earnings were the only source for repayment); *Harlan v. United States*, 409 F.2d 904, 909 (5th Cir. 1969) (repayment was contingent on surplus funds exceeding an arbitrary number agreed upon by the parties).

<sup>187</sup> *Id.* (quoting *Estate of Mixon v. United States*, 464 F.2d 394, 405 (5th Cir. 1972)).

<sup>188</sup> See *In re Autostyle Plastics, Inc.*, 269 F.3d at 752 (6th Cir. 2001).

2. *Factors that should be Rejected in a Bankruptcy Court's Analysis of a Debt or Equity Transaction*

a. *Undercapitalization*

Undercapitalization used to be a primary factor in recharacterization. The court in *Roth Steel Tube* reasoned that “[t]hin or inadequate capitalization is strong evidence that the advances are capital contributions rather than loans.”<sup>189</sup> If a corporation is undercapitalized at the time of a purported loan, courts are increasingly skeptical of the loan because “they may in reality be infusions of capital.”<sup>190</sup> Courts today have moved away from using this as a per se factor, often finding undercapitalized corporations are capable of receiving true loans. Thus, if a court is considering other factors of the loan such as the source of payment, maturity rate, and interest rate, it seems unnecessary to inquire into this.

In light of the primary factors, undercapitalization or financial state of the corporation should not be considered in determining the true nature of the transaction. If a corporation is seeking loans the transaction should be same whether they are undercapitalized or not.

b. *The Corporation's Ability to Obtain Outside Funding*

In interpreting this factor, several circuits employed a “reasonable investor” standard, “[w]hen there is no evidence of other outside financing, the fact that no reasonable creditor would have acted in the same manner is strong evidence that the advances were capital contributions rather than loans.”<sup>191</sup>

However, recent interpretations of this factor have rendered it unnecessary. Courts consider outside financing, that has been guaranteed by an interested party, as sufficient to cut in favor of a loan. It appears contradictory to say a loan by an insider is indicative of a capital contribution, but if the insider were to personally guarantee that same transaction it would cut in favor of a loan. This appears to be a legal loophole. If a lender becomes aware courts use this factor, the lender simply must convince someone else to be the name on the loan and

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<sup>189</sup> *Roth Steel Tube Co. v. Comm’r*, 800 F.2d 625, 630 (6th Cir. 1986).

<sup>190</sup> *Cf. In re Autostyle Plastics, Inc.*, 269 F.3d at 746–47 (discussed by the court in the context of equitable subordination, but applicable to recharacterization as well).

<sup>191</sup> *E.g., id.* at 752.

personally guarantee the transaction as he would his own loan. Removing this element simply removes the middleman.

In *Autostyle Plastics*, the court reasoned that “the fact that no reasonable creditor would have acted in the same manner is strong evidence that the advances were capital contributions rather than loans.”<sup>192</sup> However, most courts have acknowledged that a near-bankrupt corporation may very likely only be able to receive debt financing from stakeholders or insiders with an interest in the company. The fact the lender also has an equity interest does not eliminate their ability to give an additional loan to the corporation, separate from their equity stake. For this reason, the ability of the corporation to obtain loans from outside lending instruments does not need to be a factor.

It would be unfair to penalize the transaction simply because the parties involved are insiders. If the transaction would otherwise indicate a strong debtor-creditor relationship, it is unjust to treat inside parties differently simply because of their proximity to the corporation provided all other benchmarks of a proper loan are met.

*c. Name Given to the Instrument*

Next, the name given to the instrument factor should not be considered for two reasons. First, it can be included in the intent analysis as stated above because the name given to the instrument is indicative of the subjective intent of the parties. Additionally, courts have found that they are “not required to accept the label of debt or equity placed by the debtor upon a particular transaction but must inquire into the actual name of a transaction to determine how best to characterize it.”<sup>193</sup>

*d. Whether Advances Were Used to Acquire Capital Assets*

Courts consider this factor by determining whether the funds advanced are used “to meet the daily operating needs of the corporation” or “to purchase capital assets.”<sup>194</sup> As argued by David A. Skeel and Georg Krause-Vilmar in *Recharacterization and the Nonhindrance of Creditors*, “a company’s financial condition is not always a good barometer of whether a loan is justified: if the

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<sup>192</sup> *Id.*

<sup>193</sup> *In re Cold Harbor Assocs., L.P.*, 204 B.R. 904, 918 (Bankr. E.D. Va. 1997).

<sup>194</sup> *In re Autostyle Plastics, Inc.*, 269 F.3d at 752 (Advances to meet operating needs are indicative of indebtedness.).

project is a good one, the loan should be encouraged even if the company is heavily indebted.”<sup>195</sup> Although sometimes advancing funds for capital assets is indicative of growth, it is in no way certain. For example, a near bankruptcy corporation may request funds for capital assets as one last ditch effort to become profitable. This use seems wholly irrelevant when determining the true nature of the transaction, and as such, should not be considered in the recharacterization analysis.

#### *F. Clear Error as the Recommended Standard of Review*

Although clear error is the strictest standard of review, courts should apply this standard in reviewing a judicial recharacterization of debt to equity. The true intent of the transaction should be the most indicative factor when determining if a loan was truly an equity investment.

Additionally, a clear error standard of review gives bankruptcy courts the authority to make the factual determinations that may not be reversed unless clearly erroneous. Since bankruptcy courts are charged with the most specific understanding of the Code, it makes sense to give deferential treatment to their understanding of the facts of a case as impacted by a debtor’s filing of bankruptcy.

##### *1. An Alternative to Codification: Supreme Court Decision*

If the concept of recharacterization is never codified, there is still a way to reduce confusion and secure the rights of creditors and debtors. The Supreme Court could take a case regarding recharacterization to resolve the split among the circuit courts. In that case, many of the same goals would be met. Although it would be more ambiguous than a clear and well-drafted statute on the matter, the effect would still be to bind the circuit courts and provide consistent precedent for them to follow.

In the event the Court does take a case regarding recharacterization, it would be important for the Court to address all the issues in the recharacterization analysis to ensure cross-circuit confusion is eliminated. For example, if the Court listed the factors it considered but did not weigh them, it would only narrow the current analysis slightly, which is not enough. To be beneficial, the Court would need to pick the case carefully and do a full analysis.

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<sup>195</sup> Skeel and Vilmar, *supra* note 163, at 278.

It would be difficult to predict the outcome of the Court's decision, since the circuit courts' rationales and tests spread such a wide variety. It seems there are also persuasive arguments to say the Supreme Court could decide there is no authority for a court to recharacterize debt as equity or to uphold a majority of the circuit courts an allow recharacterization under § 105(a) or § 502(b).

The Court's decision would eliminate the discrepancy between the circuit courts if it addressed the source of authority for recharacterization, the factors that should be used and how to weigh them, and the standard of review on appeal. Alternatively, the Court might find there is no authority for recharacterization, putting an end to judicial recharacterization as currently practiced. It would be up to Congress to create that authority by means of a statute. If the proponents of the legislative acquiescence arguments were correct, and the legislature approved of this action all along, it would not be unfeasible to propose a statute.

Although this alternative is less desirable than a statute delineating the issues discussed in this note, even this solution would create a more secure environment for lenders, precedent for judges, and certainty for debtors. Interestingly, even though there has been a division among the circuits with many issues of recharacterization since 1986, the Court has never taken a case addressing the issue.

#### CONCLUSION

Codifying recharacterization will make capital more fluid. Lenders will be less constrained to invest in struggling businesses because they will recoup their losses in the event things go south. This codification will have broad benefits for investors, clarity for the courts, and no negative ramifications.

Currently, lenders have no predictability surrounding their transactions. There are too many litigious issues. First, does a bankruptcy court have authority to recharacterize the transaction? If yes, then what factors shall the court consider and how will the factors be analyzed? And finally, when the case goes up on appeal, what standard of review shall the recharacterization face? Recognizing the policy needs for a doctrine of this type, the majority of bankruptcy courts that have faced the issue allow recharacterization as an equitable measure.

Although the majority of circuits find authority to recharacterize claims pursuant to § 105(a) and § 502(b) of the Code, those provisions do not explicitly authorize recharacterization. Recognizing the need for a recharacterization

scheme, beyond the elements of equitable subordination, judicial recharacterization should be codified and clarified.

Instead of considering a myriad of thirteen, seven, or six inconsistent and unweighted factors, courts should consider only the following factors in a recharacterization analysis: (1) intent of the parties; (2) presence/absence of a fixed maturity date/schedule of payment; (3) source of payment; (4) presence/absence of fixed interest payments; and (5) the security interest for the advances. Because these factors are indicative of the true nature of the transaction, they are most helpful in determining whether a debt-to-equity recharacterization is proper.

Finally, courts should apply the clear error standard of review to a lower court's decision to recharacterize. The five proposed factors can be determined through a fact-based inquiry. As such, the bankruptcy courts are the fact finders and are entitled to the common standard for questions of fact, clear error.

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