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Debt Equity:

Recharacterization of debt in bankruptcy proceedings – and what to do about it

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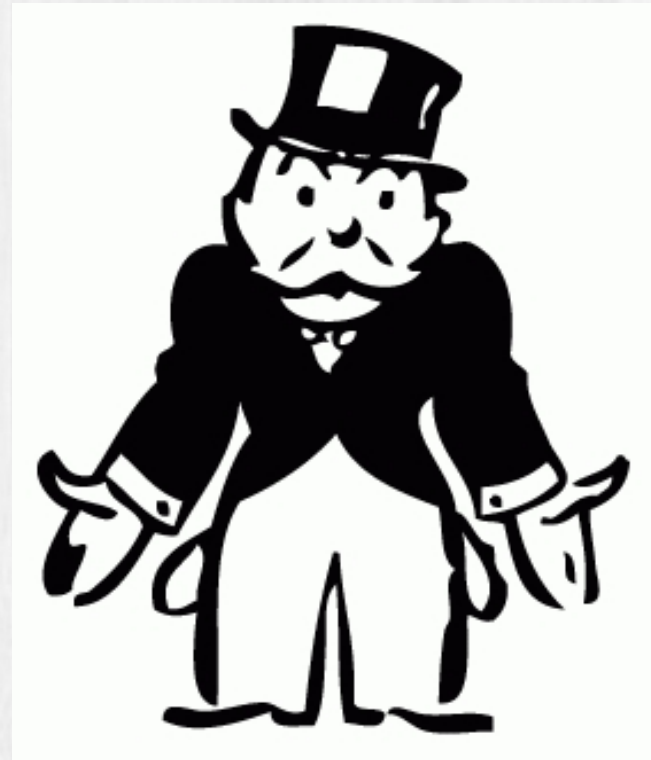
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A Common Scenario:

- Your client invested in a real estate or commercial venture that is now struggling
- The client decides to “prop up” the initial equity investment with a loan that *should* fund the venture until it recovers
- Recovery never arrives
- Other creditors argue the loan should be recharacterized as “equity”
- *What happened?*



Several Circuits Have Historically Recognized Recharacterization

In re N & D Properties, Inc., 799 F.2d 726 (11th Cir. 1986)

The Eleventh Circuit:

- ✓ Declined to recharacterize shareholder's loans
- ✓ "Shareholder loans may be deemed capital contributions in one of two circumstances: where the trustee proves initial undercapitalization or where the trustee proves that the loans were made when no other disinterested lender would have extended credit."
799 F.2d at 733
- ✓ Permitted equitable subordination

Several Circuits Have Historically Recognized Recharacterization

In re Autostyle Plastics, Inc., 269 F.3d 726 (6th Cir. 2001)

- ✓ Shareholders' indirect funding via "participation agreements" with senior lender weren't equity.
- ✓ Lack of principal repayment schedule not dispositive.
- ✓ Inadequate capitalization less important under the circumstances.

Several Circuits Have Historically Recognized Recharacterization

In re Hedged-Investments Associates, Inc., 380 F.3d 1292 (10th Cir. 2004)

| <i>Debt?</i> | <i>Equity?</i> |
|---|--|
| Transactional documents treating the fund as a loan | Absence of a fixed loan maturity date |
| Lender's right to enforce principal and interest | Debtor's "thin" capitalization |
| Lack of management control | Debtor's payment of lender's interest out of a pooled investment account |
| Lack of subordination to other creditors | |
| Availability of other funding | |
| Intent of the parties | |

Several Circuits Have Historically Recognized Recharacterization

In re SubMicron Sys. Corp., 432 F.3d 448 (3d Cir. 2006)

- ✓ Court acknowledged Bankruptcy Courts' inherent equitable powers, but declined to recharacterize loan to distressed company as equity
- ✓ Contractual language important
- ✓ Borrower's distress and lender's participation on borrower's board not dispositive
- ✓ Recently followed in *United States v. State St. Bank & Trust Co. (In re Scott Cable Communic'n, Inc.)*, 520 B.R. 29 (Bankr. D. Del., 2014)

Several Circuits Have Historically Recognized Recharacterization

In re Dornier Aviation, Inc., 453 F.3d 225 (4th Cir. 2006)

- ✓ Court invoked equitable powers (11 U.S.C. 105(a)) to recharacterize debt as equity.
- ✓ Lender was a parent of the debtor (insider).
- ✓ Lack of fixed maturity date.
- ✓ Debtor did not have to repay loan until it became profitable.
- ✓ Debtor had long history of unprofitability and financial dependence on its corporate parent.
- ✓ Debtor was insolvent at the time of the loan.
- ✓ Lender/parent assumed debtor's losses.

Several Circuits Have Historically Recognized Recharacterization

A majority of Circuits have relied on Bankruptcy Courts' inherent ***equitable powers under Section 105(a)*** for authority to recharacterize, and has borrowed heavily from tax law in determining whether an advance to a corporation is in the nature of debt or equity.



Several Circuits Have Historically Recognized Recharacterization

In re Lothian Oil Inc., 650 F.3d 539, 543 (5th Cir. 2011)

- ✓ Court upheld recharacterization of non-insider's loans to debtor.
- ✓ Anticipated payments were to be derived from royalties and proceeds from debtor's "equity placements"
- ✓ Documents lacked any specified interest rate, term of repayment, and maturity date

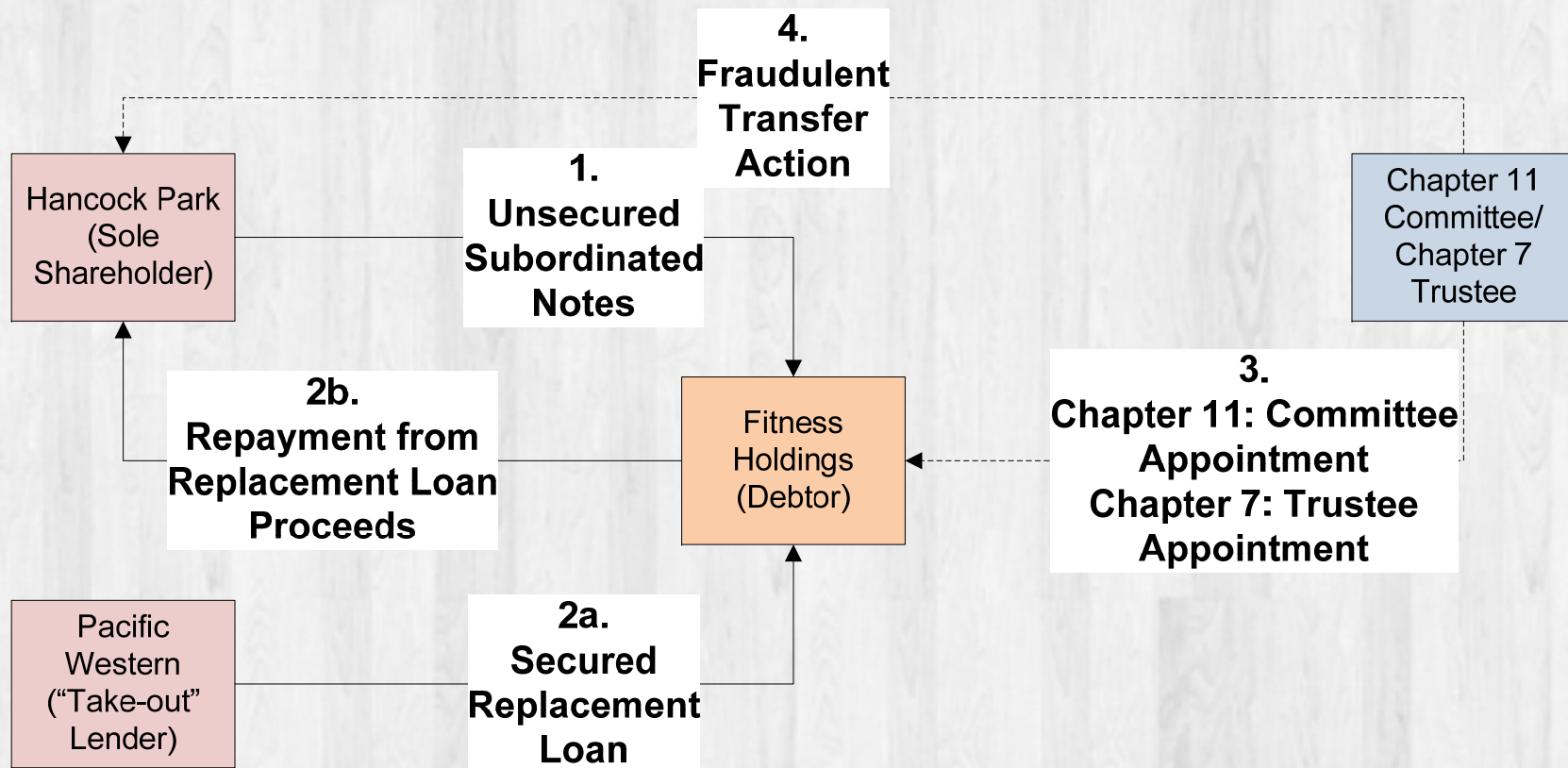
Several Circuits Have Historically Recognized Recharacterization

The Fifth Circuit relied on Supreme Court precedent and Section 502(b) – not the Bankruptcy Court’s equitable powers – as the basis for recharacterization.

“The Supreme Court has held that the ‘applicable law’ [under Section 502(b)] is state law *Butner v. United States*, 440 U.S. 48, 54, 99 S.Ct. 914, 918, 59 L.Ed.2d 136 (1979). . . . Our analysis of ‘applicable law’ under § 502(b) is therefore an application of state law, unless Congress has stated otherwise. ***Taken together, Butner and § 502(b) support the bankruptcy courts’ authority to recharacterize claims.***” *In re Lothian Oil Inc.*, 650 F.3d 539, 543 (5th Cir. 2011) (emphasis supplied).



The Ninth Circuit Followed Lothian Oil In Fitness Holdings 714 F.3d 1141 (9th Cir. 2013)



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“We interpret [the trustee’s recharacterization] claim as a request for a determination that Fitness Holdings’ transfer to Hancock Park was not made in repayment of a ‘debt’ as that term is defined in the Code. 11 U.S.C. § 101(12).” 714 F.3d 1141, 1145, n.4 (9th Cir. 2013).

The Ninth Circuit Followed Lothian Oil In Fitness Holdings 714 F.3d 1141 (9th Cir. 2013)

“Value”

- “In construing the statutory requirement that the debtor ‘received less than a reasonably equivalent **value** in exchange for such transfer or obligation,’ § 548(a)(1)(B)(i), . . . ‘[v]alue’ . . . includes the ‘satisfaction or securing of a present or antecedent **debt** of the debtor.’ § 548(d)(2)(A).” 714 F.3d at 1145.

“Debt”

- “We next address the definition of the term ‘**debt**.’ . . . The Code . . . broadly defines ‘debt’ as liability on virtually any type of ‘**right to payment**.’ Under these interlocking definitions, to the extent a transfer is made in satisfaction of a ‘claim’ (i.e., a ‘right to payment’), that transfer is made for ‘reasonably equivalent value’ for purposes of § 548(a)(1)(B)(i). And a determination that a transfer was made for ‘reasonably equivalent value’ precludes a determination that it was constructively fraudulent under § 548(a)(1)(B).” *Id.* at 1146.

“Right to Payment”

- “This analysis raises the further question of how courts are to determine whether there is a ‘**right to payment**’ that constitutes a ‘claim’ under the Code. Supreme Court precedent establishes that, unless Congress has spoken, **the nature and scope of a right to payment is determined by state law.**” *Id.*

Recharacterization

- “Therefore, in an action to avoid a transfer as constructively fraudulent under § 548(a)(1)(B), if any party claims that the transfer constituted the repayment of a debt (and thus was a transfer for ‘reasonably equivalent value’), **the court must determine whether the purported ‘debt’ constituted a right to payment under state law. If it did not, the court may recharacterize the debtor’s obligation to the transferee under state law principles.**” *Id.* at 1147.

Recharacterization and “State Law”: What Factors Apply?

Delaware

The “question of whether or not the holder of a particular instrument is a stockholder or a creditor depends upon the terms of his contract.” *Wolfensohn v. Madison Fund, Inc.*, 253 A.2d 72, 75 (Del. 1969) (when preferred stock holders received debentures and certificates to eliminate arrearage in corporate debt, issuance of debentures and certificates created a debtor-creditor relationship).

Delaware courts have considered numerous factors to determine whether a debtor-creditor relationship was created, including: (1) the name given to the instrument; (2) the right to enforce payment of principal and interest; (3) presence or absence of a fixed maturity date; and (4) presence or absence of right to share in profits or participate in management. *Moore v. American Fin. & Secs. Co.*, 73 A.2d 47, 47-48 (Del. Ch. 1950) (holders of certificates should be treated as stockholders and not creditors because of lack of definite maturity date).

California



Recharacterization and “State Law”: What Factors Apply?

Lothian Oil cited a “menu” of multi-factor tests (derived from tax decisions), which together incorporate 20 separate factors; 9 of them common to all tests:

| Relationships | Transaction | Documents | Performance |
|--|--|--------------------------------|------------------------------|
| Identity of shareholders and creditors* | Intent of the parties* | Denomination of instrument(s)* | Source of interest payments* |
| Holder’s participation in management* | Availability of funds from outside sources* | Fixed rate of interest? | Source of payments |
| Relationship of would-be “creditors” to general creditors* | Capital structure <i>vis á vis</i> debt* | Payment contingencies? | Failure to pay? |
| Holder’s voting power | Transactional risk | Fixed maturity date* | |
| | Timing of advance <i>vis á vis</i> corporate formation | Borrower’s redemption rights | |
| | Use of funds: Capital asset purchase? | Holder’s redemption rights | |
| | | Enforcement rights | *Common factors |

What Recharacterization *Isn't*

Debt Recharacterization v. Equitable Subordination (11 U.S.C. § 510(c)):

Recharacterization

A judge-made doctrine by which a court may deem a debt to be an equity investment to better match the intent of the parties.

Equitable Subordination

Authorized by statute (11 U.S.C. § 510(c)) and authorizes a court to subordinate a claim to remedy a harm to creditors arising from inequitable conduct by the claimant.

Recharacterization and equitable subordination are usually presented in the same complaint and are often alleged together.

What Recharacterization *Isn't*

Mandatory Subordination of Securities-Related Claims Under Section 510(b)

Contractual Subordination Under Section 510(a) – Subordination agreements are enforceable to the same extent as non-bankruptcy law permits.



“You only find out who is swimming *naked* when the tide goes out.”



- Warren Buffett

How To Avoid Swimming Naked: Transactional Tips

Context is critical:

- ✓ How are similarly capitalized firms funded? Are outside funds available?
- ✓ How are the funds to be used?
- ✓ Is the funding part of a larger restructuring?
- ✓ What is the pre-existing relationship between the lender and the borrower?
- ✓ Where possible, monitor post-funding performance.

Form is important:

- ✓ Form of documentation?
- ✓ Maturity date?
- ✓ Interest?
- ✓ Redemption and enforcement rights?
- ✓ Contingencies?

Deal structure is important:

- ✓ *AutoStyle*

Questions?



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