
Subordination and Recharacterization of Claims in Bankruptcy

PRESENTED BY INSOLVENCY LAW COMMITTEE, CALIFORNIA LAWYERS ASSOCIATION

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Panelists:

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*Equitable Subordination of
Claims in Bankruptcy*

Evolution of Equitable Subordination

- ▶ In bankruptcy, claims or interests generally fall into one of the following classes:
 - ▶ Administrative Claims
 - ▶ Secured Claims (to the extent of the value of the collateral)
 - ▶ Unsecured Claims
 - ▶ Equity Interests
- ▶ Equitable subordination occurs when a court applies equitable reasons to alter the general distribution scheme provided under the Bankruptcy Code (i.e., secured claims, administrative and other priority claims, general unsecured claims, and equity interests).

Evolution of Equitable Subordination

▶ Pre-Code Supreme Court Cases

▶ *Taylor v. Standard Gas & Electric Company*, 306 U.S. 307 (1939):

- ▶ Where actions of corporate parent were responsible for insolvency of subsidiary, parent's bankruptcy claim was subordinated to the interests of the subsidiary's other stockholders.

▶ *Pepper v. Litton*, 308 U.S. 295 (1939):

- ▶ Where the controlling stockholder of a company made a salary claim against its bankruptcy estate, the district court correctly disallowed the claim, which had lied dormant for years and was only enforced when the debtor was in financial difficulty. The Supreme Court found the stockholder was perpetrating a fraudulent plan to defeat the company's other creditors.

▶ *Comstock v. Group of Institutional Investors*, 335 U.S. 211 (1948):

- ▶ A claim against a debtor subsidiary should be disallowed or subordinated when the parent wholly dominated and controlled it and in creating the subsidiary's debt to the parent breached its fiduciary duty and acted in its own benefit and to the detriment of the debtor.

Evolution of Equitable Subordination

- ▶ Bankruptcy Code Section 510(c) (11 U.S.C. § 510(c)):
 - ▶ 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 a subordinated claim be transferred to the estate.
- ▶ Legislative History:
 - ▶ Congress envisioned the doctrine of equitable subordination would continue to evolve over time.
- ▶ Equitable subordination of claims is typically sought through an adversary proceedings, but can also be asserted in a Chapter 11 plan. *See* F.R.B.P. 7001(8).

Evolution of Equitable Subordination

- ▶ Common circumstances where courts apply equitable subordination:
 - ▶ Where a fiduciary abuses its position with the debtor to the disadvantage of other creditors.
 - ▶ Where a third party exercises control over the debtor, to the detriment of other creditors.
 - ▶ Where a third party defrauds other creditors or engages in other inequitable conduct that results in harm to creditors.
- ▶ Guiding principles:
 - ▶ Equitable subordination resets the regular distribution scheme to correct harm caused by inequitable or fraudulent conduct.
 - ▶ Equitable subordination serves a remedial purpose and only exists to the extent necessary to correct the harm caused.
 - ▶ Equitable subordination is discretionary, not mandatory.

Elements of Equitable Subordination

▶ *Mobile Steel Factors*

- ▶ *Benjamin v. Diamond (In re Mobile Steel Co.)*, 563 F.2d 692 (5th Cir. 1977) is considered a “landmark” case establishing factors for imposing equitable subordination.
 - ▶ The claimant committed fraud or engaged in other inequitable conduct.
 - ▶ The wrongdoer’s conduct harmed other creditors or gave the wrongdoer an unfair advantage.
 - ▶ The subordination of the claim will not be contrary to or inconsistent with the principles of bankruptcy law.

Elements of Equitable Subordination

- ▶ **1. “Claimant committed fraud or engages in other inequitable conduct”**
 - ▶ Fraud, illegality and breach of fiduciary duties;
 - ▶ Substitution of debt for capital when a company is undercapitalized; and/or
 - ▶ Claimant’s use of the debtor as its alter ego/instrumentality.

Elements of Equitable Subordination

- ▶ Typical situations where a claimant has committed fraud or engaged in other inequitable conduct:
 - ▶ Fiduciary of the debtor misuses their position to the disadvantage of other creditors.
 - ▶ Parties seeking equitable subordination must show, by a preponderance of the evidence, that they have a substantial basis in fact to support allegations of impropriety.
 - ▶ Insiders are subject to “rigorous scrutiny.” *See, e.g., In re AutoStyle Plastics, Inc.*, 269 F.3d 726 (6th Cir. 2001).
 - ▶ Insiders have the burden to establish both “the inherent fairness” and the “good faith” nature of the transaction being challenged.
 - ▶ Exception: “No Fault” equitable subordination of certain claims (*e.g.*, tax penalty claims) based upon the nature or origin of the claim, as opposed to the claimant’s conduct.

Elements of Equitable Subordination

- ▶ Criminal Activity
- ▶ Breaches of fiduciary duties
- ▶ Actual fraud

Who is an insider?

▶ Statutory Insiders

- ▶ Specified in 11 U.S.C. § 101(31)
- ▶ A director
- ▶ An officer
- ▶ A “person in control”
- ▶ A general partner
- ▶ A relative of an insider
- ▶ An affiliate of the debtor at the time of the transaction to be avoided

▶ Non-Statutory Insiders

- ▶ Fact-specific judicial inquiry requiring:
- ▶ A “close relationship” between the creditor and the debtor; and
- ▶ A non-arms'-length transaction

Equitable Subordination: Insiders

- ▶ Typical situations where a claimant has committed fraud or engaged in other inequitable conduct
 - ▶ Where an insider purchases claims against the debtor during bankruptcy (i) for the dual purpose of profit making and to exert influence over the reorganization; (ii) with the benefit of non-public information acquired as a fiduciary; and (iii) where the insider did not make adequate disclosure of its purchasing plans.
 - ▶ *In re Papercraft Corp.*, 160 F.3d 982 (3d Cir. 1998)
 - ▶ Where an insider induced a creditor to extend credit despite knowing of a debtor's failing financial condition and presented a fraudulent corporate resolution to open a new bank account to prevent an existing bank from exercising its right of setoff.
 - ▶ *In re Fabricators*, 926 F.2d 1458 (5th Cir. 1991)
- ▶ Important to note that insider status **alone** is not sufficient to equitably subordinate a claim. *AutoStyle Plastics*, 269 F.3d at 745.

Equitable Subordination: Fraud & Inequitable Conduct

- ▶ Typical situations where a claimant has committed fraud or engaged in other inequitable conduct
 - ▶ Where a third party controls the debtor to the disadvantage of other creditors.
 - ▶ If the lender “exercise[d] . . . such total control over the debtor as to have essentially replaced its decision-making capacity with that of the lender”
 - ▶ *In re Clark Pipe & Supply Co.*, 893 F.2d 693 (5th Cir. 1990)
 - ▶ *See also In re Heartland Chemicals, Inc.*, 136 B.R. 503 (Bankr. C.D. Ill. 1992)

Equitable Subordination: Alter Ego

- ▶ Claimant's Use of the Debtor as its "Alter Ego" or Instrumentality
 - ▶ For non-insiders/non-fiduciaries, courts have generally not found "control" in the creditor's exercise of its negotiated contractual rights.
 - ▶ A lender is held to a fiduciary standard only when it usurps the borrower's ability to make business decisions
 - ▶ If a lender takes away a borrower's authority to make business decisions, it is held to the same fiduciary obligations that officers and directors owe to the corporation and its creditors
 - ▶ *In re Auto Specialties Mfg. Co.*, 153 B.R. 457, 478 (Bankr. W.D. Mich. 1993)

Equitable Subordination: Non-Insiders

- ▶ Non-insiders usually must be found to have engaged in specific conduct giving rise to a fiduciary, contractual, or other legally recognized duty to other creditors before their claims will be equitably subordinated, **but not always**.
- ▶ *Yellowstone Mountain Club* involved the effective equitable subordination of a non-insider and non-fiduciary secured lender group led by Credit Suisse that provided an exotic credit facility to a fledgling ultra-luxury, residential skiing development founded by Timothy Blixseth. He extracted \$200M+ before the project's collapse into bankruptcy.

Equitable Subordination: Non-Insiders

- ▶ “Credit Suisse’s actions in the case were so far overreaching and self-serving that they shocked the conscience of the Court.”
 - Loan facility featured low due-diligence, unverified inflated projections, was non-recourse, permitted proceeds to be used for unrelated purposes, and designed to allow developers to take profits upfront and Credit Suisse to earn substantial fees.
 - Equitable subordination order was later vacated at the request of the parties in connection with a settlement. See, *Partial & Interim Order*, 2009 WL 3094930 (Bankr. D. Mont. May 12, 2009), *vacated*, No. 08-61570-11-RBK, 2009 WL 10624435 (Bankr. D. Mont. June 29, 2009).
- ▶ Court later said it “will not at this time enter an order that would in any way benefit Credit Suisse, the Prepetition Lenders or other parties who have speculated on a monumental award against Blixseth” and awarded damages in an amount sufficient to pay all allowed claims **except** those of Credit Suisse and the prepetition lenders (and to cover the liquidating trust’s expenses). *In re Yellowstone Mountain Club, LLC*, 436 B.R. 598 (Bankr. D. Mont. 2010).

Equitable Subordination: Strategic Debt Purchases

- ▶ *In re Lightsquared Inc.*, 611 B.R. 253 (Bankr. S.D.N.Y. 2014)
 - ▶ Charles Ergen, chairman and majority owner of Echostar and DISH Network, used a personal investment vehicle to acquire a strategic debt position in LightSquared, a competitor of his two companies.
 - ▶ Bankruptcy court concludes equitable subordination of Ergen’s personal investment vehicle’s claims is appropriate remedy. Ergen’s investment was made for the benefit of DISH, and although not technically prohibited, was an end-run around the eligible assignee provisions of LightSquared’s credit agreement.
 - ▶ This was “creditor misconduct in connection with the chapter 11 process itself [that] provides an appropriate predicate for equitable subordination of such creditor’s claim.”

Elements of Equitable Subordination

- ▶ Typical situations where a claimant has committed fraud or engaged in other inequitable conduct
 - ▶ Evidence that a lender is exercising “control” over a borrower:
 - Stock ownership
 - Interference with business operations
 - Participation in management decisions
 - Directing which creditors to pay
 - Placement of lender’s employees as directors and officers
 - Hiring and firing personnel
 - Participation in shareholder meetings
 - Participation in management meetings
 - Scrutiny of borrower’s financial affairs becomes effective control of day-to-day management
 - Not dealing with debtor at arms’-length
 - Debtor must follow “advice” of lender
 - Loan not arms’-length bargain
 - Lender exceeds authority under loan agreement
 - Lender requires borrower to hire an outside manager
 - Lender assesses excessive “soft costs” against borrower’s accounts

Limits on Doctrine vis-à-vis Lenders

- ▶ Important to note that courts have recognized many legitimate exercises of rights and powers by lenders that do **not** rise to level of “control” and are not deemed to be inequitable conduct:
- ▶ *See, e.g., In re American Consolidated Transportation Companies, Inc.*, 433 B.R. 242, 254 (Bankr. N.D. Ill. 2010)
- ▶ “In contrast, control is not established when a lender insists on standard loan agreement restrictions, closely monitors the borrower's finances, and makes business recommendations, even in the context of heated negotiations . . . Nor is control established when a borrower hires a management or restructuring consultant selected by the lender.”

Limits on Doctrine vis-à-vis Lenders

- ▶ **See also *In re Prima Co.*, 98 F.2d 953, 965 (7th Cir.), cert. denied, 305 U.S. 658 (1938)**
 - ▶ “Aside from the provisions of the bankruptcy law, a creditor has a right to call a loan when due and to lawfully enforce collection. He may refuse an extension for any cause which may seem proper to him, or even without any cause. The law provides certain means for the enforcement of claims by creditors. The exercise of those rights is not inherently wrongful.”
- ▶ ***In re Prince Frederick Inv., LLC*, 516 B.R. 778 (Bankr. D. Md. 2014)**
 - ▶ Bank exercising approval rights on construction draws and change orders, as provided in loan documents, did not rise to level of exercising dominion and control over borrower.
- ▶ **See generally *Kham & Nate’s Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1356 (7th Cir. 1990)**
 - ▶ “Contracts specify the duties of the parties to each other, and each may exercise the privileges it obtained.”

Elements of Equitable Subordination

- ▶ Undercapitalization
 - ▶ Typically occurs when insiders convert their equity interests to debt in anticipation of bankruptcy.
 - ▶ Initial undercapitalization generally does not support an equitable subordination claim.
 - ▶ Generally additional inequitable conduct must occur during the course of a lending transaction.
 - ▶ A finding of undercapitalization requires evidence of deception of the debtor's financial position or other misconduct.

Elements of Equitable Subordination

▶ Undercapitalization

- ▶ *Mobile Steel* created a two-part test for establishing undercapitalization for equitable subordination:

(1) Capitalization is inadequate if, in the opinion of a skilled financial analyst, it would definitely be insufficient to support a business the size and nature of the bankrupt in light of the circumstances existing at the time the bankrupt was capitalized; and

(2) Capitalization is inadequate if, at the time when the advances were made, the bankrupt could not have borrowed a similar amount of money from an informed outside source.

Elements of Equitable Subordination

- ▶ **2. “The Wrongdoer’s conduct harmed other creditors or gave the wrongdoer an unfair advantage.”**
 - ▶ Requires a showing of (1) unfair advantage to misbehaving creditor or (2) harm to the debtor or its other creditors.
 - ▶ A majority of courts only require a showing of one of these.
 - ▶ Good faith by a claimant will not negate harm caused to the debtor or its other creditors.
 - ▶ Creditors who benefit from the subordination of the claim must be the same creditors injured by the inequitable conduct.
 - ▶ An injury occurs where there is inequitable conduct by a claimant shortly before bankruptcy or while a debtor is in financial distress.
 - ▶ Injury occurs where general creditors are less likely to collect their debts.
 - ▶ Quantifying the harm is helpful to establish whether equitable subordination is proportional, but is not a requirement for equitable subordination.

Elements of Equitable Subordination

- ▶ **3. “The subordination of the claim will not be contrary to the principles of bankruptcy law.”**
 - ▶ Debtor cannot deny first priority to non-compensatory, post-petition tax penalty claims under guise of equitable subordination. *United States v. Noland*, 517 U.S. 535 (1996).
 - ▶ Court said third element is a “reminder to the bankruptcy court that although it is a court of equity, it is not free to adjust the legally valid claim of an innocent party who asserts the claim in good faith merely because the court perceives the result is inequitable.” *Id.* at 539.
 - ▶ Bankruptcy courts cannot reorder the priorities of the Bankruptcy Code based on categorical determinations that claims “by their very nature” deserve subordination.
 - ▶ “The circumstances that prompt a court to order equitable subordination must not occur at the level of policy choice at which Congress itself operated in drafting the Code.” *Id.* at 543.
 - ▶ Some courts have questioned the continuing need for this 3rd prong in light of the codification of equitable subordination under the Bankruptcy Code.
 - ▶ Availability of alternative remedies under the Bankruptcy Code and Bankruptcy Rules does not preclude equitable subordination.

Equitable Subordination – Burden of Proof

- ▶ A party seeking equitable subordination must prove all of the required elements.
 - ▶ If the proponent of equitable subordination establishes injury, the burden shifts to the creditor being subordinated to show that (1) the injury was discrete in nature, and (2) the court cannot determine the amount of harm done without undue complication.
 - ▶ If the subordinated creditor shows the value of its claim exceeds the damage caused by its conduct, the court will likely limit equitable subordination to an appropriate partial amount. *See Mobile Steel*, 563 F.2d at 701 (“claims should be subordinated only to the extent necessary to offset the harm which the bankrupt and its creditors suffered on account of the inequitable conduct”).
 - ▶ If the court cannot identify the nature and extent of the injury, it can subordinate the entire claim.
- ▶ Standard is heightened for non-insiders/non-fiduciaries.
 - ▶ Proving that an outside creditor behaved inequitably in anticipation of a debtor’s bankruptcy is difficult as the interests of the outside creditor and the debtor are not necessarily aligned.
 - ▶ Cases subordinating claims of creditors that dealt at arms’ length with the debtor are “few and far between.” *In re Sentinel Mgmt. Grp.*, 728 F.3d 660, 669-70 (7th Cir. 2013).

Equitable Subordination of Transferred Claims

- ▶ “Good Faith Transferee” Defense?
 - ▶ Bankruptcy Code Section 550(b) protects good faith transferees of transfers avoidable pursuant to Section 547 (preferences) and 548 (fraudulent transfers).
 - ▶ Section 510(c) does not specifically provide for a “good faith” defense for purchasers of claims subject to equitable subordination.
 - ▶ *Enron Corp. v. Springfield Assocs., LLC (In re Enron Corp.)*, 379 B.R. 425 (S.D.N.Y. 2007):
 - ▶ Finding that Congress did not intend to punish an innocent transferee of a claim subject to subordination under Section 510(c) due to creditor acted inequitably
 - ▶ Whether equitable subordination applies to a transferred claim depends on the means of transfer
 - ▶ If a claim is “assigned” the equitable subordination travels with the claim; if a claim is “sold,” the transferee takes the claim free of the equitable subordination

Equitable Subordination of Transferred Claims

- ▶ *Enron's* sale vs assignment distinction criticized as arbitrary.
 - ▶ Practical impact: claims traders change language in claim purchase agreements
- ▶ *In re Firestar Diamond, Inc.*, 615 B.R. 161 (Bankr. S.D.N.Y. 2020) (April 2020).
 - ▶ Debtors and certain non-debtor entities involved in multi-billion diamond industry fraud.
 - ▶ Banks acquiring claims of fraudsters relied on *Enron*, arguing Bankruptcy Code § 502(d) disallowance was specific to the claimant, and should not apply to the claims they now held that originally belonged to the non-debtor fraud co-participants.
- ▶ *Firestar* rejects *Enron* and the sale vs. assignment distinction.
 - ▶ Adopts Third Circuit's reasoning in *In re KB Toys, Inc.* 736 F.3d 247 (3d Cir. 2013) that the susceptibility of a claim to disallowance exists regardless of who holds the claim.

Comparing Equitable Subordination and Recharacterization

▶ Similarities:

- ▶ Both permit the bankruptcy court to reorder distributions of the debtor's assets.
- ▶ Both have undercapitalization as an element.

▶ Differences:

- ▶ Equitable subordination is (or may be) partial while recharacterization impacts the entire claim.
- ▶ Equitable subordination looks at the parties' harmful behavior whereas recharacterization only looks at the substance of a particular transaction.

How to Avoid Equitable Subordination

- ▶ Practice Pointers:
 - ▶ Keep transactions at arms' length.
 - ▶ Loans should be properly documented with interest rates, maturity dates and/or amortization schedules, provide for remedies, and be secured (if possible).
 - ▶ Adhere to the borrower's governance procedures and the loan documents – lenders can rigorously enforce bargained-for contractual rights, even if net effect may potentially be detrimental to other constituents.
 - ▶ Nonetheless, lenders should consider how actions will impact the borrower's other creditors.
 - ▶ Insiders
 - ▶ Don't lend money to undercapitalized or insolvent companies.

How to Avoid Equitable Subordination

- ▶ Anticipate and prepare for potential litigation:
 - ▶ Document all arms' length negotiations.
 - ▶ Conduct due diligence into borrower's solvency, operations and contractual relationships.
 - ▶ Respect borrower's corporate governance procedures.
 - ▶ Follow contractual remedies and record only objective facts and observations.
 - ▶ Memorializing subjective comments in writing (e.g., internal memos) may later be viewed as evidence of improper intent by creditor.
 - ▶ Such matters may be better communicated by telephone, rather than written down.

Standing

- ▶ Prudential Standing
 - ▶ **General Claims** – Where there is no particularized injury and the claim could be brought by any creditor of the debtor, the **trustee** is the proper party to assert the claim.
 - ▶ The creditors are bound by the outcome of the trustee’s action.
 - ▶ A creditor’s committee cannot assert an equitable subordination claim for a particular creditor absent special court authorization.
 - ▶ In the limited authority available, the majority view is a chapter 11 debtor-in-possession has standing to bring an equitable subordination claim.
 - ▶ *Reagor Auto Mall, Ltd. v. Firstcapital Bank of Texas, N.A. (In re Reagor-Dykes Motors, LP)*, Adv. No. 20-05002, 2020 WL 4939180, at *10 (Bankr. N.D. Tex. Aug. 24, 2020)
 - ▶ **Particular Claims** – Where a creditor has an interest uniquely affected by alleged inequitable conduct, the **individual creditor** has standing separate from the trustee

Defenses

- ▶ *In Pari Delicto* and Unclean Hands Defenses?
- ▶ Apparently not available against equitable subordination claims.
 - ▶ “A claim of equitable subordination arises under 11 U.S.C. § 510(c) rather than under non-bankruptcy law, and the limitations on the causes of action that become property of the estate under 11 U.S.C. § 541(a), such as *in pari delicto*, do not apply. *In re Bernard L. Madoff Inv. Sec. LLC*, 557 B.R. 89, 127 (Bankr. S.D.N.Y. 2016).
 - ▶ “There is no justification for applying the common law defense of unclean hands to a claim for equitable subordination under §510(c). To the contrary...permitting this defense would be inconsistent with the traditional test for equitable subordination, the substantial case law allowing subordination despite debtors' participation in wrongdoing, and the purpose of equitable subordination.” *In re Auto. Professionals, Inc.*, 398 B.R. 256, 262 (Bankr. N.D. Ill. 2008).

*Recharacterization of
Claims in Bankruptcy*

I. Introduction

- ▶ Creditor claims get paid before equity. *See e.g.*, 11 U.S.C. § 726(a)(6).
- ▶ Creditors, debtors and other parties in interest in a bankruptcy case may object to the validity and amount of competing claims to increase their share of a limited fund (the assets of a bankruptcy estate).
- ▶ Section 502(b)(1) provides that if there is an objection to a claim, the bankruptcy court "shall determine that amount of such claim. . . ." In addition, 28 U.S.C. § 157(b)(2)(B) provides that a bankruptcy court may determine the "allowance or disallowance of claims against the estate."
- ▶ Section 510 of the Bankruptcy Code provides for the subordination of:
 - (a) claims based upon a subordination agreement;
 - (b) claims arising from a security or equity interest; or
 - (c) claims tainted by inequitable conduct.

II. The Statutory Context for Recharacterization

- ▶ This section will address “recharacterization” vs. “subordination,” in which purported claims are “recharacterized” by the court as “equity” interests, and thus only entitled to payment after all “claims” are paid in full. “Recharacterization” refers to the court identifying the true nature of transaction which a claimant has identified as a claim.
- ▶ A “claim,” under Section 101(5) of the Bankruptcy Code, is defined to mean a “right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.”
- ▶ The Bankruptcy Code does not expressly address the issue of the recharacterization of claims. Thus, it has been left to the courts to determine whether it has such authority, and under what circumstances.
- ▶ Courts that have considered the issue have generally found they have the legal authority to recharacterize. However, courts disagree on the legal basis for “recharacterization.”

III. The “Equitable Remedy” Circuits

- ▶ Bankruptcy courts have the power to ignore the form of a transaction and give effect to its substance. *See Pepper v. Litton*, 308 U.S. 295, 305 (1939) (insider “salary” claims were disallowed).
- ▶ A majority of the courts recognizing recharacterization, including the Third, Fourth, Sixth, and Tenth Circuits, have found authority in the equitable powers granted by Section 105(a) of the Bankruptcy Code (“The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]”).

III. The “Equitable Remedy” Circuits

- ▶ *In re **AutoStyle Plastics, Inc.***, 269 F.3d 726 (6th Cir. 2001) (11 factors [taken from Roth Steel tax case] show transaction was loan) (“Recharacterization is appropriate where the circumstances show that a debt transaction was “actually [an] equity contribution ab initio”).
- ▶ *In re **SubMicron Sys. Corp.***, 432 F.3d 448, 454 (3d Cir. 2006) (Autostyle 11 factors and Color Test 7 factors referenced; finds that overarching inquiry is parties’ intent inferred from terms of contracts, actions, and “from the economic reality of the surrounding circumstances”) (district court denial of recharacterization upheld).
- ▶ *In re **Dornier Aviation, Inc.***, 453 F.3d 225, 231 (4th Cir. 2006) (uses Autostyle 11 factors) (district court recharacterization as equity was upheld);
- ▶ *In re **Hedged-Invs. Assocs., Inc.***, 380 F.3d 1292, 1297 (10th Cir. 2004) (13 factor test) (loan upheld);
- ▶ *In re **N D Properties, Inc.***, 799 F.2d 726, 733 (11th Cir. 1986) (trustee failed to prove initial undercapitalization or that no disinterested lender would have extended credit); see *In re **First NLC Fin. Servs.***, 415 B.R. 874, 880 (Bankr. S.D. Fla. 2009) (discussing use of multi-factor tests in the 11th Circuit)

IV. “State Law” Circuits

- ▶ Based on *Butner v. United States*, 440 U.S. 48, 54 (1979) (rights created by state law will be honored in bankruptcy unless a specific bankruptcy law provision or policy requires differently), the Fifth and Ninth Circuits, have found that recharacterization is permissible but only to the extent that applicable state law would treat an alleged “claim” or loan as a contribution to capital (an “equity” contribution).
- ▶ *In re Fitness Holdings Int’l, Inc.*, 714 F.3d 1141, 1148 (9th Cir. 2013) (remanded to district court)
- ▶ *Grossman v. Lothian Oil Inc. (In re Lothian Oil, Inc.)*, 650 F.3d 539, 542-43 (5th Cir. 2011) (relies on Texas state law to affirm bankruptcy court’s characterization of non-insider claims as equity, and refers to multi-factor tests);

IV. “State Law” Circuits

- ▶ In the Ninth Circuit, from 1986 to 2013, the prevailing law was that bankruptcy courts could only use the § 510 subordination provisions, and that “re-characterization” of alleged claims would be an impermissible exercise of a bankruptcy court’s equitable power. *In re Pacific Express, Inc.*, 69 B.R. 112 (B.A.P. 9th Cir. 1986).
- ▶ The *Pacific Express* case was reversed by the 9th Circuit in *Fitness Holdings*, which held that in addition to rights to seek subordination of claims, the Trustee in that case could seek recharacterization of the claims: “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.” 714 F.3d at 1147.

IV. State Law” Circuits

- ▶ However, it appears that no California case establishes standards for recharacterizing debt as equity. *In re L. Scott Apparel, Inc.*, 615 B.R. 881, 888-89 (C.D. Cal. 2020).
- ▶ In the absence of any state law, the district found that California courts would most likely look to the law of Delaware given its long-standing expertise on corporate issues, and in particular the Scott Apparel court adopted the 7-factor “re-characterization” test described in *In re Color Tile, Inc.* , No. 96-76 (HSB), 2000 WL 152129, at *4 (D. Del. Feb. 9, 2000).

**CA law- Scott Apparel case,
adopting Delaware Color Tile test**

**In Re Autostyle Plastics, Inc.,
269 F.3d 726, 749-50 (6th Cir. 2001) (§ 105)**

(1) the name given to the instrument;

(1) the names given to the instruments, if any, evidencing the indebtedness;

(2) the intent of the parties;

(2) the presence or absence of a fixed maturity date and schedule of payments;

(3) the presence or absence of a fixed maturity date;

(3) the presence or absence of a fixed rate of interest and interest payments;

(4) the right to enforce payment of principal and interest;

(4) the source of repayments;

(5) the presence or absence of voting rights;

(5) the adequacy or inadequacy of capitalization;

(6) the status of the contribution in relation to regular corporate contributors;

(6) the identity of interest between the creditor and the stockholder;

(7) certainty of payment in the event of the corporation's insolvency or liquidation."

(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;

(11) the presence or absence of a sinking fund to provide repayments.

V. Reviewing and Comparing the Factor Tests

- ▶ As described by the court in *Scott Apparel*, 615 B.R. at 888-89:
“These tests are similar as they all assign weight to factors depending on case circumstances and find no one factor dispositive” and noting that multi-factor tests devolve to an overarching inquiry regarding intent.
- ▶ Thus, it appears that the results achieved in the Fifth and Ninth Circuits are likely to be substantially similar to the results reached by courts that recharacterize pursuant to Section 105(a) and employ the 11-factor analytical model.

VI. Conclusion and some Practical Guidance

- ▶ When a loan complies with the formalities for a valid loan agreement and the advanced funds are treated as a loan in the borrower's business records, courts generally will not recharacterize a loan as an equity contribution, even when the borrower was undercapitalized. This is especially true for non-insider lenders.
- ▶ Different courts view recharacterization in disparate ways. The analysis is fact-intensive and has not always been consistent.
- ▶ There is essentially no "California law" on the subject, so there appears to be more room for argument that a particular test used in another context should be used. For example, the 11th Circuit has used a test for recharacterizing shareholder loans that arguably is satisfied when (1) the trustee proves initial under-capitalization, or (2) where the trustee proves that the loans were made when no other disinterested lender would have extended credit." *In re N D Properties, Inc.*, 799 F.2d 726, 733 (11th Cir. 1986).

VI. Conclusion and some Practical Guidance

- ▶ The decisions in *Scott Apparel*, 615 B.R. 881, 888-89 (C.D. Cal. 2020), and *Lothian Oil* are instructive due to their clear and focused application and analysis of the evidence adduced in relation to each of the seven and eleven factors, respectively, as to whether a particular obligation constitutes a loan or a capital contribution.
- ▶ Consistent with the lessons of these cases, a party making an advance intended to be paid back as a loan should:
 - ▶ Have formal documentation, including a promissory note
 - ▶ Use normal business terms, including interest rate and payment terms comparable to those from an unaffiliated lender –and–
 - ▶ Avoid terms that are red flags for recharacterization, such as:
 - ❖ A contingency on the obligation to repay;
 - ❖ Redemption provisions; and
 - ❖ Provisions granting voting power to the note holder

***SUBORDINATION OF
EQUITY
RELATED CLAIMS IN
BANKRUPTCY***

Subordination of Equity Related Claims under Bankruptcy Code § 510(b)

- ▶ Bankruptcy Code Section 510(b) (11 USC §510(b)) provides that a claim either:
 - (i) arising from rescission of a purchase or sale of a security of the debtor or its affiliate, or
 - (ii) for damages arising from purchase or sale of such security or
 - (iii) for reimbursement or contribution allowed on account of such claim

- ▶ “shall be subordinated to all claims or interests that are senior to or equal to the claim or interest represented by such security.”

Practical Implications of Subordination

- ▶ Bankruptcy priority scheme: creditor claims generally must be fully repaid before equity interests recover anything.
- ▶ Bankruptcy estates rarely have sufficient funds to repay all creditor claims.
- ▶ Practical effect of subordination under §510(b) is claimant often receives nothing for claim based on securities sale.

Subordination of Judgment Based on Equity Interest

- ▶ *In re Tristar Esperanza Properties, LLC*, 782 F.3d 492 (9th Cir. 2015):
- ▶ Subordinating claim under §510(b) based on judgment resulting from arbitration award on claim against LLC for repurchase of membership interest pursuant to LLC agreement.
- ▶ Whether claim is debt or equity when bankruptcy filed not dispositive; rather, key is claim's nexus with purchase or sale of a security.

Employee Compensation Payable in Stock Subordinated

- ▶ *In re Lehman Brothers Holdings Inc.*, 855 F.3d 459 (2d Cir. 2017):
- ▶ Employee claims based on restricted stock units (contingent right to purchase common stock) received as compensation subordinated
- ▶ Receipt of RSUs in exchange for labor constituted “purchase” of securities.

Employee Compensation Payable in Stock Subordinated

- ▶ *GSE Environmental, Inc. v. Sorrentino (In re GSE Environmental, Inc., No. 16-616 (D. Del. Nov. 15, 2017):*
- ▶ CEO's claim for unpaid compensation payable in stock subordinated under §510(b).
- ▶ Stock exchanged for labor constitutes equity security rather than debt claim based on employment agreement breach.

Dividend Based Claim Subordinated

- ▶ *French v. Linn Energy, L.L.C. (In re Linn Energy, LLC)*, 936 F.3d 334 (5th Cir. 2019):
- ▶ Claim based on “deemed dividends” subordinated under §510(b).
- ▶ Contractual payments by corporation each time dividends paid to shareholders were more like equity interest than creditor debt, including unlimited upside.

Contribution Claims Arising from Securities Purchase Subordinated

- ▶ *ANZ Securities, Inc. v. Giddens (In re Lehman Bros. Inc.)*, 808 F.3d, 942 (2nd Cir. 2015):
- ▶ Subordination of reimbursement and contribution claims of co-underwriters of debtor's affiliate in defending investor lawsuits
- ▶ Subordinated to claims of debtor's other creditors (although securities issued by debtor's affiliate), per statutory language.

Claim Based on Guaranty of Affiliate's Securities Subordinated

- ▶ *In re American Housing Foundation*, 785 F.3d 143 (5th Cir. 2015):
- ▶ Claims under debtor's guaranty of securities issued by debtor's affiliate subordinated under §510(b).
- ▶ Debtor guaranteed investments in limited partnerships in which it was GP (or its parent).

§510(b) Subordination Applicable to Individual Debtors

- ▶ *In re Del Baggio*, 834 F.3d 1003 (9th Cir. 2016):
- ▶ § 510(b) subordination provisions applicable when debtor is individual, even though individual cannot issue stock in himself.
- ▶ Claim based on debtor's embezzlement of funds intended for group investment.
- ▶ Overruling 9th Cir. BAP and agreeing with *In re Lehman Brothers*, 808 F.3d 942 (2d Cir. 2015).

No Subordination of Stock Conversion Claim

- ▶ *Khan v. Barton (In re Khan)*, 846 F.3d 1058 (9th Cir. 2017):
- ▶ Damage award against individual debtors for conversion of stock not subordinated as not deemed to arise from purchase or sale of securities, although based on wrongful cancellation of investor's stock, and based on stock value at time of conversion.
- ▶ Apparently resulted-oriented decision.

No Subordination of Claim Indirectly Related to Sale of Security

- ▶ *CIT Group Inc. v. Tyco Int'l, Inc. (In re CIT Group Inc.)*, No. 12-1692 (2d Cir. 2012):
- ▶ Mere connection between claim and security purchase/sale doesn't require subordination.
- ▶ Claim based on repayment of tax benefits resulting from use of affiliate's NOL's related to affiliate's purchase of debtor's securities does not arise from securities sale under §510(b).

No Subordination of Membership Units in SPVs Holding Debtor Securities

- ▶ *In re FAH Liquidating Corp.*, 563 B.R. 160 (Bankr. D. Del. 2017) [Fisker Automotive case]:
- ▶ Membership units in special purpose vehicles holding securities of debtor outside scope of §510(b) as not securities of debtor or affiliate.
- ▶ SPV established by placement agent for debtor financing but no direct connection with debtor.