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Seventh Circuit Reverses 'Inconsistent' District Court Fraudulent Transfer and Equitable Subordination Ruling

By Michael L. Cook

The U.S. Court Appeals for the Seventh Circuit held on Aug. 26, 2013, that an investment manager's "failure to keep client funds properly segregated" and subsequent pledge of those funds "to secure an overnight loan" to stay in business may have constituted: 1) a fraudulent transfer to the lender; and 2) grounds for equitably subordinating the lender's $312 million secured claim. *In re Sentinel Management Group, Inc.*, 2013 WL 4505152, *1 (7th Cir. Aug. 26, 2013) (*Sentinel II*). Reversing and remanding the case to the district court for further litigation because of "inconsistencies" in that court's opinion, the Seventh Circuit found that the debtor-manager's "pledge of segregated funds as collateral for loans" was likely a fraudulent transfer based on an "actual intent to hinder, delay or defraud" creditors under Bankruptcy Code (Code) §548(a)(1)(A). *Id*. at *6.

The court stressed that a "good faith-for-value" defense by the lender on remand will be "very difficult because it will have to prove that it was not on inquiry notice of [the debtor's] possible insolvency." *Id*. at *6-*7n.2. On remand, the lower court also must, because of "inconsistencies throughout" its opinion, "clarify … exactly" what the lender knew and whether its "failure to investigate" the debtor was "reckless" or "deliberately indifferent." *Id*. at *11.

Missing from the recent Court of Appeals decision was any mention of its earlier Aug. 9, 2012 decision (*Sentinel I*) affirming the district court on the same facts. 689 F.3d 855, 863, 866 (debtor's failure to segregate "client funds … not … sufficient to rule … that [debtor] acted with actual intent to hinder, delay or defraud its customers"; "incompetence alone, however problematic, won't require the equitable subordination of the [lender's] lien."). The plaintiff trustee, however, supported by an amicus brief from the Commodities Futures Trading Commission (CFTC),

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Recharacterization: The Debate

By James B. Sowka and Steven Schwartz

In recent years, bankruptcy courts have come closer to reaching a consensus regarding their ability to recharacterize debt into equity. Yet, beneath this consensus lies a deepening divide that lenders should be aware of. Recharacterization challenges "the assertion of a debt against the bankruptcy estate on the ground that the 'loaned' capital was actually an equity investment." *In re Insilco Techs., Inc.*, 480 F.3d 212, 217 (3d Cir. 2007) (internal citations omitted).

Historically, courts were divided as to whether bankruptcy courts had the power to recharacterize purported debt as equity. That debate has essentially ended and the general consensus is that bankruptcy courts can recharacterize purported debt as equity.

Most recently, on April 30, 2013, the Ninth Circuit, in *In re Fitness Holdings Int'l, Inc.*, overruled a prior opinion from the Ninth Circuit Bankruptcy Appellate Panel, holding that bankruptcy courts do in fact possess the power to recharacterize claims. *See In re Fitness Holdings Int'l, Inc.*, No. 11-56677, 2013 WL 1800000 (9th Cir. April 30, 2013). In addition to the Ninth Circuit, the Third, Fourth, Fifth, Sixth, and Tenth Circuits have all recognized a

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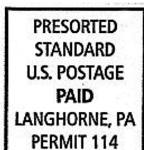

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successfully convinced the Seventh Circuit to reconsider its earlier opinion, vacate it, and reach an entirely different result.

Relevance

Sentinel II is of critical importance to so-called "rescue" lenders. A close reading of the facts shows that these loans are still risky, but feasible in certain cases. In terms of legal analysis, the decision deals with: 1) the meaning of the Code's actual intent to "hinder, delay, or defraud" creditors language; 2) whether actual intent to cause harm to creditors must be proved; 3) what constitutes "egregious and conscience shocking" behavior for a lender's claim to be subordinated on equitable grounds; and 4) whether the parties' illegal behavior makes a contract intrinsically illegal.

If nothing else, the case shows how the Seventh Circuit itself wrestled with this decision, but was convinced by effective lawyering to change its mind over a two-year period after oral argument on Sept. 8, 2011. Indeed, the district court itself "struggled with the issues following a 17-day bench trial. After hearing from more than a dozen witnesses, listening to audio recordings between [the parties], and reviewing hundreds of exhibits," it had dismissed the trustee's claims. *Id*. at *5.

Facts

The debtor investment manager had "marketed itself to its customers as providing a safe place to put their excess capital, assuring solid short-term returns, but also promising ready access to the capital." *Id*. at *1. Its customers "were not typical investors; most of them were futures commission merchants" like broker-dealers in the securities industry. *Id*. In the debtor's hands, its "client money could, in compliance with industry regulations governing such funds, earn a decent return while maintaining the liquidity" that clients needed. *Id*. "[The debtor] constructed a fail-safe system that virtually eliminates risk from short term investing," said the debtor's 2004 website. *Id*.

The debtor "represented that it would maintain customer funds in segregated accounts as required under the Commodity Exchange Act." *Id*. Thus, "at all times a customer's accounts held assets equal to the amount [the debtor] owed the customer, and … [the debtor] treated and dealt with the assets 'as belonging to such customer.'" *Id*.

The debtor "pooled customer assets in various portfolios, depending on whether the customer assets were" regulated or unregulated funds. *Id*. at *2. Because the debtor did not differentiate between its own funds and its customers' non-segregated assets, it "could sell securities or borrow the money" whenever customers wanted their capital back." *Id*. "This arrangement allowed [the debtor] to borrow large amounts of cash while pledging customers' securities as collateral." *Id*.

Nevertheless, the debtor "maintained segregated accounts [with] assets that could not be subject to any [lender] lien." *Id*. The lender agreed it had no lien and would "not assert" a "lien against securities held in a Segregated Account." *Id*. Although the debtor was responsible "for keeping assets at appropriate levels of segregation," the lender's "main concern was ensuring that [the debtor] had sufficient collateral in the lienable accounts to keep its … loan secured." *Id*. at *3.

The debtor went through a liquidity crunch during the summer of 2007. *Id*. In a series of transactions, the debtor moved securities from segregated accounts to "lienable accounts." *Id*. at *4. A lienable account, however, could contain only securities and other assets that belonged to the debtor or that were not subject to segregation. When the debtor's "segregation deficit grew to $644 million, [the lender] became suspicious." *Id*. A managing director of the lender

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Prepayment Premiums and Make-Whole Payments

Part One of a Two-Part Article

By Joel H. Levitin

Many loan agreements include clauses that permit borrowers to repay debt prior to the maturity date only if they make additional payments that are typically referred to as "prepayment premiums" or "make-whole payments." The purpose of such prepayment premiums is to compensate lenders for what would otherwise be the loss of their bargained-for yields for the scheduled lives of their loans. Prepayment premiums are usually either based on a fixed fee, such as a percentage of the principal balance at the time of prepayment, or a yield maintenance formula that approximates the lenders' damages in the event of prepayment.

In the bankruptcy context, a prepayment premium will rarely be triggered by the debtor's voluntary prepayment of debt. Instead, usually the debtor will have defaulted and the debt will have been accelerated prior to bankruptcy, or the debt will have automatically accelerated due to the bankruptcy filing.

In these circumstances, to be enforceable, the loan documents must contain clear and unambiguous language requiring the prepayment premium upon acceleration. The majority of courts have held that prepayment premiums are not "unmatured interest" and may constitute recoverable liquidated damages if they satisfy the applicable state law test for enforcement, including in many states if the prepayment premium bears a reasonable relationship to the creditor's actual damages caused by the debtor's early repayment of the debt. Many courts also consider whether the prepayment premium is "reasonable" under § 506(b) of the Bankruptcy Code.

Clear and Unambiguous Contract Language

To determine whether a creditor has an enforceable right to collect a prepayment premium in bankruptcy, courts first consider the text of the loan documents. A prepayment premium clause typically governs the situation in which a borrower voluntarily elects to prepay its debt and represents the price of the option exercisable by the borrower to repay the loan in advance of its maturity. *See, e.g., In re S. Side House, LLC*, 451 B.R. 248, 268 (Bankr. E.D.N.Y. 2011). Upon a default and acceleration of the borrower's loan, the acceleration advances the maturity date, and any subsequent payment is no longer considered a voluntary prepayment. *See In re Madison 92nd St. Assocs. LLC*, 472 B.R. 189, 195 (Bankr. S.D.N.Y. 2012) (citing *In re LHD Realty Corp.*, 726 F.2d 327, 330-31 (7th Cir. 1984)). The lender forfeits the collection of a prepayment premium in such a scenario unless the parties' agreement contains a "clear and unambiguous" clause requiring payment of the prepayment premium upon default and acceleration. *See In re Madison 92nd St. Assocs. LLC*, 472 B.R. at 195-96. Several courts have prohibited creditors from recovering prepayment premiums in bankruptcy where the loan document language is not clear and unambiguous.

In *In re S. Side House, LLC*, the language of the note and mortgage dictated that the debtor was liable for the prepayment premium in a default and acceleration situation only if full payment of the debt was deemed an "evasion of the [d]ebtor's obligation to pay prepayment consideration. … " 451 B.R. at 272. The court reasoned that the prepayment premium was not due because the debtor did not tender the full amount of the loan after default, and the loan documents did not make the prepayment premium due upon default and acceleration alone. *Id*.

For the creditor to recover, the contract would have had to have given the lender an unambiguous right to prepayment consideration upon default and acceleration without requiring the debtor's intentional evasion of the premium. *Id*.; *see also In re S. Side House, LLC,* 2012 WL 273119, at *5 (quoting *Northwestern Mut. Life Ins. Co.*, 816 N.Y.S.2d at 836). *Compare U.S. Bank Trust Nat'l Ass'n v. AMR Corp*. (*In re AMR Corp*.), 2013 WL 4840474, at *6 (2d Cir. Sept. 12, 2013) (declining to enforce premium in light of following language in debt documents: "if an Event of Default [defined to include Debtors' voluntary filing of bankruptcy petition that automatically results in acceleration without any action by Loan Trustee] … shall have occurred and be continuing, then … the unpaid principal amount … (but for the avoidance of doubt, without Make-Whole Amount), shall immediately and without further act become due … " and "[n]o Make-Whole Amount shall be payable on the … Equipment Notes as a consequence of or in connection with an Event of Default or the acceleration of the Equipment Notes."), with *In re CP Holdings, Inc.*, 332 B.R. 380, 382, 385 (W.D. Mo. 2005) (holding that language "if the holder of this Note accelerates the whole or any part of the principal sum … the undersigned waives any right to prepay said principal sum in whole or in part without premium and agrees to pay a prepayment premium" clearly gives creditor right to collect premium upon acceleration of debt).

Liquidated Damages or 'Unmatured Interests'

A majority of courts have determined that prepayment premium clauses should be scrutinized as liquidated damages provisions, and the amounts should not be considered unmatured interest under

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§ 502(b)(2) of the Bankruptcy Code, which provides that allowed claims may not include claims for "unmatured interest." *See In re Trico Marine Servs., Inc.*, 450 B.R. 474, 480 (Bankr. D. Del. 2011) (citing *Noonan v. Fremont Fin.* (*In re Lappin Elec. Co., Inc.*), 245 B.R. 326, 330 (Bankr. E.D. Wis. 2000)). *But see In re Ridgewood Apartments*, 174 B.R. 712, 720-21 (Bankr. S.D. Ohio 1994) (deciding that prepayment premiums are not allowable claims in bankruptcy because they compensate lender for lost interest payments and therefore constitute unmatured interest).

A clause providing for liquidated damages is evaluated under state law standards to determine whether such damages are valid or constitute an unenforceable penalty. *See In re Madison 92nd St. Assocs. LLC*, 472 B.R. at 195-96 (citing *U.S. Bank Nat'l Ass'n v. S. Side House, LLC*, 2012 WL 273119, at *5 (E.D.N.Y. Jan. 30, 2012); and *Northwestern Mut. Life Ins. Co. v. Uniondale Realty Assocs.*, 816 N.Y.S.2d 831, 836 (Sup. Ct. 2006)).

The standard for determining whether liquidated damages are valid under New York law is whether actual damages are difficult to determine, and whether the amount of damages are not "plainly disproportionate" to the potential loss. *See In re Sch. Specialty, Inc.*, 2013 WL 1838513, at *2 (Bankr. D. Del. Apr. 22, 2013) (citing *In re S. Side House, LLC*, 451 B.R. at 270). Many courts have used tests similar to New York's standard for determining whether liquidated damages are enforceable. *But see 400 Walnut Assocs., L.P. v. 4th Walnut Assocs., L.P.* (*In re 400 Walnut Assocs., L.P.*), 461 B.R. 308, 321 (Bankr. E.D. Pa. 2011) (internal citations omitted) (stating that standard for evaluating enforceability of liquidated damages in Pennsylvania is whether they are reasonable).

Damages

In the prepayment premium context, courts look at a number of factors to determine whether actual damages are difficult to determine: "the loss of interest to the lender, the rate of return on any substitute loan or loans, the duration of that loan … , the risk of the substitute loan or loans, and the extent and realizability of the collateral for the substitute loan or loans." *In re Vanderveer Estates Holdings, Inc.*, 283 B.R. 122, 130 (Bankr. E.D.N.Y. 2002). The evaluation of whether damages are difficult to determine is evaluated as of the time the agreement was made. *See In re Duralite Truck Body & Container Corp.*, 153 B.R. 708, 712 (Bankr. D. Md. 1993).

The court in *In re Madison 92nd St. Assocs. LLC* held that the prepayment premium satisfied the first prong of the liquidated damages evaluation. 472 B.R. at 197. The premium, due upon either the debtor's prepayment or default and acceleration, was intended to estimate the present value of the lender's lost future interest, which depended on future changes in interest rates not readily ascertainable at the time of contracting. *Id.* at 193, 197. Moreover, the creditor was seeking a prepayment premium based on the debtor's default, not actual prepayment, and therefore the creditor lost not only future income payments, but also the opportunity to reinvest its money. *Id.* at 197.

We continue this discussion in next month's issue.

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e-mailed colleagues involved with the debtor's accounts, asking how the debtor had "so much collateral? With less than [$2 million] in capital I have to assume that most of this collateral is for somebody else's benefit. Do we really have rights on the whole $300MM?" *Id.*

The lender's officials knew the debtor "had an agreement that gave the [lender] a lien on any securities in clearing accounts." *Id.* By Aug. 13, 2007, the debtor told its customers "that it was halting redemptions because of problems in the credit market," causing the lender to cut the debtor's "remote access to its systems, … [to send] its officials to [the debtor's] offices, demand … full repayment of the loan, and threaten … to liquidate the collateral." *Id.* The debtor then filed a Chapter 11 petition, owing the lender $312 million. *Id.*

The court ordered the appointment of a trustee who later became the post-plan confirmation liquidating trustee. When the lender filed a $312 million secured claim, the trustee sued the lender, alleging that the debtor had "fraudulently used customer assets to finance the loan to cover its house trading activity"; the lender "knew about it and, as a result, acted inequitably and unlawfully," giving rise to fraudulent transfer and equitable subordination claims, including invalidation of the lender's lien. *Id.* at *5.

The District Court

The district court "dismissed the lien invalidation count on the pleadings," and held a lengthy bench trial on the trustee's other claims. According to the lower court, after trial, the trustee had "failed to prove that [the debtor] made the Transfers with the actual intent to hinder, delay or defraud its creditors." *Id.* at *5. The district court also "rejected the [trustee's] preference claim because the [lender] was over-collateralized on the transfer dates." *Id.* It further rejected the trustee's equitable subordination claim "because it did not believe that [the lender's] conduct was 'egregious or conscience shocking,'" reasoning that the lender's employees "had no legal obligation … to seek out or analyze the data … that would have revealed [the debtor's] misuse of the segregated funds." *Id.*

Attacking the lender's secured claim, the trustee made three arguments in the lower court. First, the debtor had "acted with actual intent to hinder, delay, or defraud when it borrowed money from the [lender],"

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making the lien avoidable by the trustee for unsecured creditors. Second, the lender had "engaged in inequitable conduct when it allowed [the debtor] to borrow money," thus entitling the trustee to subordinate the lender's lien "to the claims of unsecured creditors." *Id*. Finally, the trustee asserted that the debtor's "contracts with the [lender] violated the law on their face," requiring invalidation of the lender's lien. *Id*.

The Unmentioned *Sentinel I*

The trustee appealed the dismissal of his complaint, leading to the Seventh Circuit's original affirmance of the district court on Aug. 9, 2012. *In re Sentinel Management Group Inc*., 689 F. 3d 855, 861; 862-63; 865-66 (7th Cir. 2012) (*Sentinel I*) (held, debtor had not transferred "customer assets out of segregation" to lender with "actual intent to hinder, delay or defraud its creditors"; trustee proved "at most" only debtor's insolvency at time of transfers; debtor's failure "to keep client funds properly segregated is not, on its own, sufficient to rule … that [the debtor] acted with requisite intent; debtor "made transfers to pay off one set of creditors in an attempt to save the enterprise from sinking"; "incompetence alone, however problematic, won't require the equitable subordination of the [lender's] lien") (citing *Boston Trading Grp. v. Burnazos*, 535 F. 2d 1504, 1508-09 (1st Cir. 1987) (Breyer, J.) (fraudulent transfer law does not include attempts "to choose among" creditors); *Dean v. Davis*, 242 U.S. 438, 444 (1917) (Brandeis J.) ("Making a mortgage to secure an advance with which the insolvent debtor intends to pay pre-existing debt does not necessarily imply an intent to hinder, delay, or defraud creditors"); *In re Sharp Int'l Corp*, 403 F. 3d 43, 56 (2d Cir. 2005) ("The $12.25 million payment was at most a preference between creditors and did not 'hinder, delay or defraud either present or future creditors.'").

The Court of Appeals withdrew *Sentinel I* in late 2012 with no explanation, merely stating that the opinion had been withdrawn and the judgment vacated.

The Later Court of Appeals Decision: *Sentinel II*

The court never mentioned *Sentinel I* in its Aug. 26, 2013 opinion (*Sentinel II*). It first found that the debtor had transferred the funds to the lender with "actual intent to hinder, delay, or defraud" creditors, thus enabling the trustee to avoid the Lender's lien as a fraudulent transfer. *Id*. at*7. "[I]nconsistencies in the district court's opinion regarding the extent of the" lender's knowledge prior to bankruptcy "lead to further inconsistencies regarding the mental state of" the lender's employees. *Id*. at*10. "If [the lender's] employees knew that [the debtor's] insiders were misusing loan proceeds, then it certainly suggests that [those] employees (at the very least) turned a blind eye to the rest of [the debtor's] misconduct." *Id*. "The district court … appears to waffle back and forth between characterizing their mental states as negligent and as reckless." *Id*. On remand, after the district court "clarifies" the facts, it will have to "revisit the ultimate issue of whether the [lender's] claim merits equitable subordination." *Id*. at *11.

Fraudulent Transfer

The Seventh Circuit rejected the district court's "rescue loan" analysis. "[W]e disagree with the district court's legal conclusion that such motivation was insufficient to constitute actual intent to hinder, delay, or defraud" the debtor's clients. *Id*. "Such a result too narrowly construes the concept of actual intent. … " *Id*. Although the debtor may have genuinely believed that it was merely trying to stay in business, it "certainly should have seen our treating these transfers as fraudulent as consistent with our construction of actual intent to defraud in other contexts." *Id*.

The court also dismissed the district court's findings as to the debtor's good intentions. "[E]ven if we assume that Sentinel had the best intentions for its … clients when it pledged the segregated funds, the fact remains that Sentinel knowingly exposed its … clients to a substantial risk of loss of which they were unaware." *Id*. at *7. The debtor's "pledge of the segregated funds as collateral for its own loan" became "particularly egregious when viewed in light of the legal requirements imposed … by the Commodity Exchange Act. … " *Id*. "… Sentinel did more than just expose its … clients to a substantial risk of loss of which they were unaware; Sentinel, in an unlawful manner, exposed its … clients to a substantial risk of loss of which they were unaware." Even if it did not intend to harm its clients, its "intentions were hardly innocent." *Id*. More important, if the lender had "sufficient knowledge to place it on inquiry notice of the debtor's possible insolvency," it will have a "very difficult time proving that it was not on inquiry notice of" the debtor's egregious conduct. *Id*., n. 2.

Equitable Subordination

The Seventh Circuit opined that the lower court's equitable subordination findings were "internally inconsistent," *Id*. On one hand, the district court found the lender to have known "Sentinel was engaging in wrongful conduct before its collapse." *Id*. On the other hand, the lower court found that the lender's "employees … neither knew nor turned a blind eye to the improper action of Sentinel." *Id*. This waffling "throughout the opinion" caused the Court of Appeals to question the district court's ultimate findings that the lender's claims should not be equitably subordinated. *Id*. at *11. On remand, therefore, the district court must "clarify" exactly what the lender knew; what it knew of the debtor's misconduct; and the level of the lender's failure to investigate — "was it reckless? Or was it deliberately indifferent?" *Id*.

Legality of Contracts

According to the Court of Appeals, the district court had "correctly dismissed the trustee's claim that the lender's contracts with the Debtor were "inherently illegal." *Id*. Because the "contracts did not require either [the debtor]] or the [lender]

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to do anything illegal, and because there was no "evidence [suggesting that the contract between the parties] was connected with an illegal scheme or plan," the defense of "illegality" was "inapplicable" here. *Id*.

COMMENTS

1. Rescue lending is not dead because of *Sentinel II*. The seminal *Dean v. Davis Supreme Court* decision, cited in *Sentinel I*, confirms that an arm's length, good faith commercial loan will not be undone. *Dean v. Davis*, 242 U.S. at 444 (securing a loan to an insolvent debtor for payment of "a pre-existing debt does not necessarily imply an intent to hinder, delay or defraud creditors. The mortgage may be made in the expectation that thereby the debtor will extricate himself from a particular difficulty and be enabled to promote the interests of all other creditors by continuing his business. The lender … may be acting in perfect 'good faith' … It is a question of fact in each case what the intent was with which the loan was sought and made.").

2. In *Dean*, the rescue lender (the debtor's brother-in-law), lost his mortgage to the Trustee's fraudulent transfer attack because of his special knowledge and participation in the debtor's misconduct. " … [K]nowing the facts, [he] cooperated in the bankrupt's fraudulent purpose, lacked the saving good faith. … " *Id*. at 445. *See* Thomas H. Jackson, The Continuing Life of *Dean v. Davis*, 1988 *Annual Survey of Bankr. L.* 3. (["T]he essence of *Dean v. Davis* remains viable and relevant today. … "). The lender in *Sentinel II*, however, still has an outside chance of showing that it had made a secured loan in good faith, without knowledge of the debtor's improper activities. At least for now, the lender lives for another round of litigation.

3. According to conventional wisdom, petitions for rehearing in the Courts of Appeals are rarely granted. *See* Richard S. Arnold, Why Judges Don't Like Petitions for Rehearing," 3 *J. App. Prac. & Process* 29 (2001); Paul D. Carrington, Crowded Dockets and the Courts of Appeals: The Threat to the function of Review and the National Law, 82 *Harv. L. Rev.* 542, 582-83 (1969) ("*en banc* process inefficient and unwise); 5th Cir. R. 35 ("*en banc* hearing or rehearing is not favored. … "). But the trustee in *Sentinel II* effectively convinced the Seventh Circuit that *Sentinel I*: 1) conflicted with the court's precedent that a knowing misuse of property held in a fiduciary capacity is fraudulent; 2) conflicted with the court's precedent that a party intends the natural consequences of its actions; and that it 3) conflicted with Supreme Court precedent that transfers made with intent to hinder or delay creditors are also recoverable as fraudulent transfers, citing *Shapiro v. Wilgus*, 287 U.S. 348, 354, 359 (1932) (Cardozo, J.) ("genuine belief" in ability to repay creditors by staying in business "does not clothe [it] with a privilege to build up obstructions [to] hold [its] creditors at bay."). The amicus brief from the CFTC also showed the court why the issues in *Sentinel* were of "exceptional importance concerning the treatment of commodity customer funds in bankruptcy."

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bankruptcy court's ability to recharacterize claims. *See In re Lothian Oil, Inc.*, 650 F.3d 539 (5th Cir. 2011); *In re SubMicron Sys.*, 432 F.3d 448 (3d Cir. 2006); *In re Dornier Aviation*, 453 F.3d 225 (4th Cir. 2006); *In re Hedged-Investments Assocs. Inc.*, 380 F.3d 1292 (10th Cir. 2004); *In re AutoStyle Plastics, Inc.*, 269 F.3d 726 (6th Cir. 2001).

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IMPACT ON THE LENDER

Recharacterization can impact a lender in two primary ways.

First, recharacterization arises in the context of claims objections where the objector argues that a lender's claim should be disallowed because it actually represents an equity contribution. In this situation, recharacterization is used to reduce the overall amount of allowed claims in a bankruptcy case by transforming claims into equity interests (which are often extinguished without compensation), thereby increasing the distribution percentage for holders of allowed claims.

Second, recharacterization can give rise to avoidance litigation — specifically, preference and fraudulent transfer actions — which could result, not only in claim disallowance, but also a judgment in favor of the bankruptcy estate against the purported lender. This occurs when a bankruptcy court determines that the purported "debt" actually constitutes an equity interest and thus the purported "repayments" of the "debt" are rendered constructively fraudulent transfers. Traditionally, recharacterization has only been employed against insider claims. Yet, as more fully discussed below, recent cases make clear that non-insider claims may also be subject to recharacterization.

BACKGROUND

In the past, bankruptcy courts struggled to distinguish recharacterization claims from equitable subordination claims. An action for equitable subordination does not challenge the existence or validity of the underlying debt. "Rather,

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it challenges granting the debt the priority to which it is entitled under applicable law because of the creditor's inequitable conduct." *Insilco Techs.*, 480 F.3d at 217 (internal citations omitted). Equitable subordination arises under Bankruptcy Code § 510, but the Bankruptcy Code does not expressly provide for recharacterization claims. In addition, equitable subordination is remedial in nature, requires a showing of misconduct, and is only employed to the extent necessary to undo the inequitable conduct. *See In re Airadigm Comm., Inc.*, 616 F.3d 642, 658 (7th Cir. 2010). In contrast, recharacterization focuses on the underlying substance of the disputed transaction without regard to misconduct. *Id.*

The recharacterization inquiry is one that attempts to determine the true nature of a transaction. Where little money is available for distribution, both recharacterization and equitable subordination can have the same practical effect of preventing a creditor's recovery. However, recharacterization can also give rise to liability in the form of avoidance of purported pre-bankruptcy debt repayments. As the debate over the viability of recharacterization has waned, perhaps unsurprisingly, so has confusion surrounding equitable subordination.

Source of Law for Recharacterization of Claims

Despite almost uniform recognition of a bankruptcy court's power to recharacterize claims, a new debate among the circuit courts has emerged. The divide centers on when and how bankruptcy courts should engage in recharacterization. As previously mentioned, there is no provision in the Bankruptcy Code that expressly grants authority to the bankruptcy court to recharacterize debt. Two divergent theories underpinning the basis for recharacterizatio have arisen.

The Equitable Power Circuits

The Third, Fourth, Sixth and Tenth Circuits agree that bankruptcy courts have the power to recharacterize claims pursuant to their general equitable powers under Bankruptcy Code § 105(a). These courts find that the power to recharacterize claims is "grounded" in a bankruptcy court's power to prevent substance from giving way to form. *See In re SubMicron*, 432 F.3d at 454 (quoting *Pepper v. Litton*, 308 U.S. 295, 305 (1939)). Thus, the recharacterization inquiry focuses on the substance of the transaction at issue, rather than the label attached to it.

Although various multi-factor tests have emerged, the circuits employing equitable power theories (Equitable Power Circuits) generally seek to determine "whether the parties called an instrument one thing when in fact they intended it as something else." *SubMicron*, 432 F.3d at 456. Thus, the overarching inquiry is often whether the parties intended a loan to be a disguised equity contribution. *In re Fedders North America, Inc.*, 405 B.R. 527, 554 (Bankr. D. Del. 2009) (citing *SubMicron*, 432 F.3d at 455-56).

The multi-factor tests from the Equitable Power Circuits use factors such as: 1) the names given to the instruments, if any, evidencing indebtedness; 2) the presence or absence of a fixed maturity date and repayment schedule; 3) the presence or absence of 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 presence or absence of security for the loans; 8) the ability of the debtor to obtain outside financing; 9) the extent to which the advances were subordinated to the claims of other creditors; 10) the extent to which the advances were used to acquire capital assets; 11) the presence or absence of a sinking fund; 12) the presence or absence of voting rights; and 13) other considerations, such as a lack of corporate formalities. *See AutoStyle*, 269 F.3d at 749-50; *In re Friedman's Inc.*, 452 B.R. 512, 519 (Bankr. D. Del. 2011) (collecting the multiple multi-factor tests).

The State Law Circuits

The two most recent circuit court decisions on recharacterization arise in the Fifth and Ninth Circuits. Both disagreed with the Equitable Power Circuits and held that Bankruptcy Code § 105(a) does not authorize recharacterization. Though the Fifth and Ninth Circuits agree that bankruptcy courts have the authority to recharacterize debt to equity, they find the power arises solely under applicable state law.

The Fifth Circuit in *Lothian Oil* held that a bankruptcy court's authority to allow and disallow a claim under Bankruptcy Code § 502 provides authority to recharacterize a claim that asserts a debt contrary to state law, but which should give the purported claimant some rights vis-à-vis the debtor. *See Lothian Oil*, 650 F.3d at 543 (citing *Dornier Aviation*, 453 F.3d at 232). Importantly, *Lothian Oil*, citing the Supreme Court's decision in *Butner v. United States*, 440 U.S. 48 (1979), concluded that recharacterization inquiries under § 502 will depend on state law. Thus, according to the State Law Circuits, the basic test used to determine whether a claim will be recharacterized as an equity interest is whether the applicable state law would disallow the claim based on the theory of recharacterization.

The Ninth Circuit's decision in *Fitness Holdings* involved litigation over alleged constructively fraudulent transfers. *Fitness Holdings* showed disapproval of the Equitable Power Circuits' decisions, stating that "courts may not rely on [section] 105(a) and federal common law rules 'of their own creation' to determine whether recharacterization is warranted." *See Fitness Holdings*, 714 F.3d at 1149. Rather, *Fitness Holdings* looked to whether state law provided the putative claimant a debt claim or equity interest. *Id.*

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State Law Alters The Contours of Recharacterization

Comparing the dictionary definition of recharacterization and the recent *Lothian Oil* decision shows that reliance on state law as the source of law for recharacterization claims can expand the scope of those claims in new ways. On the one hand, Black's Law Dictionary defines "recharacterization" as "a court's determination that an insider's loan to an entity in liquidation … should be treated as a capital contribution, not as a loan, thereby entitling the insider to only part of the liquidation proceeds payable after all the business's debts have been discharged." Black's Law Dictionary (9th ed. 2009).

However, in *Lothian Oil*, the Fifth Circuit concluded "that recharacterization extends beyond insiders and is part of the bankruptcy courts' authority to allow and disallow claims under" Bankruptcy Code § 502. *Lothian Oil*, 650 F.3d at 542. In *Lothian Oil*, the Fifth Circuit looked to the relevant state law [Texas] and did not find that state law distinguished between mischaracterized insider and non-insider claims. *Id.* at 544. Recharacterizing a non-insider's debt runs contrary to the more established grain of the Equitable Power Circuits. Yet, recharacterization of non-insider claims may become more common as bankruptcy courts rely on state law.

Lenders that find themselves in the Fifth and Ninth Circuits should closely examine applicable state law to determine the risks posed by a potential recharacterization claim. For example, in *In re Gulf Fleet Holdings, Inc.*, 491 B.R. 747 (Bankr. W.D. La 2013), the bankruptcy court rejected the Trustee's recharacterization claim to the extent that it was based on the court's equitable powers under § 105 and instead looked to state law. *Id.* at 773. The bankruptcy court held that while a recharacterization claim could be asserted under governing Louisiana state law based on a legal theory known as a "simulation" — or "contract which by mutual agreement … does not express the true intent of the parties" — the plaintiff failed to allege the necessary elements to support such a claim. As a practical problem, without local counsel or extensive research, a lender may be wholly unaware of potential recharacterization claims.

In the few circuits that have not addressed recharacterization, the logic and policy underpinning the *Lothian Oil* decision may be gaining traction. For example, one oral ruling from a bankruptcy court in the Northern District of Illinois relied on *Lothian Oil* in stating that § 105 does not constitute an independent basis to recharacterize a claim that would otherwise be allowable under § 502. The court determined that state law governed and requested briefing regarding whether Illinois state law recognized recharacterization. *In re Agri-Best Holdings, LLC*, No. 12 A 01378, (Bankr. N.D. Ill. March 27, 2013) (Dkt. No. 33). As of the date of publication, this litigation was ongoing.

Nevertheless, many bankruptcy courts still employ the Equitable Power Circuits' analysis. For example, the bankruptcy court in *In re Shubh Hotels Pittsburgh, LLC*, 476 B.R. 181 (Bankr. W.D. Pa. 2012), recharacterized debt to equity based on the Third Circuit's equitable power framework. In *Shubh Hotels*, the bankruptcy court held that a claimant's unsecured claim was properly characterized as an equity contribution. The court based its decision on the objector's proffered evidence, including: 1) the testimony from the chief operating officer of the purported claimant that the advances were recorded on the debtor's books as equity; 2) the debtor's balance sheet prepared just seven days prior to the debtor's petition date did not reflect that any money was owed to the purported claimant; 3) the debtor's bankruptcy schedules signed under penalty of perjury did not reflect that any money was owed to the purported claimant; and 4) an expert report concluded that the transactions between the purported claimant and the debtor were appropriately accounted for as equity transactions.

Implications and Conclusions

Clearly, any financial transaction between an insider and a debtor is subject to heightened inspection in bankruptcy. In the Third, Fourth, Sixth, and Tenth Circuits where courts rely on equitable powers under § 105 for recharacterization, it is critical for a lender to satisfy as many of the factors discussed above as possible. At a minimum, a lender should comply with corporate formalities and execute a valid and binding note.

It is also recommended that lenders avoid obtaining rights traditionally linked to equity interest holders, such as voting rights. Recent case law makes clear that reliance on state law has broadened the scope of recharacterization claims beyond just transactions involving insiders. In the Fifth and Ninth Circuits, and before any other court employing state law, lenders must recognize that non-insiders who engaged in financial transactions with debtors may also face newly cast recharacterization-like claims. Texas appears to be one such jurisdiction. *See Lothian Oil*, 650 F.3d 539.

Therefore, lenders should assess the likelihood of recharacterization claim on a circuit-by-circuit and state-by-state basis going forward in order to fully understand all of the risks of providing debt financing to financially troubled borrowers.

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