Transforming Debt to Equity

Fourth Circuit Rules that Bankruptcy Courts Have the Power to Recharacterize

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The ability of a bankruptcy court to reorder the priority of claims or interests by means of "equitable subordination" or "recharacterization" of debt as equity is generally recognized. Still, the Bankruptcy Code itself expressly authorizes only the former of these two remedies — even though common law uniformly acknowledges the power of a court to recast a claim asserted by a creditor as a shareholder interest in an appropriate case, the Bankruptcy Code is silent upon the availability of the remedy in a bankruptcy case. This has led to confusion among bankruptcy courts concerning their power to recharacterize claims and the interaction between these two equitable remedies. The Fourth Circuit Court of Appeals recently had an opportunity to weigh in on the issue in *Fairchild Dornier GMBH v. Official Committee of Unsecured Creditors (In re Official Committee Of Unsecured Creditors for Dornier Aviation (North America), Inc.)*. In a matter of first impression, the Fourth Circuit affirmed a bankruptcy court's recharacterization of a parent corporation's claim arising from the sale of spare parts to its chapter 11 debtor-subsidiary as an equity contribution.

Equitable Subordination and Recharacterization

The bankruptcy court is a court of "equity." Although the distinction between courts of equity and law has largely become irrelevant in modern times, courts of equity have traditionally been empowered to grant a broader spectrum of relief in keeping with fundamental notions of fairness as opposed to principles of black-letter law. This means that a bankruptcy court can exercise its discretion to produce fair and just results to prevent fraud, to preclude the elevation of form over substance and to ensure that technical considerations do not thwart the commission of substantial justice. One of the tools available to a bankruptcy court in exercising this broad equitable mandate is “equitable subordination.”

Equitable subordination is a remedy developed under common law to penalize misconduct that results in injury to creditors or shareholders. It is expressly recognized in Bankruptcy Code section 510(c), which provides that the bankruptcy court may, “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.” However, the statute neither explains the concept nor the standard that should be used to apply it.

This has been left to the courts. In 1977, the Fifth Circuit Court of Appeals articulated what has become the most commonly accepted standard for equitably subordinating a claim in *In re Mobile Steel Co.* Under the *Mobile Steel* standard, a claim can be subordinated if the claimant engaged in some type of inequitable conduct that resulted in injury to creditors (or conferred an unfair advantage on the claimant) and if equitable subordination of the claim is consistent with the provisions of the Bankruptcy Code. Courts have refined the test to account for special circumstances. For example, many make a distinction between insiders (*e.g.*, corporate fiduciaries) and non-insiders in assessing the level of misconduct necessary to warrant subordination.

A related but distinct remedy is "recharacterization." The power to treat a debt as if it were actually an equity interest is derived from principles of equity under common law. It emanates from the bankruptcy court's power to ignore the form of a transaction and give effect to its substance. The remedy is most commonly invoked when an insider purports to loan money to a company when it is undercapitalized and the cash infusion should have taken the form of a capital contribution. Recharacterization in such a circumstance ensures that non-insider creditor claims will be paid first from the available assets of the corporation.

Courts consider various factors when determining whether a debt should be recharacterized. As articulated by the Sixth Circuit Court of Appeals in *Bayer Corp. v. Masco Tech, Inc. (In re AutoStyle Plastics, Inc.)*, these can include the labels given to the debt, the presence or absence of a fixed maturity date, interest rate and schedule of payments, whether the borrower is adequately capitalized, any identity of interest between the creditor and the stockholder, whether the loan is secured and the corporation's ability to obtain financing from outside lending institutions. No single factor is controlling. Instead, they are considered within the particular circumstances of each case.

The effect of recharacterization may be similar to subordination — in both cases, the priority of the claim is made subordinate to that of other creditors. However, there are important differences. Recharacterization and equitable subordination serve different functions. Also, the extent to which a claim is subordinated under each remedy may be different. Recharacterization turns on whether a debt actually exists, not on whether the claim should be reprioritized. If the court determines that an advance of money is equity and not debt, the claim is transformed to a proprietary interest in respect of which no portion of the company's assets can be distributed unless and until its debts are paid in full. By contrast, in an equitable subordination analysis, the court reviews whether an otherwise legitimate creditor engaged in misconduct, in which case the remedy is subordination of the creditor's claim to the claims of other creditors, but only to the extent necessary to offset injury or damage suffered by the latter.

Because the Bankruptcy Code does not expressly empower a bankruptcy court to recharacterize debt as equity, courts are split as to whether they have the authority to do so. According to some, because the statute authorizes subordination but is silent concerning recharacterization, Congress intended to deprive bankruptcy courts of the power to recharacterize a claim. Others disagree (including every circuit court of appeals that has considered the question), finding that a bankruptcy court's power to recharacterize debt stems from the authority vested in the bankruptcy courts to use their equitable powers to test the validity of debts. According to this view, the source of the court's power is section 105 of the Bankruptcy Code, which gives bankruptcy courts the authority to "issue any order, process or judgment that is necessary or appropriate to carry out the provisions" of the statute. In a matter of first impression, the Fourth Circuit allied itself with courts expansively construing the scope of a bankruptcy court's equitable powers in this context in *Dornier Aviation*.

Dornier Aviation

Dornier Aviation (North America) ("DANA") was a wholly-owned subsidiary of German aircraft manufacturer Fairchild Dornier GMBH ("GMBH"), which sold spare parts to DANA that DANA then either used to provide warranty services for GMBH-manufactured aircraft or sold to end users providing repair services for out-of-warranty aircraft. Parts shipped by GMBH to

DANA were accompanied by invoices which provided for 30 day payment terms "unless otherwise agreed."

Certain former DANA employees filed an involuntary bankruptcy case against the company in 2002 in Virginia, which DANA later converted to chapter 11. Unable to reorganize, DANA ultimately confirmed a liquidating chapter 11 plan in 2003. During the course of the case, evidence came to light indicating that DANA did not actually pay invoices generated by GMBH within 30 days, but instead had an agreement with GMBH whereby DANA was not expected to pay for any shipped spare parts until its operation became profitable.

GMBH asserted claims aggregating $146 million based upon, among other things, parts shipments that had not been paid for by DANA. The creditors' committee objected to the claims, contending that $86 million in claims for unpaid shipments of parts should be equitably subordinated or recharacterized as equity. The bankruptcy court rejected the committee's equitable subordination argument, but recharacterized GMBH's $86 million spare parts claim as equity, effectively putting GMBH out of the money due to DANA's inability to pay its unsecured creditors in full. The district court upheld that determination on appeal, rejecting GMBH's contention that a bankruptcy court lacks the power to recharacterize debt as equity.

The Fourth Circuit's Ruling

GMBH appealed to the Fourth Circuit. The Court of Appeals ruled that the power to recharacterize debt is drawn from sections 726 and 105 of the Bankruptcy Code. Section 726, the Court explained, establishes the priority scheme for the payment of claims and interests in a chapter 7 liquidation, incorporating the rule that equity is relegated to the lowest priority, and section 105 gives bankruptcy courts broad equitable powers to effectuate other provisions of the statute. Given the fundamental division of obligations into claims and equity interests, the Fourth Circuit reasoned, bankruptcy courts must have the power to distinguish between the two by looking beyond the form of any given transaction to examine its underlying substance. The power to recharacterize debt as equity in an appropriate case, the Court concluded, assists in implementing the priority scheme of section 726.

According to the Fourth Circuit, the different policy purposes served by disallowance, equitable subordination and recharacterization also suggest that the latter must exist as an independent remedy. Disallowance of a claim, the Court of appeals explained, is appropriate only when it is determined that the claimant has no rights vis-à-vis the debtor or its assets. In addition, the Fourth Circuit observed, "[w]hile a bankruptcy court's recharacterization decision rests on the substance of the transaction giving rise to the claimant's demand, its equitable subordination decision rests on its assessment of the creditor's behavior." In fact, the Court noted, the power to recharacterize debt as equity has been recognized by every other circuit court of appeals that has considered the question.

The Fourth Circuit applied the *AutoStyle* test to determine whether it would be appropriate to recharacterize GMBH's spare parts claims as equity. Noting that application of the test produced mixed results, it agreed with the courts below that the factors weighing in favor of recharacterization predominated: (i) GMBH was an "insider" of DANA; (ii) the purported loan from GMBH lacked a fixed maturity date; (iii) DANA was not obligated to pay for shipped parts until it became profitable; (iv) DANA had a long history of unprofitability and its liabilities far exceeded its assets; and (v) GMBH had historically assumed DANA's losses. The Fourth Circuit accordingly upheld the determinations rendered below.

Analysis

Recharacterization is a remedy deeply rooted in the fabric of equity jurisprudence. The Fourth Circuit's ruling in *Dornier* reaffirms its vitality as an important tool available to bankruptcy courts entrusted with ensuring that the basic priority scheme underpinning federal bankruptcy law is not thwarted by reason of misconduct or artful machinations designed to disguise the true nature of a stakeholder's relationship to a debtor or its assets. By ruling that bankruptcy courts have the power to recharacterize debt as equity, the Fourth Circuit joins the Third, Sixth and Tenth Circuits, whose approach to the issue can fairly be characterized as the majority rule.

Dornier also provides some useful lessons for insiders when dealing with corporations in financial distress. If a transaction is made according to terms that would not be acceptable to an arm's-length creditor, any resulting obligation may be susceptible to recharacterization as equity in any later bankruptcy proceeding.

Fairchild Dornier GMBH v. Official Committee of Unsecured Creditors (In re Official Committee Of Unsecured Creditors for Dornier Aviation (North America), Inc.), 453 F.3d 225 (4th Cir. 2006).

In re Mobile Steel Co., 563 F.2d 692 (5th Cir. 1977).

Bayer Corp. v. Masco Tech, Inc. (In re AutoStyle Plastics, Inc.), 269 F.3d 726 (6th Cir. 2001).

Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Systems Corp.), 432 F.3d 448 (3d Cir. 2006).

Sender v. Bronze Group, Ltd. (In re Hedged-Invs. Assocs., Inc.), 380 F.3d 1292 (10th Cir. 2004).