First Impressions: Fifth Circuit Rules That Noninsider Claims Can Be Recharacterized as Equity

Scott J. Friedman
Mark G. Douglas

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. Even so, the Bankruptcy Code itself expressly authorizes only the former of these two remedies. Although common law uniformly acknowledges the power of a court to recast a claim asserted by a creditor as an equity interest in an appropriate case, the Bankruptcy Code is silent upon the availability of the remedy in a bankruptcy case. This has led to uncertainty in some courts concerning the extent of their power to recharacterize claims and the circumstances warranting recharacterization. The Fifth Circuit Court of Appeals recently had an opportunity to weigh in on this issue as an apparent matter of first impression in that court. In *Grossman v. Lothian Oil Inc. (In re Lothian Oil Inc.)*, 650 F.3d 539 (5th Cir. 2011), the court ruled that a bankruptcy court's ability to recharacterize debt as equity is part of the court's authority to allow and disallow claims, and the remedy is not limited to claims asserted by corporate insiders.

Equitable Subordination and Recharacterization

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, distinguished from principles of black-letter law. One of the tools available to a bankruptcy court in exercising its broad equitable mandate is "equitable subordination."

Equitable subordination is a remedy developed under common law prior to the enactment of the current Bankruptcy Code to remedy 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 explains neither the concept nor the standard that should be used to apply it.

This has been left to the courts. In *In re Mobile Steel Co.*, 563 F.2d 692 (5th Cir. 1977), the Fifth Circuit Court of Appeals articulated what has become the most commonly accepted standard for equitable subordination of a claim. 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 noninsiders in assessing the level of misconduct necessary to warrant subordination.

A related but distinct remedy is "recharacterization." Like equitable subordination, the power to treat a debt as if it were actually an equity interest is derived from principles of equity. It emanates from the bankruptcy court's power to ignore the form of a transaction and give effect to its substance. However, because the Bankruptcy Code does not expressly empower a bankruptcy court to recharacterize debt as equity, some courts disagree as to whether they have the authority to do so and, if so, the source of such authority. 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. *See*, *e.g.*, *In re Pac. Express, Inc.*, 69 B.R. 112 (B.A.P. 9th Cir. 1986).

However, other courts, including four federal circuit courts of appeal, have held that a bankruptcy court's power to recharacterize debt derives from the broad equitable powers set forth in section 105(a) of the Bankruptcy Code, which provides that "[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]." *See Committee of Unsecured Creditors for Dornier Aviation (North America), Inc.*, 453 F.3d 225 (4th Cir. 2006); *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); *Bayer Corp. v. Masco Tech, Inc. (In re AutoStyle Plastics, Inc.)*, 269 F.3d 726 (6th Cir. 2001).

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.)*, 269 F.3d 726 (6th Cir. 2001), 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, each one is considered in the particular circumstances of each case. In *SubMicron*, the Third Circuit rejected a factorbased inquiry as a "mechanistic scorecard," opting instead to focus on the parties' intent at the time of the transaction through a common-sense evaluation of the facts and circumstances.

The effect of recharacterization may be similar to that of subordination—in both cases, the priority of the asserted claim is made subordinate to the claims of other creditors. However, there are important differences. For example, recharacterization turns on whether a debt actually exists, not on whether the claim should be reprioritized. 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.

In *Lothian Oil*, the Fifth Circuit considered for the first time whether a bankruptcy court has the power to recharacterize debt as equity.

Lothian Oil

In April and May 2005, Texas-based Lothian Oil Inc. and its affiliates ("Lothian") entered into a series of "loan" agreements with Israel Grossman ("Grossman"), whereby Grossman agreed to lend Lothian $200,000 in exchange for a 1 percent royalty on Lothian's oil production in New Mexico and Lothian's undertaking to repay the principal amount from the proceeds of an anticipated equity offering. No maturity date or interest rate was specified in the agreements, which provided that the loan obligation was subordinate to Lothian's debt under a bank credit agreement.

Lothian filed for chapter 11 protection in Texas in June 2007 and objected to Grossman's claims on the basis of the loan agreements, contending that the underlying obligations should be recharacterized as equity. The bankruptcy court agreed, ruling that the claims "assert common equity interests at best and that insufficient evidence of the value of the interests was presented." On appeal, the district court, "declin[ing] to extend the concept of debt recharacterization to a non-insider creditor," reversed this determination.

The Fifth Circuit's Ruling

Addressing the question as a matter of first impression before it, a three-judge panel of the Fifth Circuit Court of Appeals reversed the district-court ruling. "We conclude," the court wrote, "that recharacterization extends beyond insiders and is part of the bankruptcy courts' authority to allow and disallow claims under 11 U.S.C. § 502."

The Fifth Circuit explained that the U.S. Supreme Court's ruling in *Butner v. United States*, 440 U.S. 48 (1979), makes clear that when a bankruptcy court is called upon to rule on an objection to a claim under section 502(b), state law determines whether, and to what extent, a claim is "unenforceable against the debtor and property of the debtor, under any agreement or applicable law." "Taken together," the court reasoned, "*Butner* and § 502(b) support the bankruptcy courts' authority to recharacterize claims." Thus, if an asserted interest would be classified as equity rather than debt under applicable state law—here, the law of Texas—a bankruptcy court would be empowered to recharacterize, rather than disallow, the claim.

The Fifth Circuit distanced itself from sister circuits that predicate the power to recharacterize debt as equity upon the bankruptcy courts' equitable authority under section 105(a). According to the court, given its interpretation of section 502(b), “resort to § 105(a) is unnecessary.” “We agree with sister circuits’ results,” the Fifth Circuit wrote, “but not necessarily their reasoning.”

The Fifth Circuit faulted the district court’s imposition of a per se rule confining recharacterization to claims filed by corporate insiders. “Unless state law makes insider status relevant to characterizing equity versus debt,” the court emphasized, “that status is irrelevant in federal bankruptcy proceedings.”

Explaining that Texas courts applying Texas law have imported a multifactor test from federal tax law to distinguish between debt and equity, the Fifth Circuit concluded that the bankruptcy court committed no error in finding that Grossman’s claims “assert common equity interests at best.” Among the factors considered by the bankruptcy court were the fact that Grossman would be paid from royalties and equity placements as well as the lack of a specified interest rate, term of repayment, and maturity date. “Because Texas law would not have recognized Grossman’s claims as asserting a debt interest,” the Fifth Circuit wrote, “the bankruptcy court correctly disallowed them as debt and recharacterized the claims as equity interests.”

Outlook

Despite its departure from section 105(a) as the source of a bankruptcy court’s power to recharacterize debt as equity, *Lothian Oil* is consistent with rulings to date by other circuits on this issue. Many courts find the distinction between equitable subordination and recharacterization to be confusing. The different standards applied in connection with the former remedy to situations involving insiders and noninsiders only compound the uncertainty. *Lothian Oil* attempts to clear the haze by explaining that the remedies are distinct and making it clear that recharacterization is not limited to claims asserted by corporate insiders. By focusing on the nature of the obligation rather than the conduct of the alleged claimant, the ruling implies that the identity of the claimant (including insider status) is irrelevant.

Finally, the Fifth Circuit's conclusion in *Lothian Oil* that resorting to section 105(a) is *unnecessary* in invoking the power to recharacterize debt as equity arguably falls short of an unequivocal pronouncement that the provision cannot be a basis for the remedy in an appropriate case. As such, courts—outside and within the Fifth Circuit—may deem recharacterization to be among the broad equitable powers granted under section 105.