A Cautionary Tale for Insider Lenders: Ninth Circuit Endorses Recharacterization Remedy in Bankruptcy

July/August 2013

Lisa G. Laukitis
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 Ninth Circuit Court of Appeals recently had an opportunity to consider this issue. In *Official Committee of Unsecured Creditors v. Hancock Park Capital II, L.P. (In re Fitness Holdings International, Inc.)*, 714 F.3d 1141 (9th Cir. 2013), the court ruled that "a court has the authority to determine whether a transaction creates a debt or an equity interest for purposes of § 548, and that a transaction creates a debt if it creates a 'right to payment' under state law."

By its ruling, the Ninth Circuit overturned longstanding Ninth Circuit bankruptcy appellate panel precedent to the contrary and became the sixth federal circuit court of appeals to hold that the Bankruptcy Code authorizes a court to recharacterize debt as equity. The decision is a cautionary tale for private equity sponsors and other corporate insiders who advance money to their businesses, as well as lenders considering taking an equity stake in a borrower.

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, as 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 courts 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 courts (albeit a minority), because the statute authorizes subordination but is silent concerning recharacterization, Congress intended to deprive bankruptcy courts of the power to recharacterize a claim.

This was the approach taken by a Ninth Circuit bankruptcy appellate panel in *In re Pacific Express, Inc.*, 69 B.R. 112 (B.A.P. 9th Cir. 1986). *Pacific Express* has been widely criticized, however, for failing to distinguish between equitable subordination and recharacterization. *See*, *e.g.*, *In re Daewoo Motor America, Inc.*, 471 B.R. 721 (Bankr. C.D. Cal. 2012); *In re The 3Do Co.*, 2004 Bankr. LEXIS 2345 (Bankr. N.D. Cal. July 2, 2004).

In fact, no fewer than 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. MascoTech, Inc. (In re AutoStyle Plastics, Inc.)*, 269 F.3d 726 (6th Cir. 2001).

In *Grossman v. Lothian Oil Inc. (In re Lothian Oil Inc.)*, 650 F.3d 539 (5th Cir. 2011), the Fifth Circuit adopted a nuanced approach to the question, ruling that a bankruptcy court's ability to recharacterize debt as equity is part of the court's authority to allow and disallow claims under section 502 of the Bankruptcy Code. In *Lothian Oil*, 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, the 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."

Courts also disagree about the law that should apply in deciding whether a purported debt should be recharacterized as equity. Some, including the Fifth Circuit in *Lothian*, view applicable state law as being determinative on this issue. Others have adopted or fashioned tests that include various factors drawn from a wide variety of sources under state, federal, and common law. For example, in *AutoStyle Plastics*, the Sixth Circuit applied an 11-factor test derived from federal tax law first articulated in *Roth Steel Tube Co. v. Commissioner of Internal Revenue*, 800 F.2d 625, 630 (6th Cir. 1986). Among the enumerated factors are 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. Under this test, no single factor is controlling. Instead, each factor is to be considered in the particular circumstances of the case.

In *SubMicron*, the Third Circuit rejected a factor-based 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. Even so, the Third Circuit affirmed a ruling below refusing to recharacterize debt as equity using a factor-based analysis derived in part from state law, noting that the lower court's findings "overwhelmingly support the Court's decision to characterize the [funding transaction] as debt (under any framework or test)."

The Ninth Circuit had an opportunity to weigh in on these and other issues in *Fitness Holdings*.

Fitness Holdings

California-based Fitness Holdings International, Inc. ("FHI") was a seller of treadmills, cross-trainers, and exercise bikes for home use. Between 2003 and 2006, FHI borrowed nearly $25 million from Hancock Park Capital II, L.P. ("Hancock Park"), its sole shareholder. The loans were evidenced by a series of unsecured subordinated promissory notes with stated maturity dates bearing interest at 10 percent per annum.

In July 2004, Pacific Western Bank ("Pacific Western") provided financing to FHI in the form of a $7 million revolving loan and a $5 million installment loan, both of which were secured by a lien on all of FHI's assets. Hancock Park guaranteed the loans. Due to FHI's ongoing financial difficulties, the loan agreements were amended several times during the next three years to extend maturities and waive defaults.

In June 2007, FHI and Pacific Western entered into a refinancing agreement whereby: (i) Pacific Western provided new financing to FHI in the form of a $17 million term loan and an $8 million revolving line of credit, both of which were secured by a lien on all of FHI's assets; (ii) $9 million of the loan proceeds was used to pay off Pacific Western's original secured loan; (iii) $12 million of the loan proceeds was disbursed to Hancock Park to pay off its unsecured loans; and (iv) Hancock Park was released from its guaranty obligations.

The refinancing did not rescue FHI from its financial difficulties, and the company filed for chapter 11 protection in California on October 20, 2008. FHI's unsecured creditors' committee was subsequently authorized to commence litigation on the estate's behalf against Hancock Park, Pacific Western, and certain individual insider defendants to recover the payments made to

Hancock Park as part of the refinancing transaction. Among other things, the complaint stated causes of action for actual and constructive fraudulent transfers under section 548 of the Bankruptcy Code and California's version of the Uniform Fraudulent Transfer Act, recharacterization, breach of fiduciary duty, and equitable subordination under section 510(c) of the Bankruptcy Code.

In January 2010, the bankruptcy court dismissed each count of the complaint for failure to state a claim. Among other things, the bankruptcy court concluded that: (i) because the $12 million payment to Hancock Park was a dollar-for-dollar satisfaction of an antecedent debt (i.e., "reasonably equivalent value"), there was no constructive fraudulent transfer under either California state law or federal bankruptcy law; (ii) the ruling in *Pacific Express* defeated the count of the complaint seeking recharacterization; and (iii) the complaint insufficiently pleaded inequitable conduct to support a claim for equitable subordination.

After FHI's chapter 11 case was converted to a chapter 7 liquidation, the trustee (who succeeded to the committee as plaintiff in the avoidance litigation) appealed the order dismissing the adversary proceeding to the district court. The district court affirmed. Addressing the trustee's recharacterization claim, the court wrote that "[w]hile Plaintiff correctly points out that other circuits have allowed claims for recharacterization, *In re Pacific Express* remains good authority here and the Court therefore rejects Plaintiff's claim for recharacterization." The trustee appealed to the Ninth Circuit.

The Ninth Circuit's Ruling

A three-judge panel of the Ninth Circuit reversed and remanded the case below for additional determinations consistent with its ruling. Writing for the court, circuit judge Sandra S. Ikuta explained that, in the context of avoidance litigation under section 548(a)(1)(B) (dealing with constructive fraudulent transfers), "reasonably equivalent value" is not defined in the Bankruptcy Code, but "value" is defined in section 548(d)(2)(A) to include the "satisfaction or securing of a present or antecedent debt of the debtor." "Under this definition," she wrote, " '[p]ayment of a pre-existing debt is value, and if the payment is dollar-for-dollar, full value is given' " (quoting 5 COLLIER ON BANKRUPTCY ¶ 548.03[5] (16th ed. 2012)). Therefore, the judge concluded, a transaction involving dollar-for-dollar repayment of an antecedent debt cannot be constructively fraudulent.

Judge Ikuta then examined the meaning of the term "debt," which is defined in section 101(12) of the Bankruptcy Code to mean "liability on a claim." The term "claim" is defined in section 101(5)(A) in relevant part 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." In accordance with these "interlocking definitions," the judge wrote, "to the extent a transfer is made in satisfaction of a 'claim' (i.e., a 'right to payment'), that transfer is made for 'reasonably equivalent value' for purposes of § 548(a)(1)(B)(i)," thereby precluding avoidance of the transfer as being constructively fraudulent.

According to Judge Ikuta, U.S. Supreme Court precedent, including *Butner* and *Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co.*, 549 U.S. 443 (2007), establishes that, unless Congress provides otherwise, the "scope of a right to payment is determined by state law." Relying on

Butner, she explained, the Supreme Court held in *Travelers* that a court should not use a federal rule to determine whether a prepetition contract guaranteeing attorneys' fees created a "right to payment" giving rise to a "claim" under the Bankruptcy Code.

On the basis of this authority, the judge concluded that a court may not "fashion a rule 'solely of its own creation' in determining what constitutes a 'claim' for purposes of bankruptcy." Instead, she wrote, "subject to any qualifying or contrary provisions of the Bankruptcy Code, . . . a court must determine whether the asserted interest in the debtor's assets is a 'right to payment' recognized under state law" (citations omitted). Judge Ikuta explained that, in the context of fraudulent-transfer litigation, if a defendant claims that a transfer constituted the repayment of a debt, the court must determine whether the purported "debt" constitutes a right to payment under state law. If no right to payment exists as a matter of state law, "the court may recharacterize the debtor's obligation to the transferee under state law principles."

According to Judge Ikuta, the district court erred by relying on *Pacific Express*. She explained that an Article III district court is not bound by the rulings of a bankruptcy appellate panel. Moreover, the judge wrote, "*Pacific Express* erred in holding that the 'characterization of claims as equity or debt' is governed by § 510(c)." According to Judge Ikuta, recharacterization and equitable subordination address distinct concerns. A court considering a motion to avoid a constructively fraudulent transfer, she emphasized, "must determine whether the transfer is for the repayment of a 'claim' at all."

Although Judge Ikuta agreed with rulings by sister circuits concluding that the Bankruptcy Code gives courts the authority to recharacterize claims, she took issue with circuits that "have fashioned a federal test for recharacterizing an alleged debt in reliance on their general equitable authority under 11 U.S.C. § 105(a)." Instead, the judge concluded that the Fifth Circuit's approach in *Lothian Oil* is more consistent with Supreme Court precedent. "Given the Supreme Court's direction," she wrote, "courts may not rely on § 105(a) and federal common law rules 'of [their] own creation' to determine whether recharacterization is warranted" (quoting *Travelers*).

Having determined that state law must govern whether a "right to payment" exists, Judge Ikuta ruled that dismissal of the complaint was improper because the lower courts' assumption that they did not have the ability to recharacterize a debt as equity was erroneous. She therefore vacated the ruling and remanded the case below for consideration of the matter "under the proper legal framework."

Outlook

With the ruling in *Fitness Holdings*, six federal circuit courts of appeal—and the great majority of bankruptcy and lower appellate courts—have now ruled that recharacterization is among the powers conferred upon a court under the Bankruptcy Code. This is a positive development for chapter 11 debtors in possession, bankruptcy trustees, and stakeholders standing to benefit by the potential for enhanced recovery from a bankruptcy estate.

Even so, by aligning itself with the Fifth Circuit—and against the Third, Fourth, Sixth, and Tenth Circuits—on the issue of choice of law in determining whether a debt should be recharacterized as equity, the Ninth Circuit in *Fitness Holdings* has added to the already considerable confusion in the courts concerning the circumstances under which the remedy should be applied. Under the approach adopted by the Fifth and Ninth Circuits, choice-of-law provisions in loan agreements may have an important role in litigation concerning whether a purported loan is treated as debt or a capital contribution.

Does this rift among the circuits create a distinction largely without a difference? Perhaps and perhaps not. Some states apply a factor-based analysis drawn from federal tax law (some citing *AutoStyle Plastics* or *Roth Steel*) in deciding whether a debt should be recharacterized as equity. *See*, *e.g.*, *Dealer Services Corporation v. American Auto Auction, Inc.*, No. NNH cv 095028282S, 2013 BL 150455 (Conn. Super. Ct. May 14, 2013); *see also Idaho Development, LLC v. Teton View Golf Est.*, 152 Idaho 401, 272 P.3d 373 (Idaho 2011) (using factors to infer intent of the parties consistent with Third Circuit's ruling in *SubMicron*). Other states do not. *See* James M. Wilton and Stephen Moeller-Sally, *Debt Recharacterization Under State Law,* 62 BUS. LAW. 1257 (Aug. 2007) (discussing development of federal and state law governing recharacterization, including common law of Massachusetts and Wisconsin, and concluding that inconsistent application of the law in state and federal courts creates undesirable commercial uncertainty).

In a separate unpublished memorandum decision, the Ninth Circuit affirmed dismissal of the complaint seeking avoidance of the payment to Hancock Park as an actual fraudulent transfer. The court wrote that "[w]e cannot reasonably infer that [FHI] was attempting to 'hinder, delay, or defraud' its creditors . . . simply because it took on secured debt to replace unsecured debt; borrowers regularly give security interests to obtain financing." *See In re Fitness Holdings*

International, Inc., No. 11-56677 (9th Cir. Apr. 30, 2013). However, the court reversed dismissal of the cause of action seeking equitable subordination, writing that “[t]he trustee’s allegations . . . that insiders ‘contrived’ to benefit themselves by knowingly funneling money to themselves out of a failing company plausibly alleged the elements of a claim for equitable subordination.”

Taken as a whole, the Ninth Circuit’s rulings are a cautionary tale to corporate insiders (including private equity sponsors) that make loans to a company or attempt to cash out in a refinancing or dividend recapitalization transaction shortly before the company files for bankruptcy.