

# The Past and Future of Debt Recharacterization

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*The bankruptcy doctrine of debt recharacterization, as developed in four federal circuits, uses multi-factor tests derived from tax cases involving solvent companies. Aspects of these tests make no sense when applied to debt of insolvent companies and the U.S. Treasury has determined that, even for the purpose originally intended, the tests produce “inconsistent and unpredictable results.” The Ninth Circuit has now joined the Fifth Circuit in looking to state law as the basis for determining whether debt claims should be recharacterized as equity and disallowed in bankruptcy cases. This article examines these two approaches, analyzing arguments for and against application of a federal or a state law rule of decision for debt recharacterization. Drawing on U.S. Supreme Court precedents, statutory analysis, and policy, the article shows that state law provides the proper framework for determining whether debt should be recharacterized as equity in bankruptcy. State law offers consistency between state and federal courts and a higher degree of predictability concerning the enforcement of insider debt. The article predicts that the U.S. Supreme Court will ultimately resolve the circuit split in favor of a state law rule of decision. In anticipation of such a ruling, the article concludes by providing an overview of choice of law issues and state law approaches to debt recharacterization.*

## I. INTRODUCTION: EQUITABLE SUBORDINATION AND EVOLUTION IN THE TREATMENT OF INSIDER CLAIMS UNDER THE BANKRUPTCY CODE<sup>1</sup>

Money is the lifeblood of business. For a business in financial distress, such as a middle market or small business struggling to fund payroll or to solve a liquidity crisis, the only source of rescue financing may be from equity owners who understand the business. There is nothing inherently inequitable about insider loans.<sup>2</sup>

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1. An article in *The Business Lawyer* published in August 2007 first argued that debt recharacterization, to the extent viable as a cause of action, must be based on state law. See James M. Wilton & Stephen Moeller-Sally, *Debt Recharacterization Under State Law*, 62 BUS. LAW. 1257, 1278 (2007). The introduction and background sections of this article and certain of the analysis and arguments herein are drawn from this earlier article. The authors are grateful for the contribution of Stephen Moeller-Sally to this article.

2. Robert Charles Clark, in his seminal article *The Duties of the Corporate Debtor to Its Creditors*, identified four equitable principles that apply to insolvent businesses: (i) Truth, (ii) Respect, (iii) Evenhandedness, and (iv) Nonhindrance. 90 HARV. L. REV. 505, 508–13 (1977). Lack of Truth results in what Clark terms “Ur-Fraud,” deception or falsehood practiced on creditors to their detriment; it is most commonly thought of as “actual” fraud. Respect is violated when an insolvent debtor openly

The well-established doctrine of equitable subordination, however, is implicated if insider creditors take unfair advantage of their control positions to the detriment of creditors. As developed under the Bankruptcy Act, the doctrine of equitable subordination established the general principle that money loaned by corporate insiders is as green as money loaned by non-insiders; absent inequitable conduct, an insider's claim to recover a loan to a corporation ranks *pari passu* with claims of non-insider lenders.<sup>3</sup> The Supreme Court in establishing this doctrine overruled a line of earlier cases that had adopted a rigid, *per se* rule subordinating insider debt regardless of whether the insider lender had engaged in improper or inequitable conduct.<sup>4</sup>

In 1978, Congress endorsed and codified the existing Supreme Court case law of equitable subordination. Section 510(c)(1) of the Bankruptcy Code gives bankruptcy courts express authority “under principles of equitable subordination” to subordinate insider or non-insider claims to claims of other creditors.<sup>5</sup> The Bankruptcy Code's legislative history makes clear that Congress “intended that the term ‘principles of equitable subordination’ follow existing case law

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consummates a transaction for no consideration or for less than full value, but without intention that creditors will be left unpaid. Respect is the admonition: “be just before you are generous”; insolvent debtors should give primacy to legal obligations before diverting assets to other purposes. The remedy for violation of the principle of Respect is contained in the law of constructive fraud.

The third principle, Evenhandedness, posits that one creditor should not be favored over another; this principle underlies the law of preferences. The fourth principle, Nonhindrance, is broader than and subsumes the other principles; it is given effect through legal doctrines of equitable subordination, substantive consolidation, and state law doctrines of veil piercing and successor liability.

Insider loans implicate none of the principles that Clark has identified, other than, arguably, the principle of Evenhandedness in the case of insider loans that are given priority as secured loans. Clark's article was written prior to the enactment of Chapter 11 of the Bankruptcy Code. Chapter 11 promotes a goal of business reorganization over liquidation and allows the incurrence of secured loans, by insiders or otherwise, to serve that purpose. Consequently, insider loans, in accordance with the statutory objectives of Chapter 11 of the Bankruptcy Code, do not as a *per se* matter run counter to any of Clark's equitable principles.

3. The case law under the Bankruptcy Act developed through a triad of U.S. Supreme Court cases. See *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307 (1939); *Pepper v. Litton*, 308 U.S. 295 (1939); *Comstock v. Grp. of Institutional Inv'rs*, 335 U.S. 211 (1948). In *Benjamin v. Diamond (In re Mobile Steel Co.)*, 563 F.2d 692, 700 (5th Cir. 1977), the United States Court of Appeals for the Fifth Circuit synthesized the existing case law into a concise, open-ended standard requiring “some type of inequitable conduct” as a prerequisite for equitable subordination of insider claims. The United States Supreme Court has acknowledged the influence of the Fifth Circuit's holding in *Mobile Steel* requiring inequitable conduct as a precondition for equitable subordination and has declined, to date, to take a contrary position. See *United States v. Noland*, 517 U.S. 535, 538 (1996).

4. See *Gannett Co. v. Larry*, 221 F.2d 269, 275 (2d Cir. 1955) (holding that the Supreme Court case of *Comstock* renders untenable a strict rule subordinating insider claims).

5. Section 510(c) provides:

(c) Notwithstanding subsections (a) and (b) of this section, 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 such a subordinated claim be transferred to the estate.

and leave to the courts development of this principle.<sup>6</sup> It is also clear that Congress, by incorporating this provision into the Bankruptcy Code, rejected any *per se* subordination of insider debt.<sup>7</sup>

Approximately thirty years ago, a bankruptcy court-created doctrine of debt recharacterization began to displace equitable subordination as a favored cause of action for bankruptcy trustees and creditors' committees seeking to invalidate loans or other debt claims held by insiders in bankruptcy cases. Certain federal circuits have recognized debt recharacterization as a "no fault" cause of action that does not require proof of inequitable conduct by the insider/creditor. As a result, a cause of action in bankruptcy court for debt recharacterization can be easier to prove than an action for equitable subordination.

The U.S. Courts of Appeals for the Fifth and Ninth Circuits, by contrast, have rejected a court-created doctrine of debt recharacterization grounded in federal law. These courts have acknowledged a circuit split, and have found that, if debt recharacterization exists at all, U.S. Supreme Court precedent requires that the doctrine must be based on state law. The source of law makes a difference. Under the majority federal debt recharacterization case law, bankruptcy courts are afforded wide discretion to recharacterize insider debt as equity under an amorphous, multi-factor federal standard derived from tax court cases involving solvent corporations. State law, in many jurisdictions, does not explicitly recognize debt recharacterization and offers a more forgiving standard for the enforceability of insider debt based on contract principles.

This article reviews the status of the circuit split, summarizes arguments for and against application of a federal or a state law rule of decision for debt recharacterization, and examines choice of law issues and applicable state law standards for the enforcement of insider debt based on a prediction that the U.S. Supreme Court will ultimately resolve the circuit split in favor of a state law rule of decision.

## II. CIRCUIT SPLIT: APPLICABILITY OF FEDERAL VERSUS STATE LAW RULE OF DECISION TO DEBT RECHARACTERIZATION

There is a well-developed circuit split regarding whether state law or federal law provides the rule of decision for debt recharacterization and the enforceabil-

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6. 124 CONG. REC. 32398 (1978).

7. The bill developed by the Commission on the Bankruptcy Laws of the United States, first introduced in the House of Representatives as House Bill 31 (H.R. 31, 94th Cong. (1976)) and introduced in the Senate as Senate Bill 236 (S. 236, 94th Cong. (1975)) contained a blanket subordination of all claims of insiders and their affiliates. Section 4-406(a)(2) of the Commission Bill provided that "any claim, whether secured or unsecured, of any principal officer, director, or affiliate of a debtor, or of any member of the immediate family of such officer, director, or affiliate" would be "subordinated in payment to all other nonsubordinated but allowable claims." S. 236, 94th Cong., § 4-406(a)(2) (1975). Congress rejected this statutory language and the concept of a blanket subordination of all claims of insiders. In the report accompanying the final bill, Congress endorsed existing case law and affirmed the equitable power of the bankruptcy courts to subordinate claims in circumstances consistent with prevailing authority: "This Section is intended to codify case law, such as *Pepper v. Litton*, 308 U.S. 295 (1939), . . . and is not intended to limit the court's power in any way. . . . The court's power is broader than the general doctrine of equitable subordination, and encompasses subordination on any equitable grounds." H.R. REP. NO. 95-595, at 359 (1978).

ity of insider claims in bankruptcy. Cases applying a federal rule of decision to debt recharacterization adopt one of two approaches. The U.S. Court of Appeals for the Eleventh Circuit has adopted a simple test that requires recharacterization of insider debt as equity in any situation where an advance by an insider was made at a time when no other disinterested lender would have extended credit. In contrast, the U.S. Courts of Appeals for the Third, Fourth, Sixth, and Tenth Circuits endorse the use of open-ended, multi-factor tests to determine whether insider loans should be recharacterized as equity. The U.S. Courts of Appeals for the Fifth and Ninth Circuits have held that state law provides the only basis for recharacterizing insider loans as equity.

## A. CIRCUITS RELYING ON FEDERAL LAW

### 1. The Eleventh Circuit's Objective, Inflexible Approach to Debt Recharacterization

The U.S. Court of Appeals for the Eleventh Circuit in *Estes v. N & D Properties, Inc.* adopted a simple test for determining whether an insider loan may be recharacterized as a capital contribution: “[S]hareholder loans may be deemed capital contributions in one of two circumstances: where the trustee proves initial under-capitalization or where the trustee proves that the loans were made when no other disinterested lender would have extended credit.”<sup>8</sup> The *N & D Properties* court’s adoption of this test is puzzling in several respects. In the first place, the test seems to have been invented without reference to relevant precedent.<sup>9</sup> In the second place, the *N & D Properties* court held that a minority stockholder and lender was a fiduciary of creditors of the corporation, again without citation to state law precedent.<sup>10</sup>

Finally, the most disturbing aspect of the *N & D Properties* test is the court’s conclusion that a shareholder loan should *per se* be deemed a capital contribution if the debtor could not obtain a loan from a disinterested lender on the same terms.<sup>11</sup> This holding, if followed, would preclude shareholders, in many circumstances, from providing debt financing except through bankruptcy court ap-

8. *Estes v. N & D Props., Inc.* (*In re N & D Props., Inc.*), 799 F.2d 726, 733 (11th Cir. 1986).

9. The only case that the *N & D Properties* court cites for support is a Fifth Circuit decision under the Bankruptcy Act: *Mach. Rental, Inc. v. Herpel* (*In re Multiponics, Inc.*), 622 F.2d 709 (5th Cir. 1980). *N & D Props., Inc.*, 799 F.2d at 733. The *Multiponics* case, however, involved a claim for equitable subordination, not debt recharacterization. Furthermore, nothing in the *Multiponics* case can be read as establishing a *per se* rule subordinating insider loans in all situations where debt financing is unavailable from third-party sources. To the contrary, the *Multiponics* court considered the non-availability of debt financing from third-party sources as evidence of undercapitalization, *In re Multiponics*, 622 F.2d at 719, but articulated a test that required evidence of misconduct that resulted in injury to creditors or the conferring of unfair advantages on the insider/claimant before the debt would be equitably subordinated. *Id.* at 713.

10. The only facts cited by the *N & D Properties* court to support the status of the stockholder/lender in that case as a fiduciary was that the minority stockholder, a housewife without prior business experience: (i) served as secretary of the corporation; (ii) engaged legal counsel and a financial consultant to evaluate the corporation’s options, although the advice of these professionals was never implemented; and (iii) took action to file a bankruptcy petition for the corporation. *Id.* at 731–32.

11. *Id.* at 733.

proved debtor-in-possession financing.<sup>12</sup> The *N & D Properties* test denies distressed corporations access to debt financing from insider investors, even when insiders may be acting in the best interests of the corporation and its creditors.

The *N & D Properties* decision is distinctly a minority approach to debt recharacterization. The case has failed to gain traction and has been cited as precedent primarily by lower courts in the Eleventh Circuit.<sup>13</sup>

## 2. The Third, Fourth, Sixth, and Tenth Circuits' Subjective, Flexible, Multi-Factor Approach to Debt Recharacterization

In other jurisdictions that have adopted a federal rule of decision, courts have adopted one or more multi-factor tests for determining when insider debt may be recharacterized as an equity contribution.<sup>14</sup> These multi-factor tests are derived from U.S. tax decisions related to the tax benefits of insider loans to solvent corporations. The most commonly cited of these tests is the eleven-factor test first articulated in *Roth Steel Tube Co. v. Commissioner of Internal Revenue*,<sup>15</sup> in which consideration is given to the following factors:

- (1) the names given to the instruments, if any, evidencing the indebtedness;
- (2) the presence or absence of a fixed maturity date and schedule of payments;
- (3) the presence or absence of a fixed interest rate and interest payments;
- (4) the source of repayments;

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12. Indeed, it could be argued that the *N & D Properties* standard, if applied consistently, would prevent even post-petition loans by insiders. This is because a debtor-in-possession is authorized to obtain secured credit post-petition only upon a showing that the loans are necessary and that no other credit is available on better terms. See 11 U.S.C. § 364(c) (2018) (authorizing court approval of secured credit only if a debtor-in-possession is unable to obtain unsecured credit); see also *In re W. Pac. Airlines, Inc.*, 223 B.R. 567, 572 (Bankr. D. Colo. 1997); *In re Aqua Assocs.*, 123 B.R. 192, 196 (Bankr. E.D. Pa. 1991) (“[C]redit should not be approved . . . when funds are readily available from insiders or others without providing the lender with the benefits of any priority.”); *In re Ames Dep’t Stores, Inc.*, 115 B.R. 34, 37 (Bankr. S.D.N.Y. 1990).

13. See, e.g., *Mukamal v. Bakes*, 383 B.R. 798, 829 (S.D. Fla. 2007); *Diasonics, Inc. v. Ingalls*, 121 B.R. 626, 630 (Bankr. N.D. Fla. 1990).

14. See *In re Province Grande Olde Liberty, LLC*, 655 F. App’x 971 (4th Cir. 2016), cert. granted sub nom. *PEM Entities LLC v. Levin*, 137 S. Ct. 2326 (2017), cert. dismissed as improvidently granted, *PEM Entities LLC v. Levin*, No. 16-492, 2017 WL 3429146 (U.S. Aug. 10, 2017); *Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Sys. Corp.)*, 432 F.3d 448, 455 n.8 (3d Cir. 2006); *Fairchild Dornier GmbH v. Official Comm. of Unsecured Creditors (In re Official Comm. of Unsecured Creditors for Dornier Aviation (N. Am.), Inc.)*, 453 F.3d 225, 233 (4th Cir. 2006); *Sender v. Bronze Grp., Ltd. (In re Hedged-Invs. Assocs., Inc.)*, 380 F.3d 1292, 1298 (10th Cir. 2004); *Bayer Corp. v. MascoTech, Inc. (In re Autostyle Plastics, Inc.)*, 269 F.3d 726, 747–53 (6th Cir. 2001). Various multi-factor tests are identified in *SubMicron Sys.*, 432 F.3d at 455 n.8. The tests overlap as to the factors considered and are very similar, if not identical. *Dornier Aviation*, 453 F.3d at 234 n.6 (“The substance of all of these multi-factor tests is identical.”).

15. 800 F.2d 625 (6th Cir. 1986), cert. denied, 481 U.S. 1014 (1987).

- (5) the adequacy or inadequacy of capitalization;
- (6) the identity of interests between the creditor and stockholder;
- (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; and
- (11) the presence or absence of a sinking fund to provide repayments.<sup>16</sup>

The debt recharacterization cases that engage in a multi-factor analysis emphasize that the process involves an open-ended inquiry. The number of factors reviewed varies from case to case.<sup>17</sup> Courts agree that the weight given to the factors can vary and that no one factor is controlling.<sup>18</sup> A creditor's status as an insider and the undercapitalization of the debtor are, standing alone, insufficient to support debt recharacterization.<sup>19</sup>

The multiple factors considered by the courts focus on the circumstances and terms of the insider loans rather than inequitable conduct of the insider in administering the loans. This is because the courts, in an effort to distinguish debt recharacterization as a cause of action that is separate and apart from equitable subordination, have concluded that debt recharacterization is a process of divining intent rather than determining fault.<sup>20</sup> Courts have held that creditor behavior is relevant to the debt recharacterization analysis only to the extent that it allows an inference as to the creditor's intent that an advance was debt or equity at the time it was made.<sup>21</sup>

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16. *Id.* at 630.

17. See *SubMicron Sys.*, 432 F.3d at 455 n.8 (noting use of eleven-factor, thirteen-factor, and seven-factor tests in reported cases).

18. See *id.* at 456 (“No mechanistic scorecard suffices.”); *Dornier Aviation*, 453 F.3d at 234 (“This test is a highly fact-dependent inquiry that will vary in application from case to case.”); *In re Hedged-Invs. Assocs., Inc.*, 380 F.3d at 1298–99 (“None of these factors is dispositive and their significance may vary depending on circumstances.”).

19. See *Dornier Aviation*, 453 F.3d at 234.

20. See *SubMicron Sys.*, 432 F.3d at 456 (the court's “overarching inquiry” is to “discern whether the parties called an instrument one thing when in fact they intended it as something else”); *Dornier Aviation*, 453 F.3d at 232 (“While 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.”).

21. See *SubMicron Sys.*, 432 F.3d at 456 (“[I]ntent may be inferred from what the parties say in their contracts, from what they do through their actions, and from the economic reality of the surrounding circumstances.”). But see *In re Province Grande Olde Liberty, LLC*, No. 13-01563-8-RDD, 2014 WL 6901052, at \*3–4 (Bankr. E.D.N.C. Dec. 5, 2014) (recharacterizing secured mortgage loan originated by an arm's length bank lender based on actions by insider that purchased the mortgage loan and failed to continue foreclosure), *aff'd*, 655 F. App'x 971 (4th Cir. 2016).

## B. CIRCUITS RELYING ON STATE LAW

In 2011, the U.S. Court of Appeals for the Fifth Circuit rejected a federal rule of decision for debt recharacterization, concluding that debt recharacterization under the Bankruptcy Code, if appropriate at all, must be based on state law.<sup>22</sup> In *Grossman v. Lothian Oil Inc. (In re Lothian Oil Inc.)*, an individual non-insider made two “loans” to the debtors in exchange for a 1 percent royalty payment from the gross proceeds of certain of the debtors’ assets and the debtors’ agreement to repay the loans from the proceeds of qualifying equity placements.<sup>23</sup> The bankruptcy court disallowed the associated claims on the basis that the claims “assert common equity interests at best.”<sup>24</sup> On appeal, the district court reversed, applying a *per se* rule to prohibit bankruptcy courts from recharacterizing contributions from non-insiders.<sup>25</sup>

The Fifth Circuit, reversing the district court and affirming the bankruptcy court’s decision, refused to apply such a *per se* rule, concluding that recharacterization, to the extent permitted under state law, applies to both insiders and non-insiders and is part of the bankruptcy court’s authority to allow and disallow claims. The Fifth Circuit grounded its holding in section 502(b) of the Bankruptcy Code, which mandates that all claims “are deemed allowed” unless the bankruptcy court determines a claim is unenforceable under state law or one of eight enumerated federal exceptions to claims allowance.<sup>26</sup> Rejecting a court-created federal test for debt recharacterization, the Fifth Circuit explained that, “[t]aken together, *Butner* and § 502(b) support the bankruptcy courts’ authority to recharacterize claims,” but only pursuant to applicable state law.<sup>27</sup> If a claim for debt is disallowed under state law, because “state law classifies the interest as equity rather than debt, then implementing state law as envisioned in *Butner* requires different treatment than simply disallowing the claim,” i.e., by “recharacterizing the claim as an equity interest.”<sup>28</sup> In light of that analysis, the Fifth Circuit observed that “resort to § 105(a) is unnecessary,” which is, moreover, consistent with precedent reflecting “a cautious view of § 105(a).”<sup>29</sup>

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22. 650 F.3d 539 (5th Cir. 2011), *cert. denied sub nom.* *Lothian Cassidy, LLC v. Lothian Oil Inc.*, 132 S. Ct. 1573 (2012).

23. *Id.* at 541.

24. *Id.* at 544. While the bankruptcy court did not issue a written opinion, the bankruptcy court’s written order incorporated by reference the findings of fact and conclusions of law announced at the hearing, which included an analysis of the multi-factor test employed by the Fifth Circuit in *Jones v. United States*, 659 F.2d 618, 622 n.12 (5th Cir. 1981), with respect to recharacterization in the tax context.

25. *Id.* at 542.

26. *Id.* at 543 (citing *Butner v. United States*, 440 U.S. 48, 54 (1979)). The enumerated exceptions to claim allowance relate to claims that are unenforceable under contract or applicable law, claims for unmatured interest or non-dischargeable unmatured debt, tax claims that exceed the value of the property securing them, insider or attorney claims for services that exceed the value of such services, lesser damages claims beyond certain limits, employment contract termination claims, and late-filed claims. See 11 U.S.C. § 502(b)(1)–(9) (2018).

27. *In re Lothian Oil Inc.*, 650 F.3d at 543.

28. *Id.*

29. *Id.*

In *Lothian Oil*, the Fifth Circuit went on to apply Texas law, finding that recharacterization was appropriate.<sup>30</sup>

Two years later, in *Official Committee of Unsecured Creditors v. Hancock Park Capital II, L.P. (In re Fitness Holdings Int'l, Inc.)*, the U.S. Court of Appeals for the Ninth Circuit followed the Fifth Circuit's lead, holding that a state law rule of decision determines whether debt may be recharacterized.<sup>31</sup> In *Fitness Holdings*, the debtor had received a secured loan from Pacific Western Bank and an unsecured loan from Hancock Park, its sole shareholder.<sup>32</sup> Three years after the initial loans were advanced, Pacific Western Bank agreed to refinance Fitness Holdings' debt, including all amounts owed to Hancock Park.<sup>33</sup> The debtor filed for bankruptcy just over a year later.

Shortly after the debtor's bankruptcy filing, the committee of unsecured creditors filed a complaint on behalf of the debtor and its estate against Hancock Park and Pacific Western Bank.<sup>34</sup> The complaint sought to recover the payments made to Hancock Park as a result of the refinancing transaction with Pacific Western Bank and requested that the court enter a declaratory judgment recharacterizing the financing provided by Hancock Park as an equity investment, rather than an extension of credit.<sup>35</sup> The bankruptcy court dismissed all claims against Hancock Park and the district court affirmed,<sup>36</sup> finding that, as a matter of law, the court was barred from recharacterizing loans as equity investments based on longstanding precedent from the Ninth Circuit Bankruptcy Appellate Panel.<sup>37</sup> The trustee appealed to the Ninth Circuit.

Noting the split in authority created by *Lothian Oil*, the Ninth Circuit found that the Fifth Circuit's reasoning was more consistent with the Supreme Court's precedents requiring bankruptcy courts to allow or disallow claims by reference to state law.<sup>38</sup> The Ninth Circuit cited the Supreme Court's decision in *Travelers Casualty & Surety Co. v. Pacific Gas & Electric Co.* for the proposition that "courts may not rely on § 105(a) and federal common law rules 'of their own creation' to determine whether recharacterization is warranted."<sup>39</sup> Instead, courts must "determine whether a party has a 'right to payment,' i.e., a 'claim,' § 101(5) [of the

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30. *Id.* at 544 (citing a reference to the sixteen-factor test applied by the Third Circuit in *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3d Cir. 1968), in the Texas state court of appeals' decision regarding recharacterization of debt for state tax law purposes in *Arch Petroleum, Inc. v. Sharp*, 1998 S.W.2d 475, 477 n.3 (Tex. App. 1997)).

31. 714 F.3d 1141 (9th Cir. 2013).

32. *Id.* at 1143.

33. *Id.* at 1143–44.

34. *Id.* at 1144.

35. *Id.*

36. A month after its ruling, the bankruptcy court appointed a trustee for the debtor. The trustee replaced the committee of unsecured creditors as plaintiff in the litigation. *Id.*

37. *In re Fitness Holdings Int'l, Inc.*, No. CV 10-0647 AG, 2011 WL 7763674, at \*1 (C.D. Cal. Aug. 31, 2011) (citing *In re Pac. Express*, 69 B.R. 112, 115 (9th Cir. B.A.P. 1986)).

38. *Fitness Holdings*, 714 F.3d at 1148.

39. *Id.* at 1148–49 (citing *Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co.*, 549 U.S. 443, 451 (2007)).



Bankruptcy Code], by reference to state law.<sup>40</sup> The Ninth Circuit remanded the case so that the debt obligation could be analyzed under a state law test.<sup>41</sup>

### C. THE U.S. SUPREME COURT MAY GRANT CERTIORARI TO RESOLVE THE CIRCUIT SPLIT

The split among the seven circuits that have addressed the issue of debt recharacterization is clear,<sup>42</sup> and there is no reason to believe that the conflict will abate without the Supreme Court's intervention. The Tenth Circuit expressly considered whether to change its approach in light of the circuit level decisions in *Fitness Holdings* and *Lothian Oil*, but decided to continue its reliance on a thirteen-factor federal test.<sup>43</sup> Similarly, the Fourth Circuit in *PEM Entities* applied a federal test comprised of "the eleven factors adopted [by the Fourth Circuit previously] in *Dornier*" and then declined a request for en banc rehearing to consider the reasoning of *Dornier* in light of *Fitness Holdings* and *Lothian Oil*.<sup>44</sup> The Supreme Court denied certiorari with respect to appeals arising out of *Lothian Oil* and *Fitness Holdings*.<sup>45</sup> However, the Court initially agreed to hear the appeal in *PEM Entities*. The Court reversed the decision to grant certiorari due to a standing issue arising from the respondent's settlement of claims in the bankruptcy case.<sup>46</sup> Nevertheless, in its original decision to grant certiorari in *PEM Entities*, the Supreme Court presumably recognized both the existence of the circuit split and that application of a federal or state law rule of decision may be outcome determinative. Accordingly, it is reasonable to assume that the Supreme

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40. *Id.* at 1148 (citing *Butner v. United States*, 440 U.S. 48, 55 (1979); *Travelers*, 549 U.S. at 451).

41. *Id.* at 1150; see *In re Fitness Holdings Int'l, Inc.*, No. CV 14-1059 AG, 2014 WL 12628681, at \*1 (C.D. Cal. Oct. 9, 2014) (applying California law on remand and holding claim not subject to recharacterization), *aff'd*, 660 F. App'x 546 (9th Cir. 2016), *cert. denied sub nom. Leslie v. Hancock Park Capital II, L.P.*, No. 16-1136, 2017 WL 1064323 (U.S. Oct. 2, 2017).

42. The First, Second, Seventh, and Eighth Circuits have not established tests for debt recharacterization. See *FCC v. Airadigm Commc'ns, Inc.* (*In re Airadigm Commc'ns, Inc.*), 616 F.3d 642, 657 n.11 (7th Cir. 2010) (acknowledging that the U.S. Court of Appeals for the Seventh Circuit has "never definitively stated" whether it recognizes a cause of action for recharacterization); *In re Eternal Enter., Inc.*, 557 B.R. 277, 286 (Bankr. D. Conn. 2016) (noting that the Second Circuit has not addressed debt recharacterization); *In re MSP Aviation, LLC*, 531 B.R. 795, 805 (Bankr. D. Minn. 2015) (noting that the Eighth Circuit has not ruled on whether § 105(a) permits a bankruptcy court to equitably recharacterize a loan to equity); *In re Wolverine, Proctor & Schwartz, LLC*, 447 B.R. 1, 29 (Bankr. D. Mass. 2011) (predicting that First Circuit would follow majority federal rule in utilizing factors culled from tax cases).

43. See *In re Alternate Fuels, Inc.*, 789 F.3d 1139, 1146 (10th Cir. 2015) (holding that the "Tenth Circuit's *Hedged-Investments* Test [r]emains [g]ood [l]aw").

44. *In re Province Grande Olde Liberty, LLC*, 655 F. App'x 971 (4th Cir. 2016).

45. See *Leslie v. Hancock Park Capital II, L.P.*, No. 16-1136, 2017 WL 1064323 (U.S. Oct. 2, 2017) (*cert. denied*); *Lothian Cassidy, L.L.C. v. Lothian Oil Inc.*, 565 U.S. 1201 (2012) (*cert. denied*).

46. See Joint Motion of PEM Entities LLC and Province Grande Olde Liberty, LLC to Confirm Party Status, *PEM Entities LLC v. Levin*, No. 16-492, 2017 WL 3429146 (U.S. July 21, 2017); *PEM Entities LLC v. Levin*, No. 16-492, 2017 WL 3429146 (U.S. Aug. 10, 2017) (*cert. dismissed as improvidently granted*).

Court, in the future, may grant certiorari in an appropriate case to resolve the split.<sup>47</sup>

### III. RESOLVING THE CIRCUIT SPLIT: ARGUMENTS FOR AND AGAINST A STATE OR A FEDERAL LAW RULE OF DECISION

#### A. ARGUMENTS FOR A STATE LAW RULE OF DECISION

Arguments for a state law rule of decision for debt recharacterization are based on (i) U.S. Supreme Court precedents requiring application of state law to the allowance of claims, (ii) the absence of a statutory basis for debt recharacterization under the Bankruptcy Code, and (iii) provisions of the Bankruptcy Code and Bankruptcy Rules that explicitly contemplate debt recharacterization as part of a claims allowance process governed by state law.<sup>48</sup> Finally, the source of law that inspired the federal test for debt recharacterization, tax cases involving solvent corporations, has changed. The U.S. Treasury has determined that *Roth Steel* type multi-factor tests produce “inconsistent and unpredictable results” even in tax cases involving solvent corporations. In a recent regulatory change, the United States has rejected the use of *Roth Steel* type multi-factor tests in favor of automatic recharacterization of debt of solvent corporations in certain types of related party transactions. Furthermore, multi-factor tests were formulated in tax cases and were never designed to apply to recharacterize debt of insolvent businesses. Two decades of use of *Roth Steel* type multi-factor tests in bankruptcy courts have proved that the tests fail to allow accurate prediction of the enforceability of insider loans in bankruptcy.

The United States Supreme Court has consistently held that claims in bankruptcy are determined by reference to state law. In *Travelers*, the Court characterized as a “settled principle” that “[c]reditors’ entitlements in bankruptcy arise in the first instance from the underlying substantive law creating the debtor’s obligation, subject to any qualifying or contrary provisions of the Bankruptcy Code.”<sup>49</sup>

The *Travelers* decision was grounded in precedents that have long recognized the principle that “the ‘basic federal rule’ in bankruptcy is that state law governs

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47. See *Butner v. United States*, 440 U.S. 48, 55 (1979) (quoting *Lewis v. Mfrs. Nat’l Bank of Detroit*, 364 U.S. 603, 609 (1961)) (prioritizing the uniform treatment of claims inside and outside of bankruptcy “to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving ‘a windfall merely by reason of the happenstance of bankruptcy’”); see also *Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co.*, 549 U.S. 443, 450–51 (2007) (noting importance of trying to avoid the application of inconsistent rules of decision inside and outside of bankruptcy); *Raleigh v. Ill. Dep’t of Revenue*, 530 U.S. 15 (2000) (same).

48. Section 502(b)(1) of the Bankruptcy Code provides that claims are disallowed if they are “unenforceable against the debtor and property of the debtor, under any agreement or applicable law.” The Supreme Court has held that the phrase “applicable nonbankruptcy law” encompasses any relevant nonbankruptcy law, including federal law. *Patterson v. Shumate*, 504 U.S. 753, 758 (1992). The Supreme Court has not interpreted the phrase “applicable law,” but lower courts have found that the phrase should be interpreted similarly. See, e.g., *In re CVAH, Inc.*, 570 B.R. 816, 825–26 (Bankr. D. Idaho 2017). While nonbankruptcy federal law is relevant to the claims allowance process, it is clear that, as a general matter, claims enforceable under applicable state law will be allowed in bankruptcy unless they are expressly disallowed. *Travelers Cas. & Surety Co.*, 549 U.S. at 452.

49. 549 U.S. 443, 450 (2007) (quoting *Raleigh*, 530 U.S. at 20).

the substance of claims, Congress having ‘generally left the determination of property rights in the assets of a bankrupt’s estate to state law.’<sup>50</sup> This principle is based on congressional intent, as expressed in the Bankruptcy Code, to achieve uniformity between state and federal courts. In *Butner v. United States*, for example, the Supreme Court rejected the idea that court-created federal common law or rules of equity would determine creditors’ rights in bankruptcy, and affirmed that, absent an express federal statute to the contrary, a creditor and mortgagee have the same rights and remedies in bankruptcy court as in state courts. As the *Butner* Court noted:

Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving a “windfall merely by reason of the happenstance of bankruptcy.”<sup>51</sup>

Similarly, in *Raleigh v. Illinois Department of Revenue*, the Supreme Court also rejected the view that claims in bankruptcy should be analyzed and allowed based on uniform federal rules, instead holding that claims should be determined consistently, whether in state or federal courts, based on state law.<sup>52</sup> In *Raleigh*, the Court considered whether substantive state law allocating the burden of proof to the taxpayer in disputing a tax assessment should be applied in bankruptcy court.<sup>53</sup> The *Raleigh* Court noted that a uniform federal substantive rule that is inconsistent with state law would create anomalous results; a claimant that obtained relief from the stay and a judgment in state court would be entitled to enforcement of the judgment in bankruptcy court even if the claim would be disallowed under uniform federal law.<sup>54</sup> Congress, the *Raleigh* Court noted, could not have intended that a claim would be allowed if relief

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50. *Id.* (quoting *Butner*, 440 U.S. at 57). The Supreme Court’s deference to state law in *Butner* was, in turn, grounded in its precedents. The *Butner* Court noted that while, under the United States Constitution, Congress is granted the power to establish uniform laws on the subject of bankruptcy throughout the United States, state laws are suspended only to the extent of actual conflict with federal statutes. *Butner*, 440 U.S. at 54 n.9 (citing *Sturges v. Crowninshield*, 17 U.S. 122 (1918); *Ogden v. Saunders*, 25 U.S. 213 (1827)); see also *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 161 (1946) (“What claims of creditors are valid and subsisting obligations against the bankrupt at the time a petition in bankruptcy is filed, is a question which, in the absence of overruling federal law, is to be determined by reference to state law.”). The Supreme Court’s precedents with regard to application of substantive non-bankruptcy law in bankruptcy cases are also in accord with similar decisions in cases involving federal diversity jurisdiction. See *Erie R.R. Co. v. Tompkins*, 304 U.S. 64, 78 (1938); Charles W. Mooney, Jr., *A Normative Theory of Bankruptcy Law: Bankruptcy As (Is) Civil Procedure*, 61 WASH. & LEE L. REV. 931, 989 (2004) (“[The] parallel rationales for federal system of bankruptcy law and diversity jurisdiction support . . . [the] core principle that bankruptcy law, like trans-substantive civil procedure law, generally should serve the interests of and respect rightsholders’ non-bankruptcy legal entitlements.”).

51. *Butner*, 440 U.S. at 55 (quoting *Lewis*, 364 U.S. at 609).

52. 530 U.S. at 20 (“The basic federal rule in bankruptcy is that state law governs the substance of claims.”).

53. *Id.* at 17.

54. *Id.* at 25–26.

from the stay were granted and the claim determined in state court, yet disallowed if the claim were litigated in bankruptcy court.<sup>55</sup> In all of its cases, the Supreme Court has endorsed a simple rule: in the absence of modification expressed in the Bankruptcy Code, a claim in bankruptcy is determined according to substantive state law.<sup>56</sup>

The Bankruptcy Code provides no express authority for debt recharacterization; courts adopting a federal rule of decision for debt recharacterization refer to the authority of section 105(a) of the Bankruptcy Code.<sup>57</sup> Section 105(a) provides generalized authority for bankruptcy courts to “issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.”<sup>58</sup> The U.S. Supreme Court, however, has consistently held that section 105(a) is not a source of substantive law. For example, in *Law v. Siegel*, the U.S. Supreme Court held that “[s]ection 105(a) confers authority to ‘carry out’ the provisions of the Code” but not authority to act outside the bounds of other “specific provision[s] of the Code.”<sup>59</sup> The Court held that a bankruptcy court could not rely on its “inherent powers” under section 105(a) to “surcharge” a debtor’s exempt assets (by making those assets liable for administrative expenses) because that surcharge violated another provision of the Bankruptcy Code, section 522.<sup>60</sup> Similarly, in *Norwest Bank Worthington v. Ahlers*, the U.S. Supreme Court rejected a bankruptcy court’s use of “a variety of ‘equitable arguments’” and “equitable powers” to create an additional ground to justify confirmation of a plan of reorganization that was otherwise precluded by the statute.<sup>61</sup> “[W]hatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code.”<sup>62</sup> Therefore, section 105(a) cannot be the font of authority for a federal rule of decision for debt recharacterization. Such a rule would be tantamount to creating an additional ground for claims disallowance beyond the express statutory grounds set forth in section 502(b) of the Bankruptcy Code, just the result that *Norwest Bank* disapproves.

The Bankruptcy Code and the Bankruptcy Rules expressly contemplate that “applicable law,” i.e., state law, will apply to the allowance or disallowance of claims,<sup>63</sup> except for eight enumerated exceptions where federal law expressly disallows certain types of claims.<sup>64</sup> Under section 502(b)(4) of the Bankruptcy Code, one of the enumerated exceptions, Congress established a uniform federal

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55. *Id.*

56. *Id.* at 20.

57. See, e.g., *Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Sys. Corp.)*, 432 F.3d 448, 454–55 n.6 (3d Cir. 2006); *Fairchild Dornier GmbH v. Official Comm. of Unsecured Creditors (In re Official Comm. of Unsecured Creditors for Dornier Aviation (N. Am.), Inc.)*, 453 F.3d 225, 231 (4th Cir. 2006); *Bayer Corp. v. MascoTech, Inc. (In re Autostyle Plastics, Inc.)*, 269 F.3d 726, 748 (6th Cir. 2001).

58. 11 U.S.C. § 105(a) (2018).

59. 134 S. Ct. 1188, 1194–95 (2014).

60. *Id.*

61. 485 U.S. 197, 206–07 (1988).

62. *Id.* at 206.

63. See 11 U.S.C. § 502(b)(1) (2018).

64. See *id.* § 502(b).

rule disallowing claims “for services of an insider . . . [if] such claim exceeds the reasonable value of such services.”<sup>65</sup> Thus, it is apparent that Congress considered whether insider claims should be disallowed or subordinated under a federal rule of decision. Congress rejected a uniform federal rule in favor of application of state law, except in connection with claims for services provided by insiders.<sup>66</sup> The legislative history of section 502(b)(1) of the Bankruptcy Code makes clear that the statute incorporates state law and “requires disallowance if the claim is unenforceable against the debtor for any reason (such as usury, unconscionability, or failure of consideration)” and that the burden of proof on the issue of allowance or disallowance is left to the Rules of Bankruptcy Procedure.<sup>67</sup>

Bankruptcy Rule 3007 provides procedures for filing objections to claims under section 502(b) of the Bankruptcy Code. Bankruptcy Rule 3007(d)(7) expressly contemplates debt recharacterization as part of the claims allowance process under section 502 of the Bankruptcy Code, authorizing omnibus claims objections, *inter alia*, on the basis that claims “are interests, rather than claims.”<sup>68</sup> Therefore, as part of the claims allowance process, applicable law (state law) governs debt recharacterization.

State law is a preferable rule of decision as a policy matter because the prevailing federal multi-factor debt recharacterization tests are unworkable for purposes of determining enforceability of insider loans made to insolvent businesses.<sup>69</sup> Courts applying multi-factor tests to recharacterize debt in bankruptcy cases assert that the purpose of the tests is an “overarching inquiry” into the objective intent of the parties to “discern whether the parties called an instrument one thing when in fact they intended it as something else.”<sup>70</sup> However, it is hard to imagine that an insider investor making a loan to an insolvent business would throw good money after bad and intend an investment documented as a loan to be an equity investment. If a business is insolvent, holders of equity interests are paid only after all creditors have been paid in full. Commonly, equity holders receive nothing at all in bankruptcy. To purport to “read tea leaves” to discern whether a party intended that its loan to an insolvent business would

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65. Another enumerated exception, section 502(b)(7) of the Bankruptcy Code, limits another particular class of claims of insiders, claims “of an employee resulting from the termination of an employment contract.” *Id.* § 502(b)(7).

66. As noted above, the legislative history of the Bankruptcy Code makes clear that Congress also considered and rejected a broader *per se* subordination of insider claims, limiting subordination to cases where subordination is justified based on “principles of equitable subordination.” See 124 CONG. REC. 32398 (1978); 11 U.S.C. § 510(c) (2018).

67. H.R. REP. NO. 595, 95th Cong., 1st Sess. 309 (1977); S. REP. NO. 989, 95th Cong., 2d Sess. 21–22 (1978), as reprinted in 1978 U.S.C.C.A.N. 5787, 5848.

68. FED. R. BANKR. P. 3007(d).

69. As discussed further in Part IV below, caution should also be used in deciding whether tax recharacterization cases from state courts have any relevance to debt recharacterization in bankruptcy.

70. See *Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Sys. Corp.)*, 432 F.3d 448, 456 (3d Cir. 2006).

be “out of the money” on the date of the advance and to have no recovery at maturity would seem to be an exercise in absurdity.

*Roth Steel* type multi-factor tests derive from old federal tax cases that sought a standard to determine whether an advance from a parent corporation to a solvent subsidiary should be recharacterized as a capital contribution for purposes of determining deductibility of interest expense.<sup>71</sup> For solvent entities, tax treatment of interest expense and other tax attributes is an “increasingly significant” revenue issue for the Treasury.<sup>72</sup> But *Roth Steel* type multi-factor tests were never intended to be applied in bankruptcy cases to recharacterize loans advanced to insolvent companies in the context of out-of-court workouts. This is apparent because a number of the *Roth Steel* factors are entirely inapplicable and nonsensical when applied in the insolvency context.<sup>73</sup> For example, the *Roth Steel* test considers the company’s ability to obtain financing from outside lending institutions, deeming a “loan” to be more like equity if arm’s-length lenders are unwilling to make loans on the same lenient terms.<sup>74</sup> However, for an insolvent company, insiders are often the only source of credit. The Bankruptcy Code itself recognizes this, permitting insider loans but requiring that a debtor-in-possession loan cannot be approved unless credit on more favorable terms from third-party lenders is *not* available.<sup>75</sup> Thus, explicit provisions of the Bankruptcy Code argue against relevance of the availability of credit from third-party lenders as part of the debt recharacterization analysis.

The *Roth Steel* test also considers the source of repayment for a loan and favors a determination that the “loan” is equity if the likely repayment source is through a sale of capital assets rather than from ordinary cash flow.<sup>76</sup> Insolvent companies, of course, often have no positive cash flow. In the case of insider “bridge loans” advanced to an insolvent business to provide liquidity to complete a sale, the only loan repayment source is a sale of capital assets. In an insolvency context, this *Roth Steel* factor makes no sense.

Similarly, the *Roth Steel* test also considers the adequacy or inadequacy of the company’s capitalization, deeming inadequate capitalization to be an indication that a “loan” should be recharacterized as equity.<sup>77</sup> An insolvent company is, by

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71. See *Roth Steel Tube Co. v. Comm’r of Internal Revenue*, 800 F.2d 625, 630 (6th Cir. 1986).

72. Treatment of Certain Interests in Corporations as Stock or Indebtedness, 81 Fed. Reg. 20916 (Apr. 8, 2016) (stating by way of example that amounts at issue in just two debt recharacterization tax cases involve more than half of a billion dollars: “the federal tax liability at issue in PepsiCo was \$363,056,012; the federal tax liability at issue in NA General Partnership was \$188,000,000”).

73. See *SubMicron Sys.*, 432 F.3d at 457 (noting that factors such as capitalization, solvency, ability to pay cash interest, and debt capacity ratios do not apply when making loans to a distressed company as they would when lending to a healthy company).

74. See *Roth Steel*, 800 F.2d at 630.

75. See, e.g., 11 U.S.C. § 364(c) (2018) (authorizing incurrence of debt as a priority administrative expense only if the trustee is unable to obtain unsecured credit as a non-priority administrative expense); *In re Med. Software Solutions*, 286 B.R. 431, 437 (Bankr. D. Utah 2002) (noting that, although debtor-in-possession financing came from an insider, “it appeared to be appropriate and the only means upon which the Debtor could continue operating”).

76. See *Roth Steel*, 800 F.2d at 630–31.

77. See *id.* at 630.

definition, inadequately capitalized. This *Roth Steel* factor, therefore, would weigh in favor of rendering all loans to distressed companies unenforceable. A better view is that this factor is meaningless in the context of loans to insolvent entities, except in the limited circumstances of initial undercapitalization. In short, *Roth Steel* type tests were never intended to be applied in bankruptcy and are ill-suited to the purpose.

What is more, even in the context of tax cases involving solvent entities, *Roth Steel* type tests have been found to be unworkable. The U.S. Treasury itself has recognized that court-created, multi-factor tests for debt recharacterization induce confusion and produce “inconsistent and unpredictable results.”<sup>78</sup> More than two years ago, the Treasury promulgated regulations with the stated purpose of resolving the “confusion created by the multi-factor tests” utilized in tax court cases.<sup>79</sup> The Treasury rejected arguments for retention of multi-factor *Roth Steel* type tests as inconsistent with congressional intent, favoring instead an analysis that classifies debt instruments primarily based on the identities of the issuer and holders and the circumstances of their issuance. For example, the final regulations automatically recharacterize certain related-party debt instruments as equity if issued or used to fund certain types of transactions, such as distributions or acquisitions of the stock of affiliates.<sup>80</sup> They also impose documentation requirements that must be met as a prerequisite for related-party loans to be respected as debt for U.S. federal income tax purposes.<sup>81</sup> In making this change to its approach, the Treasury stated that “[t]he congressional objective of providing clarity regarding the characterization of instruments would be undermined if the regulations authorized by section 385 were required to replicate the flawed multi-factor tests in the case law that motivated the enactment of section 385.”<sup>82</sup>

This inconsistency of application and result in tax cases involving solvent entities has been repeated in circuits that have adopted *Roth Steel* type tests as the federal rule of decision for recharacterization of debt in bankruptcy. Courts differ as to the meaning and weight to be given to the various *Roth Steel* factors.<sup>83</sup> Some courts have viewed debt issued pursuant to demand notes as demonstrating that an advance is capital and not a loan.<sup>84</sup> Other courts have disagreed.<sup>85</sup> The

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78. See Treatment of Certain Interests in Corporations as Stock or Indebtedness, 81 Fed. Reg. 72858, 72861 (Oct. 21, 2016) (to be codified at 26 C.F.R. pt. 1, § 1.385).

79. *Id.* at 72858–94.

80. *Id.*

81. *Id.*

82. *Id.*

83. Hilary A. Goehausen, Comment, *You Said You Were Going to Do What to My Loan? The Inequitable Doctrine of Recharacterization*, 4 DEPAUL BUS. & COM. L.J. 117 (2005).

84. 204 B.R. 904, 917–18 (Bankr. E.D. Va. 1997); see also *Fairchild Dornier GmbH v. Official Comm. of Unsecured Creditors* (*In re Official Comm. of Unsecured Creditors for Dornier Aviation (N. Am.), Inc.*), 453 F.3d 225, 234 (4th Cir. 2006) (citing the lack of a fixed maturity date as one of four factors deemed “particularly significant”).

85. See *Bayer Corp. v. MascoTech, Inc.* (*In re Autostyle Plastics, Inc.*), 269 F.3d 726, 750 (6th Cir. 2001) (“[U]se of demand notes along with a fixed rate of interest and interest payments is more in-

bankruptcy court in *In re Cold Harbor Associates, L.P.* viewed debt advanced by equity holders in the same proportions as their equity interests as “the most critical factor” in its analysis.<sup>86</sup> However, other courts have held that debt may be recharacterized as equity where the holder of the debt had no equity interest at all in the debtor but had “pervasive” *de facto* control over the debtor’s operations.<sup>87</sup> The bankruptcy court in *PEM Entities* recharacterized debt that originated as commercial bank debt advanced by a lender that held no equity in the debtor.<sup>88</sup> The debt was purchased by an insider as part of a workout in an effort to avoid foreclosure.<sup>89</sup> One court has even indicated that debt may be recharacterized as an equity contribution where the debtor is a natural person.<sup>90</sup> In short, multi-factor federal debt recharacterization tests are ill-suited to their original purpose, determining the proper tax treatment of loans to solvent entities, and not at all suited to determining the enforceability of loans in bankruptcy. Use of these tests leads to inconsistent and unpredictable results that discourage out-of-court workouts and reorganizations of insolvent businesses.

## B. ARGUMENTS FOR A FEDERAL LAW RULE OF DECISION

Arguments for a federal rule of decision for debt recharacterization are based on a view that (i) the bankruptcy claims allowance process requires a threshold determination as to whether an asserted insider loan is, in fact, a “right to payment” under section 101(5)(A) of the Bankruptcy Code; and (ii) section 105(a) of the Bankruptcy Code permits entry of debt recharacterization orders independent of the process of claims allowance or disallowance under section 502 of the Bankruptcy Code. Under this logic, the circuits that have embraced a federal rule of decision for debt recharacterization recognize that bankruptcy courts have equitable authority to ensure that “substance will not give way to form” and to determine whether an advance styled as a loan was intended by the parties to be enforced as a claim.<sup>91</sup> The

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dicative of debt than equity.”); *In re Phase I Molecular Toxicology, Inc.*, 287 B.R. 571, 577 (Bankr. D.N.M. 2002).

86. *In re Cold Harbor Assocs., L.P.*, 204 B.R. 904, 918 (1997).

87. *Matrix IV, Inc. v. Am. Nat’l Bank & Tr. Co. (In re S.M. Acquisition Co.)*, No. 05 C 7076, 2006 WL 2290990, at \*5 (N.D. Ill. Aug. 7, 2006); *In re AtlanticRancher, Inc.*, 279 B.R. 411, 435 (Bankr. D. Mass. 2002); see *In re Comprehensive Power, Inc.*, 578 B.R. 14, 27 (Bankr. D. Mass. 2017) (denying motion to dismiss debt recharacterization claims where secured creditor owned no equity of the debtor but was alleged to have pursued a “loan to own” strategy). Other courts have rejected the argument that *de facto* control by non-stockholder lenders can be a basis for debt recharacterization, at least where lenders have failed to exercise voting rights or other control pursuant to loan documents. See Official Comm. of Unsecured Creditors of Radnor Holdings Corp. v. Tennenbaum Capital Partners, LLC (*In re Radnor Holdings Corp.*), 353 B.R. 820, 840–41 (Bankr. D. Del. 2006).

88. *In re Province Grande Olde Liberty, LLC*, No. 13-01563-8-RDD, 2014 WL 6901052, at \*3–4 (Bankr. E.D.N.C. Dec. 5, 2014).

89. *Id.* at \*2.

90. *Wilson v. Moir (In re Wilson)*, Adv. No. 06-1063, 359 B.R. 123, 139–41 (Bankr. E.D. Va. 2006).

91. See, e.g., *Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Sys. Corp.)*, 432 F.3d 448, 454 (3d Cir. 2006) (citing *Pepper v. Litton* in holding that recharacterization is “grounded in bankruptcy court’s equitable authority to ensure ‘that substance will not give way to form’”); *Fairchild Dornier GmbH v. Official Comm. of Unsecured Creditors (In re Official Comm. of Unsecured Creditors*



Bankruptcy Code defines the term “claim” broadly as 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.”<sup>92</sup> The claims allowance process under section 502 of the Bankruptcy Code relates to the enforceability of claims in bankruptcy, through allowance or disallowance, of claims.<sup>93</sup> But, because section 502 uses the defined term “claim,” the bankruptcy court must first make a threshold determination whether or not a claim exists. In other words, the bankruptcy court must assess whether an advance is, in substance as well as form, a loan that constitutes a right to payment. Because this is a threshold inquiry into what Congress intended, the rule of decision for the issue is necessarily a federal question.

*Butner v. United States* and the rest of the line of U.S. Supreme Court cases calling for deference to state law in the process of allowance or disallowance of claims are, under this view, not relevant. None of the decisions in this line of cases involved debt recharacterization or the interpretation of whether a purported insider loan is a “claim” under the Bankruptcy Code definition. Although *Law v. Siegel* and other cases deny application of section 105(a) of the Bankruptcy Code in situations where its use is contrary to or outside of the bounds of specific provisions of the Bankruptcy Code, for courts applying a federal rule of decision, these cases are simply not applicable to debt recharacterization. Section 105(a) authorizes bankruptcy courts to “carry out” provisions of Title 11, including to interpret and to enforce the Bankruptcy Code definition of “claim” in section 101(5)(A) of the Bankruptcy Code.

Finally, as a policy matter, deference to a state law rule of decision for debt recharacterization arguably creates great uncertainty. Many states do not recognize a cause of action for debt recharacterization but simply apply contract principles to determine the enforceability of insider debt. In other states, the law is embryonic, limited to lower court decisions or applied in tax cases or other fact situations that may have little relation to bankruptcy. Federal bankruptcy choice of law rules for deciding on application of state law rules are inconsistent from circuit to circuit and are fact intensive and may be difficult to apply even within a single circuit. As a result, bankruptcy policy, arguably, favors application of a uniform federal test for debt recharacterization that would not require federal courts to interpret and apply state law.

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for Dornier Aviation (N. Am.), Inc.), 453 F.3d 225, 232 (4th Cir. 2006) (“Because disallowance and recharacterization are distinct inquiries, ‘[e]ven if a claimant is able to meet § 502’s minimal threshold for allowance of the claim,’ a court must still ‘determine the claim’s proper priority’ by scrutinizing the true substance of a contested transaction.”).

92. 11 U.S.C. § 101(5)(A) (2018).

93. *Id.* § 502.

#### IV. PREDICTING THE FUTURE: DEBT RECHARACTERIZATION UNDER STATE LAW

##### A. THE DEBT RECHARACTERIZATION CIRCUIT SPLIT IS LIKELY TO BE RESOLVED BASED ON APPLICATION OF A STATE LAW RULE OF DECISION

The debt recharacterization circuit split is likely to be resolved in favor of application of a state law rule of decision. A settled principle of bankruptcy law is the notion that “[c]reditors’ entitlements in bankruptcy arise in the first instance from the underlying substantive law creating the debtors’ obligation, subject to any qualifying or contrary provision of the Bankruptcy Code.”<sup>94</sup> The reason for this is that, absent an explicit statute requiring a contrary result, the Bankruptcy Code requires uniform treatment of claims in both state court and bankruptcy court.<sup>95</sup> Application of a court-created, federal rule for debt recharacterization has improperly resulted in disallowance of claims in bankruptcy court that would be enforceable under state law.<sup>96</sup>

Arguments that the Bankruptcy Code definition of “claim” requires a threshold determination of whether an insider claim is a “right to payment” or a nominal claim that must be recharacterized as an “interest” are contrary to U.S. Supreme Court precedents and express provisions of the Bankruptcy Code and Bankruptcy Rules. In *Midland Funding, LLC v. Johnson*, the Court expressly held that the broad Bankruptcy Code definition of “claim” includes claims that might be disputed or unenforceable, noting that:

Section 502(b)(1) of the Code . . . says that, if a “claim” is “unenforceable” it will be disallowed. It does not say that an “unenforceable” claim is not a “claim.”<sup>97</sup>

Thus, U.S. Supreme Court precedent rejects the idea of any threshold determination of what constitutes a “claim” that is separate and apart from a bankruptcy claims allowance and disallowance process that is based, primarily, on state law.

In *Travelers*, the Court held that “when the Bankruptcy Code uses the word ‘claim’ . . . it is usually referring to a right to payment recognized under state law.”<sup>98</sup> The Bankruptcy Code establishes procedures for allowance and disallowance of both claims and interests. Specifically, section 501 of the Bankruptcy Code requires the filing of proof of claims and interests and section 502(a) of the Bankruptcy Code provides that “[a] claim or interest, proof of which is filed under sec-

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94. *Raleigh v. Ill. Dep’t of Revenue*, 530 U.S. 15, 20 (2000); see also *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 161 (1946) (“What claims of creditors are valid and subsisting obligations . . . is to be determined by reference to state law.”).

95. *Butner v. United States*, 440 U.S. 48, 55 (1979) (citing *Lewis v. Mfrs. Nat’l Bank of Detroit*, 364 U.S. 603, 609 (1961)); *Raleigh*, 530 U.S. at 25.

96. See *In re Province Grande Olde Liberty, LLC*, 655 F. App’x 971 (4th Cir. 2016); see also *Bluebird Corp. v. Aubin*, No. 04 CvS 02563, 2006 WL 4511542 (N.C. Super. Ct. Dec. 5, 2006), *aff’d*, 657 S.E.2d 55 (N.C. Ct. App. 2008); *Gelatt v. DeDakis (In re Mader’s Store for Men, Inc.)*, 254 N.W.2d 171 (Wis. 1977).

97. 137 S. Ct. 1407, 1412 (2017).

98. *Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co.*, 549 U.S. 443, 451 (2007).

tion 501 of this title, is deemed allowed, unless a party in interest . . . objects.”<sup>99</sup> The Bankruptcy Code definition of “claim” was drafted broadly in contemplation that “all legal obligations of the debtor, no matter how remote or contingent, will be dealt with in the bankruptcy case,”<sup>100</sup> including, specifically, rights to payment that are “disputed.” Obligations, of course, refer to obligations under applicable non-bankruptcy law. Congress contemplated that proofs of claim would be deemed allowed and subject to disallowance only “if there is an objection to a proof of claim,” and that the burden of proof and other procedures for allowance or disallowance of claims would be “left to the Rules of Bankruptcy Procedure.”<sup>101</sup> As noted above, Rule 3007 of the Federal Rules of Bankruptcy Procedure expressly contemplates recharacterization and disallowance of claims or “interests” under the normal claims objection process pursuant to section 502(b) of the Bankruptcy Code. Accordingly, by defining the term “claim” Congress did not require or intend any threshold determination under federal common law as to whether an insider is the holder of a claim or an equity interest.

Because section 502 of the Bankruptcy Code explicitly addresses claims allowance and disallowance both procedurally and substantively and does not provide for recharacterization, the only source of law for debt recharacterization is state law. The U.S. Supreme Court has called it “hornbook law” that section 105(a) of the Bankruptcy Code “does not allow the bankruptcy court to override explicit mandates of other sections of the Bankruptcy Code.”<sup>102</sup> Therefore, federal court-created tests for debt recharacterization are not permitted.

As a policy matter, state law provides a more predictable test for debt recharacterization. The dominant federal multi-factor tests for debt recharacterization have proven to be unreliable, even in the context of solvent tax cases, and were never intended to address claims in bankruptcy. In most cases, as noted below, choice of state law is straightforward; as long as the governing law designated by contract choice of law provisions has a reasonable relation to the transaction, the contract choice of law should control. In other debt recharacterization cases, the law of the debtor’s jurisdiction of organization is likely to apply. In many state jurisdictions, specific debt recharacterization law is well developed. In other state jurisdictions, settled, generic principles of contract law will apply to the allowance or disallowance of insider debt claims. In jurisdictions where application of debt recharacterization law is uncertain, bankruptcy courts are well equipped with tools necessary to clarify uncertainties.<sup>103</sup> In

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99. 11 U.S.C. §§ 501, 502 (2018).

100. H.R. REP. NO. 595, 95th Cong., 1st Sess. 309 (1977); S. REP. NO. 989, 95th Cong., 2d Sess. 21–22 (1978), as reprinted in 1978 U.S.C.A.N. 5787, 5807–08, 6266.

101. *Id.* at 5848.

102. *Law v. Siegel*, 134 S. Ct. 1188, 1194–95 (2014).

103. See, e.g., DEL. CONST. art. IV, § 11(8) (granting Delaware Supreme Court jurisdiction to “hear and determine questions of law certified to it by other Delaware Courts, the Supreme Court of the United States, a Court of Appeals of the United States, a United States District Court, the United States Securities and Exchange Commission, or the highest appellate court of any other state, where it appears to the Supreme Court that there are important and urgent reasons for an immediate determination of such questions by it”). *But see* CAL. CT. R. 8.548 (only providing jurisdiction to hear

short, except in situations specified under section 502(b) of the Bankruptcy Code where Congress has provided express federal grounds for disallowance,<sup>104</sup> insider claims in bankruptcy are likely to be allowed or disallowed based on a state law rule of decision.

## B. CHOICE OF LAW

To the extent that questions of debt recharacterization are governed by state law, the question remains as to *which* state law should govern. In many cases, choice of law is relatively straightforward. If an insider loan is well-documented and has choice of law provisions that select a jurisdiction that has a reasonable relation to the transaction, the choice of law should be respected.<sup>105</sup>

Debt recharacterization cases involving no loan documentation or inadequately documented loans that fail to specify governing law pose a more difficult problem. The U.S. Supreme Court has yet to decide whether the forum state or federal choice of law rules apply in bankruptcy cases involving state law claims. While dicta in the Supreme Court case, *Vanston Bondholders Protective Committee v. Green*,<sup>106</sup> provides support for a federal choice of law rule, the issue has split the circuits. A majority of courts, including the Second, Third, Fourth, and Eighth Circuits, look to the choice of law rules of the forum state,<sup>107</sup> whereas

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questions from the United States Supreme Court, a United States Court of Appeals, or the court of last resort of any state, territory, or commonwealth); N.Y. Cr. R. 500.27 (same).

104. See, e.g., 11 U.S.C. § 502(b) (2018) (disallowing claims for services of an insider where such claim exceeds the reasonable value of such services).

105. See *Kronovet v. Lipchin*, 415 A.2d 1096, 1104 n.16 (Md. 1980) (noting that “courts and commentators now generally recognize the ability of parties to stipulate in the contract that the law of a particular state or states will govern construction, enforcement and the essential validity of their contract” but recognizing that “the parties’ ability to choose governing law on issues of contract validity is not unlimited and will not be given effect unless there is a ‘substantial’ or ‘vital’ relationship between the chosen sites and issues to be decided”); *DeSantis v. Wackenhut Corp.*, 793 S.W.2d 670, 677–78 (Tex. 1990) (adopting approach of § 187 of the *Restatement (Second) of Conflict of Laws* to find that choice of law provision will be given effect if the contract bears a reasonable relation to the state whose law is chosen and no public policy of the forum state requires otherwise); *RESTATEMENT (SECOND) OF CONFLICT OF LAWS* § 187 (1971) (the law of the state chosen by the parties governs their contractual rights and duties and will be applied if the particular issue is one which the parties could have resolved by an explicit provision in their agreement directed to that issue); see also *Auto-Owners Ins. Co. v. Websolv Computing, Inc.*, 580 F.3d 543, 547 (7th Cir. 2009) (“We honor reasonable choice-of-law stipulations in contract cases regardless of whether such stipulations were made formally or informally, in writing or orally.”).

106. 329 U.S. 156, 161–63 (1946) (acknowledging that the determination of which state law applies to a complex bankruptcy case is difficult because many states will have significant contact and distinguishing jurisdiction arising under the Bankruptcy Code, in light of the fact that “a bankruptcy court does not apply the law of the state where it sits”).

107. Notably, within the majority, there is a further split; the Second and Fourth Circuits also take into account whether there are federal policy implications that would justify or require application of federal choice of law rules. *Bianco v. Erkins (In re Gaston & Snow)*, 243 F.3d 599, 607 (2d Cir. 2001) (limiting its holding to cases where no significant federal policy, calling for the imposition of a federal conflicts rule, exists); *Compliance Marine, Inc. v. Campbell (In re Merritt Dredging Co.)*, 839 F.2d 203, 206 (4th Cir. 1988) (adopting choice of law rule of the forum state because no overwhelming federal policy requires the formulation of a choice of law rule as a matter of independent federal judgment).

a minority of courts, including the Ninth Circuit, apply federal choice of law rules, namely the most significant contacts test.<sup>108</sup>

Despite the circuit split as to whether the forum state or federal choice of law rules apply, the outcome is likely the same given that more than thirty states and the Ninth Circuit, in its application of federal choice of law rules, have either adopted the significant contacts approach supported by the Restatement (Second) Conflict of Laws or an analysis that is substantively indistinguishable from the significant contacts approach.<sup>109</sup> The significant contacts approach analyzes the following principles from the perspectives of the states that have significant contacts with the matter at hand:

- (a) the needs of the interstate and international systems,
- (b) the relevant policies of the forum,
- (c) the relevant policies of other interested states and the relative interests of those states in the determination of the particular issue,
- (d) the protection of justified expectations,
- (e) the basic policies underlying the particular field of law,
- (f) certainty, predictability and uniformity of result, and
- (g) ease in the determination and application of the law to be applied.<sup>110</sup>

In the context of debt recharacterization, absent contractual governing law provisions, the law of the debtor's jurisdiction of organization should govern based on considerations of the relevant significant contacts and the principles outlined in the Restatement. A recharacterization dispute certainly involves significant contact with the jurisdiction of organization of the corporation. It also involves significant contact with the jurisdictions of the entity or entities making the relevant contribution or loan and of the other creditors that will be affected by the outcome of the recharacterization claim. Consideration of multiple jurisdictions, other than the jurisdiction of organization, would significantly increase the difficulty in determining the law to be applied and decrease certainty, predictability, and uniformity of result.<sup>111</sup> Recharacterization issues where choice of law is not specified by contract are similar to corporate law issues, such as questions relating to a director's breach of fiduciary duty or the interpretation of a shareholder agreement, for which courts have historically applied the inter-

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108. Compare *Gaston & Snow*, 243 F.3d at 606, *Teleglobe USA Inc. v. BCE Inc. (In re Teleglobe Commc'ns Corp.)*, 493 F.3d 345, 358 (3d Cir. 2007), *Compliance Marine*, 839 F.2d at 206, and *Amtech Lighting Servs. Co. v. Payless Cashways, Inc. (In re Payless Cashways, Inc.)*, 203 F.3d 1081, 1084 (8th Cir. 2000) (applying state choice of law rules), with *Lindsay v. Beneficial Reinsurance Co. (In re Lindsay)*, 59 F.3d 942 (9th Cir. 1995) (applying federal choice of law rules).

109. See Symeon C. Symeonides, *Choice of Law in the American Courts: Twenty-Seventh Annual Survey*, 62 AM. J. COMP. L. 223, 282 (2014).

110. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 6(2).

111. *Id.* § 6(2)(f), (g).

nal affairs doctrine.<sup>112</sup> The law of the jurisdiction of organization in these cases should govern debt recharacterization for many of the same reasons that the internal affairs doctrine requires the same with respect to other related corporate questions: (1) it allows for an easily applied, bright-line rule; (2) it provides certainty to parties in their dealings with corporations; and (3) it prevents subjective and potentially unfairly prejudiced choice of law decisions tied to a court's forum ties.<sup>113</sup>

### C. DEBT RECHARACTERIZATION UNDER STATE LAW

Despite the recent evolution of the doctrine of debt recharacterization in federal courts, a body of state law exists that, in many cases, applies different standards to the enforceability of insider loans to distressed businesses. State law is often more protective of insider creditors. Whereas the federal doctrine permits “recharacterization” of insider loans as equity contributions even in situations where the insider lender has engaged in no inequitable conduct, certain state statutes require that loans by insiders be treated the same as non-insider loans, based on contract principles.<sup>114</sup> Insider creditors advancing loans subject

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112. See, e.g., *Matson Logistics, LLC v. Smiens*, No. 12-400 ADM/JJK, 2012 WL 2005607 (D. Minn. June 5, 2012) (applying Minnesota law to a Minnesota company in a case including a veil-piercing claim); *Heine v. Streamline Foods Inc.*, 805 F. Supp. 2d 383 (N.D. Ohio 2011) (applying Delaware law to a breach of fiduciary duty claim in a suit involving a Delaware company); *Patriot Sci. Corp. v. Korodi*, 504 F. Supp. 2d 952, 956–57 (S.D. Cal. 2007); *In re Del-Met Corp.*, 322 B.R. 781, 801 (M.D. Tenn. 2005) (refusing to enforce the parties' stipulated choice of law to breach of fiduciary duty claims based on internal affairs doctrine); *Rosenmiller v. Bordes*, 607 A.2d 465, 468–69 (Del. Ch. 1991) (applying Delaware law to a claim regarding a shareholder voting restriction in a suit involving a Delaware company in New Jersey); *Storetrax.com, Inc. v. Gurland*, 915 A.2d 991, 999–1000 (Md. 2007) (affirming application of the incorporating state's law to a breach of fiduciary duty claim). But see *Johnson v. Myers*, No. CV-11-00092 JF, 2011 WL 4533198 (N.D. Cal. Sept. 30, 2011) (applying California law based on contractual choice of law provision to a breach of contract claim involving a director's performance instead of applying the incorporating state's law); *Boyle v. Jacor Commc'ns, Inc.*, 799 F. Supp. 811 (S.D. Ohio 1992) (applying New York law based on contractual choice of law provision to a veil piercing claim instead of the incorporating state's law); see also RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 303–310.

113. Notably, however, in the *Fitness Holdings* proceedings, the Central District of California found, on remand, that the internal affairs doctrine was inapplicable, and applied the forum state law. *In re Fitness Holdings Int'l, Inc.*, No. CV 14-1059 AG, 2014 WL 12628681, at \*3 (C.D. Cal. Oct. 9, 2014), *aff'd*, 660 F. App'x 546 (9th Cir. 2016). The Ninth Circuit stated that the district court correctly applied California law, but did not discuss the internal affairs doctrine. *In re Fitness Holdings Int'l, Inc.*, 660 F. App'x 546, 547 (9th Cir. 2016), *cert. denied sub nom. Leslie v. Hancock Park Capital II, L.P.*, No. 16-1136, 2017 WL 1064323 (U.S. Oct. 2, 2017). Additionally, a Louisiana bankruptcy court similarly has held that the internal affairs doctrine is not applicable to recharacterization claims. See *In re Gulf Fleet Holdings, Inc.*, 491 B.R. 747, 764–65, 773 & n.7 (Bankr. W.D. La. 2013) (applying Louisiana instead of Delaware law to recharacterization claim because Louisiana has the most substantial relationship to the claims).

114. See, e.g., Delaware Revised Partnership Act, DEL. CODE ANN. tit. 6, § 15-119 (2017) (“Except as provided in the partnership agreement, a partner may lend money to . . . the limited partnership and, subject to other applicable law, has the same rights and obligations with respect thereto as a person who is not a partner.”); Delaware Revised Limited Partnership Act, DEL. CODE ANN. tit. 6, § 17-107 (2017) (“Except as provided in the partnership agreement, a partner may lend money to . . . and transact other business with, the limited partnership and, subject to other applicable law, has the same rights and obligations with respect thereto as a person who is not a partner.”); Delaware Limited Liability Act, DEL. CODE ANN. tit. 6, § 18-107 (2017) (“Except as provided in a limited liability company agreement,

to those statutes simply have the burden of proof with respect to the existence of an enforceable contract claim, with equitable subordination available as a remedy if bad acts are involved.

Under decisional law, states are generally divided into two camps: (i) jurisdictions that enforce insider loans under contract law, but with a heightened level of scrutiny based on equitable considerations, and (ii) jurisdictions that apply multi-factor or other tests similar to existing federal debt recharacterization tests. In all jurisdictions, insider claims based on belatedly or inadequately documented loans are routinely invalidated either under contract law, based on an insider's failure to satisfy a burden of proof, or "objective" recharacterization tests meant to determine the status of insider advances as debt or equity.

## 1. States Applying Contract Principles and Equitable Considerations to Enforceability of Insider Debt

### i. Alaska

Alaska courts will enforce a corporate debt owed to an insider if the transaction was "entered into fairly." In *Robson v. Smith*, the Supreme Court of Alaska considered whether directors of a corporation who make secured loans in good faith to the corporation are entitled to be paid ahead of unsecured creditors.<sup>115</sup> Citing to an opinion of the Nevada Supreme Court, the *Robson* court held that loans are fairly entered into if the loans were essential to the corporation; incurred for the preservation of assets and for the benefit of the corporation; used entirely for corporate business to meet corporate obligations; made in good faith and upon reasonable terms; and made at a time when the corporation was solvent.<sup>116</sup> Although the loans at issue were made to a solvent corporation, the *Robson* court indicated that insider loans to an insolvent corporation would also be permitted "if the director is a bona fide creditor."<sup>117</sup> An insider's "good faith" loans, according to the *Robson* court, should be validated under public policy because a debtor corporation in financial distress needs to be able to rely on its shareholders or other insiders most interested in its survival.<sup>118</sup>

### ii. California

In *Fitness Holdings*, the Ninth Circuit held that courts must look to applicable state law to determine whether a purported debt constitutes a right to payment.<sup>119</sup>

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a member or manager may lend money to, . . . and transact other business with, a limited liability company and, subject to other applicable law, has the same rights and obligations with respect to any such matter as a person who is not a member or manager.")

115. 777 P.2d 659 (Alaska 1989).

116. *Id.* at 662 (citing *Foster v. Arata*, 325 P.2d 759 (Nev. 1958)).

117. *Id.* at 662 n.8 (citing 3 W.M. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 7470 (rev. perm. ed. 1981)).

118. *Id.* at 663.

119. Official Comm. of Unsecured Creditors v. Hancock Park Capital II, L.P. (*In re Fitness Holdings Int'l, Inc.*), 714 F.3d 1141 (9th Cir. 2013); see also *In re Daewoo Motor Am., Inc.*, 554 F. App'x 638 (9th Cir. 2014).

On remand, the bankruptcy court dismissed the recharacterization claims without issuing an opinion. The district court affirmed the bankruptcy court's order, finding no evidence that the promissory notes failed to create a valid contract giving rise to a right to payment under California law.<sup>120</sup> The district court rejected the plaintiffs' argument to apply the test employed by California courts in usury cases and assess the notes in light of all circumstances and with a view to substance rather than form.<sup>121</sup> On further appeal, the Ninth Circuit affirmed the district court, noting that there was no basis to ignore basic contract law and apply the usury law approach.<sup>122</sup> It does not appear that California state case law has otherwise directly addressed the concept of debt recharacterization.<sup>123</sup>

### iii. Delaware

Delaware state courts have distinguished between debt and equity in a few instances. In *Wolfensohn v. Madison Fund, Inc.*, the Supreme Court of Delaware stated that such a determination should be made by examining the terms of the contract.<sup>124</sup> Similarly, in *Moore v. American Finance & Securities Co.*, the Delaware Court of Chancery examined the contract in determining that holders of Certificates of Contingent Obligations would be treated as though they were stockholders.<sup>125</sup> Although noting that the use of the word "obligation" in the certificates, considered in connection with the payment of interest, suggested that a debtor-creditor relationship existed, the *Moore* court held that the contract terms overall warranted equality of treatment among all holders of certificates.<sup>126</sup> Specifically, the *Moore* court noted that the certificates lacked a definite maturity date and provided that interest and principal were only to be paid when and if profits of the company were sufficient to warrant payment.<sup>127</sup> Furthermore, each certificate provided that, in the event of liquidation, dissolution, or insolvency, each certificate holder would "share and share alike."<sup>128</sup>

Delaware courts have also considered the distinction between debt and equity for tax purposes. In *Lasker v. McDonnell & Co.*, the Delaware Court of Chancery

120. *In re Fitness Holdings Int'l, Inc.*, No. CV 14-1059 AG, 2014 WL 12628681, at \*5 (C.D. Cal. Oct. 9, 2014), *aff'd*, 660 F. App'x 546 (9th Cir. 2016).

121. *Id.* (noting that the test California courts employ in usury cases is geared toward striking "down as usurious arrangements bearing little facial resemblance to what is normally thought of as a loan," as some lenders "fashion[ ] transactions designed to evade the usury law." (quoting *Boerner v. Colwell Co.*, 21 Cal.3d 37, 44 (1978))).

122. *In re Fitness Holdings Int'l, Inc.*, 660 F. App'x at 548.

123. See *Petition for Writ of Certiorari, Leslie v. Hancock Park Capital II, L.P.*, No. 16-1136, 2017 WL 1064323 (U.S. Oct. 2, 2017).

124. 253 A.2d 72, 75 (Del. 1969) (examining whether to void the exchange of existing stock for that of a newly formed company).

125. 73 A.2d 47, 47–48 (Del. Ch. 1950).

126. *Id.*; see also *Caspian Select Credit Master Fund Ltd. v. Gohl*, No. 10244-VCN, 2015 WL 5718592, at \*5 (Del. Ch. Sept. 28, 2015) (the fact that a loan had no fixed maturity date and as having no real repayment schedule was "insufficient to transform the [loan], facially a debt instrument, into equity").

127. *Moore*, 73 A.2d at 48.

128. *Id.*



was asked to determine the proper classification of subordinated debentures with respect to interest deductions taken on a corporation's federal income tax return.<sup>129</sup> The United States argued that the payments were actually dividends and could not be deducted from the corporation's federal income tax. The court focused its inquiry on four specific characteristics. The characteristics applied were: (1) the degree of risk assumed by the creditor;<sup>130</sup> (2) whether the debentures were issued to stockholders in proportion to their stockholdings or in exchange for their capital holdings;<sup>131</sup> (3) the ability to share the corporation's assets with general creditors in the event of liquidation;<sup>132</sup> and (4) whether the instruments provide sufficient capital to sustain the normal operations of the corporation.<sup>133</sup>

#### iv. Maryland

In Maryland, "[a] loan to a corporate entity by a substantial or even the sole owner of stock is not *per se* invalid, although such a transaction is always open to inquiry."<sup>134</sup> In the absence of bad faith or fraud, a corporate insider may recover on a loan to the same extent as if the loan were made to the corporation by any other lender.<sup>135</sup> In *Obre v. Alban Tractor Co.*, the Court of Appeals of Maryland considered whether a \$35,548.10 purported loan evidenced by a promissory note given to the corporation's largest stockholder at the time of incorporation constituted debt or equity.<sup>136</sup> The shareholder also made a contemporaneous \$30,000 capital contribution, which evidence showed was adequate initial capital.<sup>137</sup> However, because the note was made on the date the company was organized, had a five-year maturity date, and the consideration paid in exchange for the note was tangible assets necessary for the corporation to operate, the trial court had determined that the loan was really "risk capital" that should be treated as equity.<sup>138</sup> The court of appeals, finding it significant that the loan was fully disclosed as debt in financial reports and that "no element of fraud,

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129. No. 3560, 1975 WL 1950 (Del. Ch. July 9, 1975).

130. *Id.* at \*10 ("A fundamental characteristic of the creditor-debtor relationship is that there be a reasonable expectation of being repaid irrespective of the fortunes of the company. A fixed rate, a fixed maturity date, the ability to accelerate upon default and the use of collateral are the usual means of affording protection to a creditor.").

131. *Id.* (Debentures that are issued in direct proportion to stockholdings give rise to a strong inference that the debentures are actually an equity capital investment, while disproportionate distribution suggests that a true indebtedness was created.)

132. *Id.* at \*11 (Complete subordination to the rights of general creditors is more indicative of an equity capital investment.)

133. *Id.* ("The capitalization of the new corporation . . . was substantially less than the capitalization of the partnership. This is a strong indication that the debentures were merely a continuation of the former equity interest.")

134. *Obre v. Alban Tractor Co.*, 179 A.2d 861, 862 (Md. 1962).

135. *Id.* (citing *Hock & Co. v. Strohm*, 170 A. 738, 739 (Md. 1934)); *Storetrax.com, Inc. v. Gurland*, 915 A.2d 991, 1005 (Md. 2007) ("Most jurisdictions countenance corporate directors becoming creditors of the corporation, in the absence of bad faith or fraud.").

136. *Obre*, 179 A.2d at 861.

137. *Id.* at 863.

138. *Id.* at 862.

misrepresentation or estoppel was alleged,” reversed the trial court and held that the note was enforceable as debt.<sup>139</sup> In short, under Maryland law, insider debt is enforceable under contract principals, absent initial undercapitalization, fraud, or misrepresentation.

v. *Massachusetts*

Massachusetts law has long provided that debt recharacterization can be a remedy in a cause of action based on equitable principles. Massachusetts court decisions strike a balance between public policy interests in respecting the separation of stockholders from the corporation and preventing fraud or abuse of corporate forms by insiders. Massachusetts courts have declined to adopt debt recharacterization as a “no fault” cause of action based on the *Roth Steel* factors.<sup>140</sup> At least three modern cases, however, have acknowledged that characterization of a contribution as debt “depends to some extent on the objective intention of the contributor.”<sup>141</sup> While “objective intention” permits recharacterization of debt, requiring an insider to prove its claim based on an objective standard is, in a basic sense, uncontroversial. All creditors are required to prove their claims, typically by introducing notes or other loan documents into evidence. Backdating of debt instruments, belated execution of loan documents, self-serving changes in accounting practices, inconsistent evidence of treatment of advances as debt in filed tax returns, or other evidence can indicate that a stockholder-creditor did not originally intend an advance to be enforceable as debt. On the other hand, if corporate formalities are observed, a Massachusetts court would likely enforce good faith loans advanced by corporate insiders as valid debt obligations.<sup>142</sup>

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139. *Id.*

140. In considering a defendant corporation’s defense based on debt recharacterization, the Massachusetts Superior Court in *SFB Corp. v. Cambridge Automatic, Inc.* rejected an invitation to apply the *Roth Steel* factors, noting that the defendant corporation “is not in bankruptcy, and unless and until this changes, it need not suffer the burdens and may not claim the benefits of bankruptcy law and practice.” No. 015304, 2002 WL 31481078, at \*3 (Mass. Super. Ct. Oct. 1, 2002). The *SFB Corp.* court is not the only court to have held that the cause of action for debt recharacterization as articulated in federal courts is viable only in bankruptcy. See *Arena Dev. Grp., LLC v. Naegel Commc’ns, Inc.*, No. 06-2806 ADM/AJB, 2007 WL 2506431, at \*7 (D. Minn. Aug. 30, 2007).

141. See *Yankee Microwave, Inc. v. Petricca Commc’ns Sys., Inc.*, 760 N.E.2d 739, 759 (Mass. App. Ct. 2002) (citing *Friedman v. Kurker*, 438 N.E.2d 76, 80 (Mass. App. Ct. 1982)); see also *Am. Twine L.P. v. Whitten*, 392 F. Supp. 2d 13, 22 (D. Mass. 2005); *Buchanan v. Warner*, No. 01-527, 2006 WL 4119791, at \*9 (Mass. Super. Ct. Nov. 8, 2006) (“Whether an advance of money or services to a corporation should be treated as a capital contribution or as creating a debt depends to some extent on the objective intention of the contributor and in part on whether, in the particular circumstances, equitable consideration requires treatment of the advance as a capital contribution.”).

142. See, e.g., *Buchanan*, 2006 WL 4119791, at \*9 (finding shareholder contributions were loans based on references in the transfer documents to such transfers as loans and evidence that the core shareholders each owned one quarter of the shares, so any disproportionate cash contributions to the corporation can be best, and justly, accounted for as loans); *Am. Twine*, 392 F. Supp. 2d at 23 (finding that a \$10 million secured bridge loan advanced by stockholders constituted debt rather than equity based on the objective intent of the investors as evidenced by the observance of corporate formalities (including the approval of the transactions by the debtor company’s board of directors) and

vi. Nevada

In *Foster v. Arata*,<sup>143</sup> the Supreme Court of Nevada considered whether deeds of trust and a collateral mortgage granted to insiders but not approved by a corporation's disinterested directors were void. The *Foster* court held that, although the good faith of the insider lender is subject to scrutiny, it is "settled law" that a contract between the insider and the corporation is valid if fairly entered into.<sup>144</sup> The trial court had made findings the loans were "essential to the business of the corporation and to the preservation of its assets and were made for the benefit of the corporation; that they were entirely used by the corporation in its corporate business and for payment of its obligations; that the corporation received and accepted the benefits of the loans; that the loans were openly made by the defendants in good faith and upon fair and reasonable terms without unfair advantage; that the corporate use was with full knowledge of the plaintiffs; that the loans constituted full cash value of the properties covered by the trust deeds and that when made, the corporation was solvent."<sup>145</sup> The *Foster* court held that their findings sufficiently established this insider lender's good faith.<sup>146</sup>

In short, the *Foster* court considered whether insider conduct was fair and found the loans enforceable under contract principles where insiders engaged in no inequitable conduct.

vii. New York

New York has not recognized a cause of action for debt recharacterization. As a result, under New York state law, conventional contract principles are likely to govern the enforceability of debt instruments, whether or not the debt is held by insiders. Under New York state law, a loan is "a contract by which one party advances monies to the other upon a promise to repay."<sup>147</sup> Where an obligation to repay an advance is established, New York law regards the transaction as a loan, regardless of form.<sup>148</sup> Other factors that New York courts have noted as distinguishing loans include "whether notes or other written acknowledgment of indebtedness were executed, collateral was given, a method or time for repayment

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other normal formalities in documenting the loans (including the issuance of promissory notes) and perfecting the security interest therein, despite the fact that the loans were onerous (35 percent per annum interest rate plus a hefty prepayment premium) and were convertible if the company were to engage in any future equity financing rounds).

143. 74 Nev. 143, 147 (1958).

144. *Id.* at 152.

145. *Id.* at 153.

146. *Id.*

147. *Haveron v. Kirkpatrick*, 824 N.Y.S.2d 704, 705 (App. Div. 2006) (internal quotation omitted); see also *Envirokare Tech., Inc. v. Pappas*, 420 F. Supp. 2d 291, 293 (S.D.N.Y. 2006); *Wagman v. Chater*, No. 94 Civ. 7243 (DC), 1996 WL 219646, at \*2 (S.D.N.Y. May 1, 1996).

148. *In re Renshaw*, 222 F.3d 82, 88 (2d Cir. 2000); *Matthiessen v. Comm'r of Internal Revenue*, 194 F.2d 659, 661 (2d Cir. 1952); *In re Grand Union Co.*, 219 F. 353, 356 (2d Cir. 1914); *In re Adelpia Comm'n Corp.*, Bankr. No. 02-41729 (REG), 2006 WL 687153, at \*10 (S.D.N.Y. Mar. 6, 2006); *People ex rel. Spitzer v. Grasso*, No. 401620/04, 2006 WL 3016952, at \*24 (N.Y. Sup. Ct. 2006), *aff'd as modified*, 54 A.D.3d 180 (N.Y. App. Div. 2008) (citing *TIFD III-E, Inc. v. United States*, 459 F.3d 220, 238 (2d Cir. 2006)).

was fixed by agreement and if there exists any evidence of systematic repayment.”<sup>149</sup> Furthermore, New York state courts have consistently held that “when parties set down their agreement in a clear, complete document, their writing should, as a rule, be enforced according to its terms.”<sup>150</sup>

In *People ex rel. Spitzer v. Grasso*, a decision involving payments by a non-profit corporation to its chairman of the board, the Supreme Court for New York County characterized the payments as a loan, notwithstanding that the payments were documented as advances in respect of employee benefits.<sup>151</sup> The court’s analysis suggests that a New York court would apply general contract principles in analyzing the validity of a loan between affiliated persons or entities, with the ongoing and unconditional right to enforce repayment being the “feature most cogently distinguishing the transaction as a loan.”<sup>152</sup>

#### viii. North Carolina

North Carolina state law has recognized that “[t]he concept and elements of a ‘loan’ are well understood in both the popular and legal usage of the term.”<sup>153</sup> A loan is “a contract by which one delivers a sum of money to another and the latter agrees to return at a future time a sum equivalent to that which he borrows.”<sup>154</sup> Thus, under North Carolina law, “the deliver[y] by one party and the receipt by the other party of a given sum of money, on an agreement, express or implied, to repay the sum lent, with or without interest” qualifies as a loan.<sup>155</sup> Additionally, in *Cross v. Capital Transaction Group, Inc.*, the North Carolina Court of Appeals held that an obligation denominated as an “investment” gave rise to a “creditor” obligation (so that certain protections arose under workers’ compensation law).<sup>156</sup> It reasoned that “the character of a transaction is not automatically changed . . . if we construe the agreement as requiring repayment . . . only in the event that their operations should prove successful. A loan is no less a loan because its repayment is made contingent.”<sup>157</sup> In *Bogovich v. Embassy Club of Sedgfield, Inc.*, the North Carolina Court of Appeals denied enforcement of a claim by an insider for advances made to the corporation, finding that, although the funds were used for corporate purposes, there were no instruments

149. *In re Estate of Palma*, 793 N.Y.S.2d 573, 576 (App. Div. 2005) (finding that transfers were not loans for purposes of administering estate); see also *In re Estate of Marshall*, 809 N.Y.S.2d 753, 754 (App. Div. 2006).

150. *Reiss v. Fin. Performance Corp.*, 764 N.E.2d 958, 960 (N.Y. 2001) (quoting *W.W.W. Assocs. v. Giancontieri*, 77 N.Y.2d 157, 162 (1990)); see also *Breed v. Ins. Co. of N. Am.*, 385 N.E.2d 1280, 1282 (N.Y. 1961) (“It is axiomatic that a contract is to be interpreted so as to give effect to the intention of the parties as expressed in the unequivocal language employed.”).

151. 2006 WL 3016952, at \*25.

152. *Id.*

153. *Kessing v. Nat’l Mortg. Corp.*, 180 S.E.2d 823, 827 (N.C. 1971) (determining “loan” for purposes of usury statute).

154. *Id.*

155. *Id.*

156. 661 S.E.2d 778, 783 (N.C. Ct. App. 2008).

157. *Id.* (internal citations and quotation marks omitted).

evidencing the debt, no fixed interest rate or payment schedule, and corporate approval was not received.<sup>158</sup>

ix. *Wisconsin*

The Wisconsin Supreme Court, in the 1977 case *In re Mader's Store for Men, Inc.*, expressly considered and rejected federal bankruptcy court precedent that sought to recharacterize insider advances as equity if the intent of the insiders was “to salvage their [equity] investment on a risk basis, as contrasted with a true loan on a temporary basis with reasonable assurance of repayment in the ordinary course of business.”<sup>159</sup> The Wisconsin Supreme Court also expressly rejected debt recharacterization on facts that would have required debt recharacterization under the test later adopted by the U.S. Court of Appeals for the Eleventh Circuit.<sup>160</sup> Wisconsin law requires initial undercapitalization or inequitable conduct by an insider before insider debt may be recharacterized as an equity contribution.<sup>161</sup> In short, Wisconsin law is inconsistent with the federal cases that attempt to divine an insider creditor’s objective intent based on *Roth Steel* type tests or that analyze the terms of a loan by comparison with underwriting standards of third party lenders.

## 2. States Recharacterizing Insider Debt Based on Standards Analogous to Federal Debt Recharacterization Tests

i. *Idaho*

The Idaho Supreme Court has endorsed a multi-factor test for debt recharacterization drawn from federal tests used in the Third, Fourth, Sixth, and Tenth Circuits. In *Idaho Development, LLC v. Teton View Golf Estates, LLC*,<sup>162</sup> the Idaho Supreme Court considered whether the trial court erred in granting summary judgment recharacterizing as an equity contribution a \$1,100,000 loan advanced by a one-third shareholder. The debtor, Teton View Golf Estates, LLC, was a joint venture by Idaho Development, LLC and Rothschild Properties, LLC. Rothschild Properties contributed its time skill, technology, and know-how to Teton View in exchange for a 66.7 percent equity interest.<sup>163</sup> Idaho Development advanced \$1,100,000 and received (i) a 33.3 percent equity interest, (ii) a 15 percent interest in the net proceeds of each lot sold by Teton View, and (iii) a promissory note for

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158. 712 S.E.2d 257, 268 (N.C. Ct. App. 2011); see also *Bluebird Corp. v. Aubin*, No. 04 CvS 02563, 2006 WL 4511542 (N.C. Super. Ct. Dec. 5, 2006).

159. See 254 N.W.2d 171, 185–86 (Wis. 1977).

160. See *id.* (acknowledging trial court finding that funds could not be obtained from banks or commercial lending institutions).

161. See *id.* at 188 (“Where a corporation is once provided with a reasonably adequate fund of stated capital but subsequently requires additional funds, the stockholders may advance those funds as a loan in an attempt to enable the corporation to continue in business, and, provided no inequitable conduct is shown, the stockholders may participate with other creditors in the distribution of the insolvent estate.”).

162. 272 P.3d 373 (Idaho 2011).

163. *Id.* at 375.

repayment of \$1,100,000 secured by a deed of trust against Teton View's real estate.<sup>164</sup> The note matured in ninety days and provided for 6 percent interest payable prior to maturity at monthly intervals.<sup>165</sup> The Joint Venture Agreement specified that, if a construction loan were obtained, \$800,000 of the Idaho Development note would be repaid and \$300,000 would remain outstanding as subordinated debt.<sup>166</sup> Idaho Development later agreed with a junior secured lender that the principal secured by its deed of trust would be reduced to \$850,000.<sup>167</sup> Before Teton View defaulted on the loan, interest was timely paid to Idaho Development and a one-month extension of the maturity date was granted in exchange for a \$10,000 payment.<sup>168</sup> After default, Idaho Development filed a complaint to foreclose its deed of trust against all junior interests.<sup>169</sup> Junior creditors sought summary judgment on the complaint, arguing that the Idaho Development loan should be recharacterized as equity. The trial court granted summary judgment, finding that Idaho Development sought to be both an investor in and a creditor to Teton View and holding that, because there was no differentiation between what money was a capital investment and what money was a loan, the entire amount would be recharacterized as a capital investment.<sup>170</sup> On appeal, the Idaho Supreme Court reversed, holding that for summary judgment the burden of proof was on junior creditors to show no genuine issue of material fact that the entire amount of the Idaho Development loan was a capital contribution.<sup>171</sup> Noting strong evidence that at least part of the advance was intended to be a loan, the Idaho Supreme Court remanded for trial.<sup>172</sup> In remanding the case, the *Teton View* court noted that prior Idaho precedents,<sup>173</sup> in essence, called for use of the Third Circuit's "streamlined common-sense approach" to find the true intent of the parties in entering the transaction.<sup>174</sup>

In *re Deer Valley Trucking, Inc.*, the U.S. Bankruptcy Court for the District of Idaho followed the Ninth Circuit's directive to apply a state law rule of decision to debt recharacterization.<sup>175</sup> Applying Idaho law, and citing to *Teton View*, the *Deer Valley* court held that a "factoring loan" advanced by parents of the debtor's principal shareholder would not be recharacterized as equity.<sup>176</sup> The *Deer Valley* court found that, even though the advance was initially undocumented, the advance at the time it was made was intended as debt.<sup>177</sup> The court also found that

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164. *Id.*

165. *Id.*

166. *Id.*

167. *Id.*

168. *Id.*

169. *Id.*

170. *Id.* at 379.

171. *Id.*

172. *Id.* at 380.

173. *Id.* at at 378 (citing *Lettunich v. Lettunich*, 111 P.3d 110 (Idaho 2005); *Vreeken v. Lockwood Eng'g, B.V.*, 218 P.3d 1150 (Idaho 2009)).

174. *Id.*

175. 569 B.R. 341, 347 (Bankr. D. Idaho 2017).

176. *Id.* at 349 (citing *Teton View*, 272 P.3d at 377–78).

177. *Id.*

the factoring loan at issue failed to satisfy a three-part test under Idaho law for determining if an oral agreement constituted an investment contract.<sup>178</sup>

To summarize, Idaho law has adopted the use of multi-factor *Roth Steel*-type tests in evaluating debt recharacterization.

ii. Oregon

In *Houston's, Inc. v. Hill*, the Court of Appeals of Oregon held that start-up expenses and advances on open account from a parent corporation to its wholly owned subsidiary that were belatedly documented as secured loans were capital contributions rather than loans.<sup>179</sup> The *Houston's* court noted that transactions between a corporation and its shareholders are subject to strict scrutiny, with shareholders bearing the burden of showing that the transactions are part of an arm's-length bargain.<sup>180</sup> Moreover, the substance and effect of a transaction, rather than the parties' label, determines the nature of the transaction.<sup>181</sup> Citing to the U.S. Supreme Court case, *Taylor v. Standard Gas & Electric Co.* and the Eleventh Circuit's decision in *In re N & D Properties, Inc.*, the *Houston's* court held that recharacterization of debt as equity is appropriate either when (i) a shareholder loan is made to an initially undercapitalized corporation, or (ii) no other disinterested lender would have extended credit.<sup>182</sup> The *Houston's* court noted that it was undisputed that no other disinterested lender would have extended credit, but also recited other facts that supported a conclusion that the advances were capital contributions: the loans were advanced by the sole shareholder, no notes were executed and no security interests were granted when the advances were made; a note was later executed and a security interest was later granted, but no interest was ever charged; the borrower prepared two sets of books for accounts payable, one showing the advances as debt and one not; and corporate resolutions approved by the boards of directors of both the parent corporation (lender) and subsidiary (borrower) stated that the distribution to the parent on liquidation of the subsidiary was in consideration of cancellation of stock rather than as repayment of debt.<sup>183</sup> The facts of the *Houston's* case would have supported debt recharacterization or disallowance of a debt claim under less strict standards applied in other jurisdictions. Nevertheless, at least at Oregon's intermediate appellate court level, the Eleventh Circuit's strict test for debt recharacterization set forth in *In re N & D Properties, Inc.* appears to be the applicable standard.

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178. *Id.* at 350–51 (citing *State v. Gertsch*, 49 P.3d 392 (Idaho 2002)). The court in *State v. Gertsch* adapted a three-part test for determining the existence of an investment contract: (i) an investment of money, (ii) a common enterprise, and (iii) a reasonable expectation of profits to be derived from the entrepreneurial or management efforts of others. 49 P.3d at 396.

179. 826 P.2d 644, 647 (Or. Ct. App. 1992), *review denied*, 833 P.2d 1283 (Or. 1992).

180. *Id.*

181. *Id.* at 646.

182. *Id.* at 646–47 (citing *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307 (1939); *In re N & D Props., Inc.*, 799 F.2d 726, 733 (11th Cir 1986)).

183. *Id.* at 647.

iii. *Pennsylvania*

In *O'Reilly v. Cellco Industries, Inc.*, the Superior Court of Pennsylvania held that notes issued to shareholders in consideration for reinvestment of stock dividends should be treated as debt, reversing a judgment of the Pennsylvania Court of Common Pleas.<sup>184</sup> The debtor corporation, *Cellco Industries, Inc.* (“Cellco”), borrowed money from the Small Business Administration (“SBA”). The SBA loan agreement permitted dividends to shareholders, but required that 25 percent of dividends be reinvested on a subordinated basis to the SBA loans.<sup>185</sup> Consistent with its actions in connection with prior dividends, Cellco issued subordinated notes to shareholders at the time of the required reinvestment.<sup>186</sup> Following a buyout of minority shareholders and Cellco’s default under the terms of the notes, the holder of subordinated notes issued to the minority shareholders obtained a confession of judgment.<sup>187</sup> Cellco sought to strike the confessed judgment on the basis that the notes represented shareholder equity rather than debt.<sup>188</sup> The trial court agreed with Cellco based on an 1886 Pennsylvania Supreme Court decision, *Bidwell v. Pittsburg*, which had held that investments by shareholders in proportion equal to their share ownership constituted equity rather than debt.<sup>189</sup> On appeal, the *Cellco* court distinguished the *Bidwell* case, noting that the shareholder advances in *Bidwell* were made in emergency circumstances with no contemporaneous documentation of the advances as loans.<sup>190</sup> In the *Cellco* case, by contrast, the advances were required to be made, were permitted as debt, and were contemporaneously documented with notes that included confession of judgment as a contract remedy.<sup>191</sup> The *Cellco* appeals court held that instruments are evidence, although not conclusive evidence, of the status of shareholder advances as debt.<sup>192</sup> Factors considered in federal tax law, the *Cellco* appeals court noted, are also not conclusive and provide “at most some indication of the factors a state court may consider in analyzing issues of this nature.”<sup>193</sup> Considering these factors, the *Cellco* appeals court noted that only one of seven loan advances by shareholders in proportion to their equity investments was present in this case.<sup>194</sup> The *Cellco* appeals court concluded that Pennsylvania law requires the notes to be treated as debt because the instruments on their face are debt instruments and the evidence showed that the parties “obviously intended that the obligations be so treated there being no

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184. 402 A.2d 686, 690 (Pa. Super. Ct. 1979).

185. *Id.* at 688.

186. *Id.*

187. *Id.*

188. *Id.* at 688–89 (citing *Bidwell v. Pittsburg, O. & E. L. Pass. Ry., Co.*, 6 A. 729 (Pa. 1886)).

189. *Id.*

190. *Id.* at 689.

191. *Id.* at 689–90.

192. *Id.* at 689.

193. *Id.*

194. *Id.* (citing *Gilbert v. Comm’r*, 262 F.2d 512 (2d Cir. 1959)).



evidence of record to show anything to the contrary.”<sup>195</sup> Based on *Cellco*, Pennsylvania law gives evidentiary weight to well-documented loans from corporate insiders. However, the existence of conventional law documentation is not necessarily conclusive; evidence of contrary intent that an advance is equity, including based on factors considered in tax cases, may also weigh into what the *Cellco* court emphasizes “must be case-by-case determination.”<sup>196</sup>

iv. *Rhode Island*

In *Tanzi v. Fiberglass Swimming Pools, Inc.*, the Rhode Island Supreme Court held that shareholder advances to an initially undercapitalized corporation were properly recharacterized as equity.<sup>197</sup> Throughout the ten-year life of the debtor corporation the equity capital invested remained at its initial level of \$3,000, an amount that the *Tanzi* court determined was inadequate to sustain corporate sales in excess of \$200,000.<sup>198</sup> The trial court had found that the shareholder operated the corporation essentially as an individual proprietorship,<sup>199</sup> taking profits out when the corporation was profitable and putting money in each spring from personal funds in order to begin pool installations for each new season.<sup>200</sup> The loans at issue were belatedly documented with a promissory note more than a year after the final advances were made,<sup>201</sup> but the note omitted provisions for interest, amortization, and events of default and had no fixed maturity date.<sup>202</sup> The *Tanzi* court held that, in general, loans by controlling shareholders are not *per se* invalid, but are subject to strict judicial scrutiny.<sup>203</sup> Judicial scrutiny is not limited to equitable considerations; a breach of fiduciary duties by a shareholder is not a prerequisite to treating shareholders’ advances as capital contributions.<sup>204</sup> Debt recharacterization cases in bankruptcy may also be instructive, the *Tanzi* court noted, citing to the following criteria used to determine the treatment of advances as debt or equity: the adequacy of capital contribution; the ratio of shareholder loans to capital; the amount of shareholder control; the availability of similar loans from outside lenders; whether the ultimate financial failure was caused by undercapitalization; whether the note included repayment provisions and a fixed maturity date;

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195. *Id.* at 690. The seven factors that the *Cellco* appeals court drew from *Gilbert v. Commissioner* were: (1) the taxpayer realized that the corporation had been inadequately capitalized at its inception; (2) no outside investor would have made similar advances without security; (3) the advances were made substantially in proportion to the stock ownership of the stockholders; (4) the advances were made without regard to the normal creditor safeguards; (5) no effort was made to enforce the obligations; (6) the taxpayer had no reason to expect repayment unless the business were successful; and (7) as a matter of “substantial economic reality,” the advances constituted risk capital. *Id.* at 689.

196. *Id.* at 689.

197. 414 A.2d 484, 490 (R.I. 1980).

198. *Id.* at 490.

199. *Id.* (citing Jules S. Cohen, *Shareholder Advances: Capital or Loans*, 52 AM. BANKR. L.J. 259, 274 (1978)).

200. *Id.* at 486.

201. *Id.* at 487–88.

202. *Id.* at 491.

203. *Id.* at 488.

204. *Id.* at 489–90.

whether a note or debt document was executed; whether proceeds were used to acquire capital assets; and how the debt was treated in corporate records.<sup>205</sup> Applying these criteria, the *Tanzi* court held that the loans at issue were contributions to risk capital rather than bona fide loans, noting in particular the inadequacy of the initial equity contribution, the shareholder's complete control of the corporation, the lack of any repayment safeguards in the loan documentations, and the belated execution of the promissory note which "strongly suggests that it was an attempt in form rather than in substance to protect the family investment."<sup>206</sup>

#### D. NEED FOR CAUTION IN APPLYING TAX CASES IN THE INSOLVENCY CONTEXT

State courts have, on occasion, cited to *Roth Steel* type multi-factor tests from federal tax cases.<sup>207</sup> As noted above, multi-factor tests applied to determine tax liability of solvent entities include factors that are irrelevant in the insolvency context and not well suited to determining whether insider claims should be entitled to treatment as debt in a liquidation or reorganization. Moreover, even in tax cases, the U.S. Treasury has recently rejected the use of multi-factor tests even for solvent taxpayers, finding that the tests produce "inconsistent and unpredictable results." Under these circumstances, federal courts should be cautious and should not assume that a citation or passing reference in a state court opinion to multi-factor recharacterization tests establishes a state law standard for debt recharacterization in bankruptcy. Caution is particularly warranted if the state court decision is a tax decision unrelated to the priority of claims in the context of insolvency.

The Fifth Circuit's review of Texas law in *Lothian Oil* illustrates risks associated with reading too much into state court tax decisions. In *Lothian Oil*, the Fifth Circuit held that Texas law controlled the characterization, as debt or equity, of the claims at issue in the bankruptcy case.<sup>208</sup> The *Lothian Oil* court cited to *Arch Petroleum v. Sharp*, an opinion of the Court of Appeals of Texas, an intermediate appellate court. Based on *Arch Petroleum*, the *Lothian Oil* court stated that "Texas courts have implemented a multi-factor test from federal tax law" and concluded that the *Lothian Oil* district court committed no error in holding that a creditor's claim should be recharacterized as equity.<sup>209</sup>

In fact, the Supreme Court of Texas, Texas' highest court, has no reported decisions on debt recharacterization. Moreover, the *Arch Petroleum* case cited by the Fifth Circuit in *Lothian Oil* was not an insolvency case: it concerned whether convertible preferred stock would be counted as debt for purposes of calculating Texas franchise tax.<sup>210</sup> The holding of *Arch Petroleum* did not involve application of any

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205. *Id.* at 490.

206. *Id.* at 490–91.

207. See e.g., *Dealer Servs. Corp. v. Am. Auto Auction, Inc.*, No. NNHCV095028282S, 2013 WL 2451250, at \*13 (Conn. Super. Ct. May 14, 2013); *Bunch v. J.M. Capital Fin., Ltd. (In re Hoffinger Indus., Inc.)*, 327 B.R. 389, 408 (Bankr. E.D. Ark. 2005).

208. *In re Lothian Oil Inc.*, 650 F.3d 539, 544 (5th Cir. 2011).

209. *Id.* (citing *Arch Petroleum, Inc. v. Sharp*, 958 S.W.2d 475, 477 n.3 (Tex. App. 1997)).

210. See *Arch Petroleum*, 958 S.W.2d at 476.

multi-factor test, but rather turned on the interpretation of the Texas Tax Code, specifically whether convertible preferred stock with mandatory dividends met the definition of “debt” under a statutory definition as a “legally enforceable obligation measured in a certain amount of money which must be performed or paid within an ascertainable period of time or on demand.”<sup>211</sup> As debt under the Texas Tax Code, the obligation at issue in *Arch Petroleum* would reduce the taxpayer’s stated capital, with the result that Texas franchise taxes would be reduced.

In short, *Arch Petroleum* had nothing to do with debt recharacterization for purposes of determining debt and equity priority on the liquidation or reorganization of an insolvent company. The only citation in *Arch Petroleum* to a federal multi-factor test was a passing reference in a footnote to a thirty-year old decision of the U.S. Court of Appeals for the Third Circuit, *Fin Hay Realty Co. v. United States*.<sup>212</sup> The *Fin Hay Realty* decision was, itself, a federal tax case involving the deductibility of interest on debt advanced by corporate insiders.<sup>213</sup> In short, neither *Arch Petroleum* nor *Fin Hay Realty* is relevant to Texas law related to debt recharacterization in the insolvency context.

## V. CONCLUSION

The federal doctrine of debt recharacterization is in transition. The U.S. Courts of Appeals for the Fifth and Ninth Circuits rejected a federal rule of decision for debt recharacterization, citing to U.S. Supreme Court precedent that requires consistency between state and federal law in the allowance or disallowance of claims in bankruptcy. Moreover, the predominant federal test for debt recharacterization derived from tax cases involving solvent corporations is ill-suited to assessing the validity of insider loans in bankruptcy, and has led to inconsistent and unpredictable results. Lack of predictability in the enforcement of insider loans and the resulting litigation risk inhibit extensions of credit to distressed businesses and may drive businesses into bankruptcy prematurely.

State law, by contrast, provides a means to determine the allowance or disallowance of insider loans. State statutes mandate that an equity holder or an insider may make loans to the business that it owns and has the same rights and obligations in respect of its loans as an arm’s-length lender. Moreover, decisional law, in many states, supports the enforceability of insider loans based on contract principles. In situations where insiders have acted inequitably, causes of action for equitable subordination under section 510(c) of the Bankruptcy Code provide appropriate remedies. For these reasons, the trend in federal courts toward deference to state law for enforcement of insider loans is a positive development that allows greater flexibility for financing distressed businesses outside of bankruptcy court.

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211. *Id.* at 477 (citing TEX. TAX CODE ANN. § 171.109(a)(3) (West 1992)).

212. 398 F.2d 694 (3d Cir. 1968).

213. *Id.* at 695.

