

## RECHARACTERIZATION

Recharacterization is the power to treat a debt as if it were actually a shareholder interest is derived from principles of equity under common law. It "emanates from the bankruptcy court's power to ignore the form of the transaction and give effect to its substance."

The remedy is most commonly invoked when an *insider purports to loan money to a company when it is undercapitalized and the cash infusion should have taken the form of a capital contribution.*

Recharacterization ensures that the non-insider creditor claims will be paid first from the available assets of the corporation.

Courts consider various factors when determining whether a debt should be recharacterized. No one factor is controlling. Instead, they are considered within the particular circumstances of each case.

***Recharacterization and equitable subordination serve different functions.***

If the Court determines that an advance of money is equity and not debt, the claim is recharacterized and the effect is subordination of the claim "as a proprietary interest because the corporation repays capital contributions only after satisfying all other obligations of the corporation."

***There is no need for misconduct in recharacterization.***

Under the doctrine of recharacterization, courts technically do not alter any party's substantive rights, as occurs under equitable subordination. When a court recharacterizes a debt as equity, it merely acknowledges economic reality by treating as equity a capital contribution that was only nominally a "loan" from the outset. Indeed, the focus of the recharacterization inquiry is whether a "debt" actually exists and what is the proper characterization in the first instance of the investment at issue.

***The characterization of a capital contribution as debt or equity is a court's attempt to discern whether the parties called an instrument one thing when in fact they intended it as something else.***

Where equity is a risk interest in ownership right in property, ie the right to control that property

The Bankruptcy Code does not expressly empower a bankruptcy court to recharacterize debt as equity. Courts are split as to whether they have the authority to do so. Some say that because there is no explicit recharacterization provision, the Congress intended to deprive bankruptcy courts of the power to recharacterize debt. Others argue, finding that a court's power to recharacterize debt as equity stems from the authority vested in the bankruptcy courts to use their equitable powers to test the validity of debts, per Section 105 of the bankruptcy Code.

Section 105 (a) The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

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An Illinois district court recently allied itself with courts expansively construing the scope of a bankruptcy court's equitable powers in *Outboard Marine*.

The Seventh Circuit Court of Appeals in ruling on an appeal of the bankruptcy court's finding that it did not have the authority to recharacterize debt as equity reversed the decision of the bankruptcy court, citing other courts, including the Sixth Circuit Court of Appeals, as having "correctly recognized recharacterization as a tool that may be used by the bankruptcy courts."

*Outboard Marine* reaffirms the broad expanse of a bankruptcy court's powers to inquire into the substance of a creditor's claim to determine whether it should be allowed on par with other legitimate debts in keeping with fundamental notions of fairness and equity.

It also provides guidance concerning the application of equitable remedies that have led to a fair amount of confusion among the courts.

***Creditors must meet a high burden to demonstrate that nominally secured debt is in fact a disguised equity contribution.***

In *Roth Steel Tube Co. v. Comm'r*, 800 F.2d 625 (6th Cir. 1986), the 6th Circuit US Court of Appeals laid out 11 factors to determine whether an investment was debt or equity in the context of assessing income tax liability. In *Autostyle Plastics*, the 6th Circuit extended the use of these factors to the recharacterization context. They are as follows:

- Names given to the instruments, if any, evidencing the indebtedness
- Presence or absence of fixed maturity date and schedule of payments
- Presence or absence of a fixed rate of interest and interest payments
- Source of repayments
- Adequacy or inadequacy of capitalization
- Identity of interest between the creditor and the stockholder
- Security, if any, for the advances
- Corporation's ability to obtain financing from outside lending institutions
- Extent to which the advances were subordinated to claims of outside creditors
- Extent to which the advances were used to acquire capital assets
- Presence or absence of a sinking fund to provide repayments

***In re SubMicron Sys. Corp.*, 432 F.3d 448, 455-456 (3d Cir. 2006), the 3rd US Circuit Court of Appeals recently stated that "no mechanistic scorecard suffices" and that a court should come to a commonsense conclusion that looks beyond the form of the transaction at issue to the substance of what the parties actually intended.**

Intent may be inferred from what the parties say in their contracts ***and do through their actions and from the economic reality of the surrounding circumstances.***

The more an exchange appears to reflect the characteristics of an arms'-length negotiation, the more likely it is that such a transaction is to be treated as debt

***Nevertheless, it is extremely difficult under the current framework to apply this doctrine successfully to reclassify purported debt as equity. Unsecured creditors face an uphill task.***

***The unsecured creditors are left with the difficult task of uncovering a "smoking gun" through the discovery process that demonstrates that the parties' true intent deviates from what is embodied in the transaction documents.***

However, over time, it is quite possible that courts, instead of requiring unsecured creditors to demonstrate that the true intent of the parties to a transaction is different from what is reflected in the transaction documents, courts should place more weight on (i) the adequacy of a debtor's capitalization at the time of the transaction; and (ii) the ability of the debtor to obtain alternative means of financing. By weighting those factors more heavily than other *Autostyle* factors, the true context of a purported secured loan transaction can be considered by a court without being obscured by the fact that the parties observed the formalities of an arms'-length transaction. This subtle change, should it occur, would ease the evidentiary burden on unsecured creditors and reveal the substance over the form.