Equitable Subordination and Recharacterization: Lessons From Recent Bankruptcy Litigation

Attacking and Defending Preference Status of Lender, Creditor and PE Sponsor Secured Claims

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Today’s faculty features:

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Equitable Subordination and Recharacterization: Looming Threats in Bankruptcy Litigation

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Recharacterization – What Is It?

• *Hypothetical*: A shareholder gives $1 million to a company. Six months later, the company files for bankruptcy. The shareholder files a proof of claim and indicates the $1 million transaction was a loan. The unsecured creditors’ committee objects and argues the $1 million was an equity infusion and not a company liability; i.e., the committee is asking the Court to **recharacterize** the debt as equity.

• It therefore follows that **recharacterization** is the process by which a court disallows a claim because the claim amount was intended to be equity, not debt.
Recharacterization – What Is It?

• Depending on the jurisdiction, either:
  – An exercise of *equitable* remedy pursuant to Section 105 of the Bankruptcy Code; or
  – An exercise of statutory authority to disallow claims pursuant to Section 502(b)
  – Nothing (Ninth Circuit). *In re Pacific Express, Inc.*, 69 B.R. 112 (B.A.P. 9th Cir. 1986) (concluding the issue is one of proper classification, not recharacterization)

• Substance over form. Recharacterization ensures that “substance will not give way to form, that technical considerations will not prevent substantial justice from being done.” *Pepper v. Litton*, 308 U.S. 295, 305 (1939).
Recharacterization – What Is It Not?

• It is not an alteration of substantive rights; instead, it is merely “calling a spade a spade.”

• Equitable subordination.
  – Equitable subordination analyzes a creditor’s misconduct. Recharacterization does not require a showing of misconduct.
  – Different remedies. Recharacterization is the elimination, not subordination, of a claim.
  – Equitable subordination disregards formal rights. Recharacterization determines what those formal rights are.
How To Raise The Issue

• **Claim objection** pursuant to Section 502(a) of the Bankruptcy Code.

• **Plan objection** pursuant to Section 1129 (e.g., the plan is not fair and equitable and violates the absolute priority rule).

• **Adversary proceeding** pursuant to Bankruptcy Rule 7001.
Arguing Recharacterization

- Different tests for different jurisdictions.
- Multi-factor test is most commonly used.
  - *In re SubMicron Systems Corp.*, 432 F.3d 448, 456 (3d. Cir. 2006)
  - *Bayer Corp. v. MascoTech, Inc. (In re Autostyle Plastics, Inc.)*, 269 F.3d 726, 749 (6th Cir. 2001)
  - *In re Hedged-Investments Assocs. Inc.*, 380 F.3d 1292 (10th Cir. 2004)
- State court factors in tax context used in a minority of jurisdictions.
  - *In re Lothian Oil Inc.*, 650 F.3d 539 (5th Cir. 2011)
  - *Stinnett’s Pontiac Serv. Inc. v. Comm’r*, 730 F.2d 634, 638 (11th Cir. 1984)
Factors

1. Name given to the instruments evidencing the debt;
2. Presence or absence of a fixed maturity date and schedule of payments;
3. Presence or absence of a fixed rate of interest and interest payments;
4. Source of repayments;
5. Adequacy or inadequacy of capitalization;
6. Identity of interest between the creditor and the stockholder;
7. Security for the advances;
Factors

8. Company’s ability to obtain financing from outside lending institutions;
9. Extent to which the advances were subordinated to the claims of outside creditors;
10. Extent to which the advances were used to acquire capital assets;
11. Presence or absence of a sinking fund to provide repayments;
12. Failure of a corporate borrower to repay on the due date or seek forbearance;
13. Ability to enforce payment;
14. INTENT, INTENT, INTENT!!!
Factors

- Not exclusive list.

- No single factor is dispositive.

- Will not be used to contravene policy. “[I]n many cases, an insider will be the only party willing to make a loan to a struggling business, and recharacterization should not be used to discourage good-faith loans.” *In re Official Committee of Unsecured Creditors for Dornier Aviation (N. Am.) Inc.*, 453 F.3d 225, 234 (4th Cir. 2006).
Case Excerpts

• Regardless of the multi-factor test used, the analysis “devolve[s] to an overarching inquiry: the characterization 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.” *In re SubMicron Systems Corp.*, 432 F.3d 448 (5th Cir. 2006).

• Recharacterization cases “turn on whether a debt actually exists...If a claim is recharacterized...the advance is not a claim to begin with.” *In re Russell Cave*, 107 Fed. Appx. 449 (6th Cir. 2004).
Application of Factors


Facts. In exchange for giving 90% of the company’s stock to Secured Lenders, Moll received exit financing in the amount of $71 million when it emerged from bankruptcy in 2003. In 2010, it filed for bankruptcy again. The committee sought to have the Secured Lenders’ claims recharacterized as equity.

- **Fixed rate of interest.** The transaction included a rate of interest that was “fixed” to market indices. This favored the creditor. “When a transaction is intended as equity, there is usually no interest paid or interest payments are sporadic because the investor is more interested in seeing the value of its investment grow.”

- **Adequate capitalization.** The lender did not strictly enforce the repayment terms by failing to declare default and forbearing. This did not favor the committee under the facts of the case. “In the case of a pre-existing lender, it is legitimate for the lender to take actions to protect its existing loans, including extending additional credit or granting forbearance.”

- **Security for the advances.** The lenders were under-secured. This did not favor the committee under the facts of the case. “[E]ven where there is no additional collateral to support the new loans, it is legitimate for an existing lender to extend additional credit to a distressed borrower as a means to protect its existing loans.”

- **Ability to obtain outside financing.** The committee argued that no prudent lender would have extended additional credit that comprises the lenders’ claims. This did not favor the committee under the facts of the case. “Existing lenders are often the only source of funding when a debtor faces distress. Therefore, inability to obtain alternative financing is insufficient to support recharacterization.

- **Sinking fund.** The loan agreements contain no sinking fund. This factor was in the committee’s favor, but this was the only factor. The court recognized that many debt arrangements don’t have sinking funds and refused to recharacterize based on this one factor alone.

- **Names of the instruments.** The instruments were properly named.

- **Fixed maturity date.** There was a fixed maturity date.
Case Study

*Fairchild Dornier*, 453 F.3d 225 (4th Cir. 2006)

- **Facts.** GMBH wholly owns DANA. GMBW sold $146 million in parts to DANA. GMBH billed Dana on 30-day terms. DANA did not repay GMBH. GMBH told DANA it did not have to pay until DANA became profitable. DANA then had an involuntary bankruptcy filed against it. The committee objected to GMBH’s claim.

- **Issue.** Whether the Court could recharacterize the debt and, if so, under what authority?

- **Argument:** GMBH argued the Court had to analyze the case on claim objection grounds and that recharacterization doesn’t exist outside of a disallowance hearing.

- **Conclusion:** The Court concluded that even if a creditor can satisfy Section 502, the Court can use Section 105 to recharacterize. This approach is consistent with the Code classifying claims according to priority.
Case Study

_In re Russell Cave Co., Inc.,_ 107 Fed. Appx. 449 (6th Cir. 2004).

- **Facts.** GECC filed a proof of claim prior to the bar date. A plan was subsequently confirmed. The confirmed plan established a claim objection deadline. The committee filed an adversary proceeding after the claim objection deadline that objected to GECC’s claim.
- **Issue.** Whether an adversary proceeding seeking recharacterization constituted a claim objection that was time barred?
- **Argument.** GECC argued that Section 502 was not the sole manner in which the Court could recharacterize GECC’s claims and that the claim objection deadline did not bar the lawsuit.
- **Conclusion.** “A recharacterization claim and objecting to a claim’s allowance are one-in-the same because the bankruptcy court may consider other equitable grounds alleged as the basis for the disallowance of a claim such as the [recharacterization] of a claim as an equity interest.” Further, “if a particular advance is equity, it never becomes a claim.”
Case Study

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

• Facts. Grossman gave Lothian Oil $200,000. In return, Lothian agreed to give Grossman (i) 1% of certain royalties that Lothian hoped to earn and (ii) proceeds from a private equity sale.

• Issue. Should the court rely on Section 105 or 502, and does the concept of recharacterization apply to non-insiders?

• Conclusion. The court took a cautious approach to Section 105 and decided that Section 502 is the correct Code provision. The court further determined that Texas state law should govern (i) whether the claim constituted debt or equity and, if so, (ii) whether claims of insiders and non-insiders alike are subject to recharacterization. The court answered both in the affirmative.
Conclusion

• Determine if your jurisdiction applies Section 105 or Section 502
• Determine if your jurisdiction applies state law to determine if a claim is debt or equity
• Conduct discovery to prove intent
• Advise clients to properly “paper” its deals
Questions?

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EQUITABLE SUBORDINATION

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SOURCE OF EQUITABLE SUBORDINATION

• Section 510(c) of the Bankruptcy Code

“(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; . . .”
LIMITATIONS

• Claims can only be brought by party that has been directly harmed
  – Creditors Committee can only sue if debtor unjustifiably refuses
• Must be commenced by adversary proceeding
• Claims may be subordinated to other claims, but may not be subordinated to equity interests
ELEMEANTS

• 3-part standard emanating from *In re Mobile Steel Co.*, 563 F.2d 692, 699-700 (5th Cir. 1977)
  – Creditor has engaged in inequitable conduct
  – Resulting in injury to creditors or conferring an unfair advantage; and
  – Subordination of the claim is not inconsistent with the provisions of the Bankruptcy Code
ELEMENT #1: INEQUITABLE CONDUCT

• Non-insiders
  – Requires proof of egregious conduct that shock's one's conscience

• Insiders
  – Burden of proof shifts and court scrutiny is rigorous
  – Must show only that insider used position to create advantage for itself

• Broad categories of conduct that are inequitable
  – Fraud, illegality, breach of fiduciary duties
  – Undercapitalization PLUS overreaching
  – Excessive control of debtor
INEQUITABLE CONDUCT?

• Insider loans to insolvent borrowers
• Excessive control
  • Enforcing rights under debt instruments
  • Monitoring
  • Suggestions/recommendations/threats = excessive control?
• Negligent lending
• Knowledge of borrower's misuse of proceeds
  • Claims trading or buying debt
ELEMENT #2: HARM TO CREDITORS

• Generally proven when
  – Other creditors receive less than defendant
  – Unnecessary expense, hindrance or delay to debtor

• Extent of subordination measured monetarily
  – May not result in complete subordination

• If no harm, then no remedy
ELEMENT #3: NOT INCONSISTENT WITH BANKRUPTCY CODE

• Invariably satisfied because Section 510(c) expressly authorizes subordination
• No case under the Code has denied equitable subordination on this ground where the first two elements have been satisfied
CLAIMS TRADING

• Is a claim for equitable subordination enforceable against a buyer of the claim?
EQUITABLE DISALLOWANCE

• Section 510(c) is silent

• Remedy is available
  o *In re Adelphia Communications*, 365 B.R. 24 (Bankr. SDNY 2007)

• Remedy is not available
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