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## CHARACTERIZING THE CURRENT STATE OF RECHARACTERIZATION: RADNOR IS NOT ALL YOU NEED TO KNOW

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The concept of recharacterizing debt to equity is neither new nor complicated. When a bankruptcy court “recharacterizes” debt, it treats as equity or investment what the parties characterized as debt. Not all judges agree, however, that bankruptcy courts have authority to do this.

Recharacterization may be considered a cousin of equitable subordination. Courts developed the doctrine of equitable subordination to ensure that claimants against a bankruptcy estate who engaged in unfair or fraudulent conduct to the detriment of others were dealt with appropriately.<sup>1</sup> The doctrine, of course, is codified in § 510(c), which states that “a court may—(1) under principles of equitable subordination, subordinate for purposes

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of distribution all or part of an allowed claim to all or part of another allowed claim or all or a part of an allowed interest to all or a part of another allowed interest[.]”<sup>2</sup>

Equitable subordination however is a remedy for *inequitable* conduct, and involves a determination whether a *legitimate creditor’s claim* should be subordinated to the extent necessary to offset injury to other creditors. Recharacterization, in contrast, requires no finding of inequitable conduct.<sup>3</sup> Courts claiming authority to recharacterize, rely on their equitable power under § 105 to do so.

Recharacterization, to be sure, has its detractors. A prominent decision criticizing the doctrine was delivered by Bankruptcy Judge Barliant in **In re Outboard Marine Corp.**<sup>4</sup> Outboard Marine Corp. (OMC) was a boat manufacturer. Prior to filing Chapter 11, as it was struggling to stay afloat in the Fall of 2000, OMC and its bank lenders completed the 10th amendment to their loan and security agreement, creating an additional \$45 million tranche of debt (Tranche B). Quantum Industrial Partners LDC, which over the course of two years had become the direct or beneficial owner of nearly 100% of OMC stock, immediately purchased a 100% participation interest in Tranche B. Quantum agreed with OMC’s bank lenders that Tranche B would be subordinated to the \$105 million Tranche A loan.

Two months later, OMC filed for Chapter 11 protection. The Chapter 11 trustee asked the bankruptcy court to use its equitable powers to decree that the Tranche B loan, allegedly owed to Quantum, did not give rise to a right to payment because it was not a loan at all, but merely an equity security. The bankruptcy court ruled in favor of Quantum, observing from the bench:

[T]here is no basis in bankruptcy law to recharacterize a debt as equity. That bizarre concept arose from a serious misreading of a few tax cases.... Somehow, those very reasonable cases got read into the bankruptcy context into some sort of equitable doctrine.... In my opinion, no bankruptcy court has the power to do any such thing under the Bankruptcy Code.<sup>5</sup>

The Ninth Circuit Bankruptcy Appellate Panel also rejected the concept of recharacterization,

holding that debts can only be *subordinated* by invoking the *equitable subordination doctrine*. **Unsecured Creditors’ Comm. of Pacific Express, Inc. v. Pioneer Commercial Funding Corp. (In re Pacific Express, Inc.)**.<sup>6</sup> The Ninth Circuit BAP explained that because recharacterization has the same result as the successful application of equitable subordination, permitting the recharacterization of debts to equity under general equitable powers would result improperly in inconsistent standards under the Code for the subordination of debts.<sup>7</sup>

Most courts that have considered the issue have determined they do have authority to recharacterize. Indeed, each of the courts of appeal to consider the question have concluded that they have the authority to recharacterize purported debt to equity under the appropriate circumstances.<sup>8</sup>

The circuits apply various tests to determine when recharacterization is appropriate. Most tests look to the baseline question of what the economic reality of the transaction was, and to do that, most consider a number of factors, including:<sup>9</sup>

- (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 rate of interest and interest payments;
- (4) the source of repayments;
- (5) the adequacy or inadequacy of capitalization;
- (6) the identity of interest between the creditor and the 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.

While the emerging trend is the recognition by courts that they have the authority to recharacterize debt to equity under appropriate circumstances, most reported decisions then conclude that exercise of that authority is unwarranted by the facts presented.<sup>10</sup>

The big news in 2006 in recharacterization is that two more circuits recognized the validity of the doctrine. The first, **Cohen v. KB Mezzanine Fund II LP (In re SubMicron Systems Corp.)**,<sup>11</sup> involved subordinated debt holders who loaned additional monies shortly before bankruptcy. The subordinated debt holders later contributed the secured claims that resulted from these loans to an acquisition vehicle, which in turn used them to credit bid for the company's assets under § 363(k), in exchange for a large equity stake in the acquisition vehicle.

To determine whether the subordinated debt holders' claims should be recharacterized, the Third Circuit in **SubMicron** described the overarching inquiry as whether the parties called an instrument one thing when in fact they intended it as something else.<sup>12</sup> Applying this inquiry, the Third Circuit held that the district court's refusal to recharacterize the debt was not clearly erroneous when the district court found evidence outside the lending documents that the parties intended to create a debt instrument.<sup>13</sup>

Even more recently, the Fourth Circuit in **Fairchild Dornier GMBH v. Official Committee of Unsecured Creditors (In re Official Committee of Unsecured Creditors for Dornier Aviation (N. Am.), Inc.)**,<sup>14</sup> also confirmed its authority to recharacterize.<sup>15</sup>

In **Dornier Aviation**, the parent of the debtor sold spare parts to the debtor and billed the debtor for those parts.<sup>16</sup> However, it was agreed between the parties that the debtor did not have to pay the parent until the subsidiary became profitable.<sup>17</sup> Discovery also revealed that the parent treated the debtor "specially" because the parent viewed its relationship with the debtor as a "market investment" designed to expand its access to the North American market.<sup>18</sup> Their agreements for repayment also did not have a fixed maturity date.<sup>19</sup>

The Fourth Circuit in **Dornier Aviation** explained that recharacterization is well within the

broad powers afforded a bankruptcy court under § 105(a) because it facilitates the application of the priority scheme laid out in § 726.<sup>20</sup> This appears to be the first circuit-level decision that has linked the power under § 105(a) to recharacterize with another section in the Bankruptcy Code, namely § 726. The Fourth Circuit stated:

The Bankruptcy Code instructs a bankruptcy court to allow a creditor's claim against the bankruptcy estate unless a party in interest objects and a recognized exception applies. 11 U.S.C. § 502. The Code sets forth in § 726, a priority scheme for the distribution of the Debtor's assets. The statutory scheme provides, inter alia, that the claims of all unsecured creditors must be satisfied before holders of equity interests can recover anything from the estate. *See* § 726(a). A bankruptcy court may alter the priority of all allowed claim via equitable subordination, that is, the court may reduce the priority of all or part of an allowed claim if it finds that the creditor engaged in equitable subordination. *See* § 510(c)(1). The Code also authorizes a bankruptcy court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. 11 U.S.C. § 105(a).<sup>21</sup>

The **Dornier Aviation** court, unlike other circuit decisions, also actually upheld the recharacterization before it. The court reasoned that a claimant's insider status and debtor's undercapitalization alone will normally be insufficient to support recharacterization of a claim, since in many cases, an insider will be the only party willing to make a loan to a struggling business and the courts should not use recharacterization to discourage good faith loans.<sup>22</sup> However, the court held that when other facts indicate a transaction is not a loan at all, recharacterization is appropriate to ensure consistent application of the Bankruptcy Code.<sup>23</sup> The **Dornier Aviation** court found several factors persuasive of recharacterization, including the lack of maturity dates on the debt instruments, that the debtor would not be required to pay until it was profitable, and that the parent was assuming the debtor's losses.<sup>24</sup>

The clear trend is for courts to recognize authority to recharacterize under appropriate cir-

cumstances.<sup>25</sup> The recent decisions by the Third and Fourth Circuits, at a minimum, further this trend. However, they also are arguably of greater moment because each goes further than prior decisions in some aspect. **Donier Aviation**, as noted above, is important because of the additional statutory basis it offers in support of the doctrine. **SubMicron** should serve as a heavy reminder that lenders, and not just equity holders, need to understand and manage the risk. To be fair and accurate, however, we must point out that the lenders in **SubMicron** were not, by any means, traditional lenders. Indeed, perhaps the more apt takeaway is that with all the new entrants into the bankruptcy space, such as hedge funds, the lines that traditionally separate players are quickly blurring. This, in turn, is forcing the evolution of case law at speeds that can sometimes be unsettling.

**Research References:** Norton Bankr. L. & Prac. 2d § 44:3

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**Notes**

1. See, e.g., **Benjamin v. Diamond (In re Mobile Steel Co.)**, 563 F.2d 692, 700 (5th Cir. 1977); see also **Pepper v. Litton**, 308 U.S. 295, 305, 310, 60 S. Ct. 238, 84 L. Ed. 281 (1939) (claim of dominant and controlling shareholder disallowed when shareholder, among other things, schemed to hinder and delay a creditor).
2. 11 U.S.C. § 510(c).
3. Under the "Deep Rock" doctrine, shareholder loans to a corporation may be treated as capital contributions, and thus effectively subordinated, when there is "knowing undercapitalization and the attendant unfairness to the creditors of the corporation." **Mobile Steel**, 563 F.2d at 702; see also **Estes v. N & D Props., Inc. (In re N & D Props., Inc.)**, 799 F.2d 726, 733 (11th Cir. 1986) ("Shareholder 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."); **Summit Coffee Co. v. Herby's Foods, Inc. (In re Herby's Foods, Inc.)**, 2 F.3d 128, 131 (5th Cir. 1993) ("[I]f an insider makes a loan to an undercapitalized corporation, the combination of undercapitalization and the insider loan may allow the bankruptcy court to recharacterize the loan as a capital contribution[.]"); **Fabricators, Inc. v. Technical Fabricators, Inc. (In re Fabricators, Inc.)**, 926 F.2d 1458, 1469 (5th Cir. 1991) ("When an insider makes a loan to an undercapitalized corporation, a court may recast the loans as contributions to capital.").
4. **In re Outboard Marine Corp.**, No. 00 B 37405, at \*33 (Bankr. N.D. Ill. Jan. 14, 2002), *rev'd*, No. 02 C 1594, 2003 WL 21697357 (N.D. Ill. July 22, 2003).
5. Judge Barliant's ruling was overturned, however. On appeal, the district court ruled that it disagreed with the bankruptcy court's reasoning and held that a bankruptcy court has the authority to recharacterize a debt as equity. **Moglia v. Quantum Indus. Partners, LDC (In re Outboard Marine Corp.)**, No. 02 C 1594, 2003 WL 21697357 (N.D. Ill. July 22, 2003). The district court cited the Seventh Circuit case, **In re Lifschultz Fast Freight**, 132 F.3d 339, 344-45 (7th Cir. 1997), stating that while the Seventh Circuit has never ruled specifically on the propriety of recharacterizing a debt as equity in a bankruptcy proceeding, the court has acknowledged in passing a cause of action for recharacterization that is distinct from equitable subordination. See also **Hezog v. Leighton Holdings, Ltd. (In re Kids Creek Partners, L.P.)**, 212 B.R. 898, 931-32 (Bankr. N.D. Ill. 1997), *aff'd*, 233 B.R. 409 (N.D. Ill. 1999), *aff'd*, 200 F.3d 1070 (7th Cir. 2000).
6. **In re Pacific Express, Inc.**, 69 B.R. 112 (B.A.P. 9th Cir. 1986).
7. **Pacific Express**, 69 B.R. at 115.
8. See, e.g., **Fairchild Dornier GMBH v. Official Comm. of Unsecured Creditors (In re Official Committee of Unsecured Creditors for Dornier Aviation (North America), Inc.)**, 453 F.3d 225 (4th Cir. 2006); **Cohen v. KB Mezzanine Fund II LP (In re SubMicron Systems Corp.)**, 432 F.3d 448 (3d Cir. 2006); **Sender v. Bronze Group, Ltd. (In re Hedged-Investments Assocs., Inc.)**, 380 F.3d 1292 (10th Cir. 2004); **Bayer Corp. v. Masco Tech, Inc. (In re AutoStyle Plastics, Inc.)**, 269 F.3d 726, 749 (6th Cir. 2001); **N&D Props., Inc.**, 799 F.2d at 730.
9. **AutoStyle Plastics, Inc.**, 269 F.3d at 749.
10. *But see* **Repository Techs., Inc. v. Nelson (In re Repository Techs., Inc.)**, Adv. No. 06 A 01247, 2007 WL 1175872 (Bankr. N.D. Ill. Feb. 13, 2007); **Fidelity Bond & Mortgage Co. v. Brand (In re Fidelity Bond & Mortgage Co.)**, 340 B.R. 266 (Bankr. E.D. Pa. 2006); **Acquino v. Black (In re AtlanticRancher, Inc.)**, 279 B.R. 411 (Bankr. D. Mass. 2002); **Citicorp Real Estate, Inc. v. PWA, Inc. (In re Georgetown Bldg. Assocs., Ltd. Partnership)**, 240 B.R. 124 (Bankr. D.D.C. 1999); **In re Cold Harbor Assocs. L.P.**, 204 B.R. 904 (Bankr. E.D. Va. 1997); **Diasonics, Inc. v. Ingalls**, 121 B.R. 626 (Bankr. N.D. Fla. 1990).
11. **In re SubMicron Systems Corp.**, 432 F.3d 448 (3d Cir. 2006).
12. **SubMicron**, 432 F.3d at 456-57. The court went on to state that the intent 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.
13. **SubMicron**, 432 F.3d at 456-57.
14. **In re Official Committee of Unsecured Creditors for Dornier Aviation (N. Am.), Inc.**, 453 F.3d 225 (4th Cir. 2006).
15. Interestingly, former Bankruptcy Judge Barliant argued this case for the Committee in **Dornier Aviation**, which was advocating recharacterization in the case.
16. **Dornier Aviation**, 453 F.3d at 230.
17. **Dornier Aviation**, 453 F.3d at 230.
18. **Dornier Aviation**, 453 F.3d at 230.
19. **Dornier Aviation**, 453 F.3d at 230.
20. **Dornier Aviation**, 453 F.3d at 232.

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21. **Dornier Aviation**, 453 F.3d at 231.
22. **Dornier Aviation**, 453 F.3d at 235.
23. **Dornier Aviation**, 453 F.3d at 235.
24. **Dornier Aviation**, 453 F.3d at 235.
25. See, e.g., **In re Insilco Techs., Inc.**, 480 F.3d 212 (3d Cir. 2007); **Wilson v. Moir (In re Wilson)**, 359 B.R. 123 (Bankr. E.D. Va. 2006); **In re Springs Hospitality, Inc.**, No. 06-13331 HRT, 2006 WL 2458679 (Bankr. D. Colo. Aug. 22, 2006); **Official Comm. of Unsecured Creditors of Radnor Holdings Corp. v. Tennebaum Capital**

**Partners, LLC (In re Radnor Holdings Corp.)**, 353 B.R. 820 (Bankr. D. Del. 2006); **Devon Mobile Commc'ns Liquidating Trust v. Adelpia Commc'ns Corp. (In re Adelpia Commc'ns Corp.)**, Adv. No. 04-03192, 2006 WL 687153 (Bankr. S.D.N.Y. Mar. 6, 2006); **Farr v. Phase-I Molecular Toxicology, Inc. (In re Phase I Molecular Toxicology, Inc.)**, 287 B.R. 571, 576 (Bankr. D.N.M. 2002); **Kids Creek Partners**, 212 B.R. at 931; **Cold Harbor Assocs.**, 204 B.R. at 915; **Diasonics Inc. v. Ingalls**, 121 B.R. at 630.