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Recharacterization Battles Likely in Next Round of Bankruptcies

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The last five years have witnessed an explosion in second lien financings. Struggling companies that could not find alternative financing elsewhere and otherwise would have been without sufficient operating capital were provided with access to additional liquidity.

This additional capital often came from shareholders or other insiders of the company in exchange for the granting of a subordinated security interest in the company's assets. With the credit crunch drying up the capital markets over the past year, the next wave of major bankruptcies will present issues regarding the validity of such liens.

Indeed, general unsecured creditors are likely to face a daunting amount of secured debt ahead of them on the proverbial food chain that far exceeds the proceeds available for distribution to creditors. Under these circumstances, the ability of unsecured creditors to receive a meaningful distribution from the estates may depend on their ability to successfully recharacterize the claims of the second lien holders.

Such an endeavor is no easy task. Under the present legal framework used by courts, creditors must meet a high burden to demonstrate that nominally secured debt is in fact a disguised equity contribution. Courts likely will have to liberalize the doctrine of recharacterization or shift the emphasis of the factors they consider to preserve the rights of unsecured creditors in the Chapter 11 process.

As an initial matter, it is important to distinguish recharacterization from equitable subordination. Both remedies are grounded in the Bankruptcy Courts' equitable authority to ensure "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, 60 S. Ct. 238, 84 L. Ed. 281 (1939). Nonetheless, recharacterization and equitable subordination address distinct concerns.

Equitable subordination is apt when, due to creditors' misconduct, equity demands that the payment priority of claims of an otherwise legitimate creditor be changed to fall behind those of other claimants. See, *e.g., Citicorp Venture Capital, Ltd. v. Comm. of Creditors Holding Unsecured Claims*, 160 F.3d 982, 986-87 (3d Cir. 1998); *Bayer Corp. v. MascoTech, Inc. (In re Autostyle Plastics, Inc.)*, 269 F.3d 726, 749 (6th Cir. 2001).

In contrast, recharacterization does not require a showing of misconduct. 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.

In light of this important distinction, the doctrine of recharacterization may be a far more promising avenue of relief than equitable subordination in the context of a challengeto the secured claim of a second lien holder. It does not require unsecured creditors to demonstrate inequitable conduct to jump ahead of second lien holders in the priority scheme contemplated by the Bankruptcy Code.

Recharacterization Requests

Courts have sought to enumerate a list of factors to aid in determining whether an obligation was really intended to be a debt or equity transaction. In *Roth Steel Tube Co. v. Comm'r*, 800 F.2d 625 (6th Cir. 1986), the 6th Circuit U.S. Court of Appeals laid out 11 factors to determine whether an investment was debt or equity in the context of assessing income tax liability. *Id.* at 630. In *Autostyle Plastics*, the 6th Circuit extended the use of those factors to the recharacterization context. See 269 F.3d at 749-50. They are the:

1. Names given to the instruments, if any, evidencing the indebtedness
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, if any, for the advances
8. Corporation'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

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

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. See *In re SubMicron Sys. Corp.*, 432 F.3d 448, 455-56 (3d Cir. 2006). Indeed, in addressing the multifactored test used by courts in determining issues of recharacterization, the 3d U.S. 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. *SubMicron*, 432 F.3d at 456.

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. An important factor that courts consider in construing the parties' intentions is whether the transaction bears the earmarks of an arm's-length negotiation. See *Pepper v. Litton*, 308 U.S. 295 (1939); *Roth Steel Tube Co.*, 800 F.2d 625. The more an exchange appears to reflect the characteristics of an arm's-length negotiation, the more likely it is that such a transaction is to be treated as debt.

Difficult Standard

Two recent appellate court decisions have reaffirmed the validity of the doctrine of recharacterization. See *SubMircron*, 432 F.3d 448; *Fairchild Dornier GMBH vs. The Official Committee of Unsecured Creditors* [*In re the Official Committee of Unsecured Creditors for Dornier Aviation (North America) Inc.*], 453 F.3d 225 (4th Cir. 2006). Nevertheless, it is extremely difficult under the current framework to apply this doctrine successfully to reclassify purported debt as equity.

Indeed, unsecured creditors face an uphill task in proving that the parties to a purported security agreement actually intended to effectuate a capital contribution. It is relatively easy for sophisticated second lien lenders, including company insiders, to argue that their investment in struggling companies should be characterized as an arm's-length secured transaction under the 11 factors set forth earlier. This can be accomplished so long as the parties observe the formalities of secured loan transactions through the execution of "loan" documents that include (i) a fixed (but illusory) maturity date; (ii) a fixed interest rate (payments for which can be deferred until the maturity date); and (iii) the granting of security for the advances.

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By documenting the investment in this way, second lien lenders can point to these hallmarks of an arm's-length transaction in response to a challenge to their liens from unsecured creditors. The unsecured creditors are then 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.

The next wave of bankruptcies undoubtedly will include attempts by unsecured creditors to recharacterize second lien debt as equity, especially when the second lien holder is an insider of the debtor. However, the current framework established by Bankruptcy Courts presents significant obstacles to unsecured creditors seeking to knock out the second lien claims of lenders that provided capital on a purportedly secured basis to a struggling debtor that was unable to find capital from alternative sources.

If unsecured creditors are to be successful in recharacterizing second lien debt as equity, a more liberal and flexible analysis of the 11 *Autostyle* factors should be considered by the 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 debtors' capitalization at the time of the transaction; and (ii) the ability of the debtor to obtain alternative forms of financing.

By weighting these factors more prominently than the 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 arm's-length transaction. This subtle change would ease the evidentiary burden on unsecured creditors and reveal the substance over the form.

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