FIFTH CIRCUIT REJECTS *PER SE* RULE THAT RECHARACTERIZATION APPLIES ONLY TO INSIDERS

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In a recent ruling, the Fifth Circuit Court of Appeals rejected a *per se* rule that only corporate insiders can have their debt claims recharacterized as equity. Instead, in *In re Lothian Oil Inc.*, 2011 WL 3473354 (5th Cir. Aug. 9, 2011), the Court of Appeals held that "recharacterization extends beyond insiders and is part of the bankruptcy courts' authority to allow and disallow claims under 11 U.S.C. § 502." Thus, all creditors, regardless of their insider status, are susceptible to having their claims recharacterized as equity.

The Facts of the Case

While the case involved extensive litigation between the parties, the issue decided by the Court of Appeals – whether a bankruptcy court can recharacterize a claim as equity rather than debt – focused on two agreements between the debtor Lothian Oil Inc. ("**Lothian**") and a non-insider third-party, Israel Grossman ("**Grossman**"). Specifically, on each of April 27 and May 12, 2005, Grossman and Lothian signed documents pursuant to which Grossman "loaned" Lothian $200,000 and $150,000, respectively. Both agreements provided that Grossman would receive a royalty of one percent of Lothian's share of gross production of oil and gas on certain properties and that each of the loan amounts would be repaid from the proceeds of an equity placement made in Lothian.

Lothian filed for chapter 11 protection on June 13, 2007, and Grossman filed various claims in the case, including claims based on the two "loans". The Bankruptcy Court for the Western District of Texas rejected the claims, finding that they "assert[ed] common equity interests at best and that insufficient evidence of the value of the interests was presented." The District Court, however, reversed the recharacterization of the two claims as equity, "declin[ing] to extend the concept of debt recharacterization to a non-insider creditor."

Recharacterization of Debt Under Section 502 of the Bankruptcy Code

The Court of Appeals found that bankruptcy courts have the authority to recharacterize debt claims as equity as part of their authority to disallow claims under section 502 of the Bankruptcy Code. Specifically, section 502 provides that "the court, after notice and a hearing, shall determine the amount of such claim ... and shall allow such claim in such amount, except to the extent that—(1) such claim is unenforceable against the debtor and property of the debtor, under any agreement or applicable law . . ." 11 U.S.C. § 502(b). Applicable law is typically state law. *See Butner v. United States*, 440 U.S. 48, 54 (1979). Thus, the Court of Appeals found that "[i]f a claim asserts a debt that is contrary to state law, the bankruptcy court may not allow the claim. . . [W]here the reason for such disallowance is that 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. . . [R]echaracterizing the claim as an equity interest is the logical outcome of the reason for disallowing it as debt." 2011 WL 3473354 at *3.

Rejection of a *Per Se* Rule for Corporate Insiders

In affirming the Bankruptcy Court's decision to recharacterize Grossman's claims, the Court of Appeals explicitly rejected the District Court's finding that only the claims of insiders can be recharacterized as equity. Based on its analysis of section 502 of the Bankruptcy Code, the Court found that unless state law makes insider status relevant to characterizing a claim as equity or debt, that status is irrelevant in bankruptcy proceedings. The Court stated that "because insiders and non-insiders alike can mischaracterize their claims in contravention of state law, we decline to limit recharacterization to insider claims." *Id.* Thus, all creditors, regardless of their relationship to a debtor, can have their claims recharacterized as equity.

Factors Relevant to Characterization of Claim as Debt

To distinguish between debt and equity, bankruptcy courts have imported various multi-factor tests from federal tax law. In the Fifth Circuit, those factors include (1) name of the instrument memorializing the transaction; (2) definitiveness of maturity date; (3) source of payments; (4) right to enforce payment; (5) participation in management; (6) relationship of would-be "creditors" to general creditors; (7) intent of the parties; (8) adequacy of capitalization; (9) identity of ownership; (10) source of interest payments; and (11) ability of corporation to obtain loans elsewhere. *See Jones v. United States*, 659 F.2d 618, 622 n. 12 (5th Cir. 1981).

In finding that Grossman's claims were equity and not debt, the Bankruptcy Court focused on the fact that Grossman would be paid from royalties and "equity placements", which depended on the success of Lothian's business, instead of a prescribed interest rate, as well as the lack of a term for repayment and a maturity date. In affirming the Bankruptcy Court's ruling, the Court of Appeals found that because Texas law would not have recognized Grossman's claims as asserting a debt interest, the bankruptcy court correctly disallowed them as debt and recharacterized the claims as equity interests.

A Warning For Creditors: Non-Insider Status Does Not Offer Protection

The Fifth Circuit's holding is a warning for creditors that non-insider status is not enough to protect their claims from recharacterization as equity. All creditors, regardless of their relationship with a debtor, must ensure that their debts are properly documented as debts.

Authored By:

Blanka Wolfe
(212) 332-3822
bwolfe@sheppardmullin.com