Subordination and Recharacterization

A Practical Guidance® Practice Note by Ira L. Herman, Blank Rome LLP

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This practice note discusses how a bankruptcy court may recharacterize documents that purport to create a loan transaction and determine that the transaction, despite labels, is something else—a transaction providing for a contribution to the debtor's capital. Although lawyers can structure a transaction to look like debt, most appellate courts agree that bankruptcy courts have the authority to determine what a transaction really is despite nomenclature used by the parties to an agreement. A true lender will always want to ensure that a transaction is treated as debt by a bankruptcy court, and therefore must structure the transaction in a way that will reduce the recharacterization risk. Private equity investors in a project who take back paper at different levels of the capital stack, will have carefully consider the structure of a transaction and determine their tolerance for the recharacterization of the portion of their investment that they have intended to be debt.

This practice note also discusses subordination of claims under Section 510 of the Bankruptcy Code.

Finally, this practice note introduces the notion that a party in interest in a bankruptcy case may object to a competing creditor's claims for strategic purposes. Creditors will do this to increase their share of a finite bankruptcy pie. The Bankruptcy Code provides objecting parties with a robust "tool box" to accomplish this task, including recharacterization, subordination, and disallowance.

This practice note discusses the requirements that must be met for recharacterization, as follows:

- Subordination of Claims
- Recharacterization Requirements
- Recharacterization Factors
- Conclusion

For more information, see Equitable Subordination versus Debt Recharacterization and Treatment of Claims in Bankruptcy.

Subordination of Claims

Section 510 of the Bankruptcy Code governs subordination of claims. Subordination does not eliminate claims; rather, it results in the subordinated claim being removed from one class of claims and placed in a class of claims that is afforded a lower priority in the pecking order of the payments to be made in a bankruptcy case. In many instances, a subordinated claim receives no distribution. By the subordination of a claim and its removal from a class of claims, claims remaining in the class will benefit by receiving their proportionate share of a distribution that otherwise would have been paid to the now subordinated claim. In other words, although the size of the pie remains the same in terms of dollars available for distribution to the affected class of creditors, the total dollar amount claims to be paid in that class is reduced. Subordination under the Bankruptcy Code may be contractual (Section 510(a)) or equitable (Section 510(c)). Additionally, the Bankruptcy Code provides that claims for damages "arising from [the] rescission of a purchased or sale of a security of the debtor or of an affiliate of the debtor" are subordinated by operation of law to claims.

Contractual Subordination

Section 510(a) of the Bankruptcy Code provides that contractual subordination provisions are enforceable in bankruptcy to the same extent as they are under applicable non-bankruptcy law. Both independent subordination agreements executed between creditors and subordination provisions in debtor-creditor agreements are included within the scope of Section 510(a).

Statutory Subordination of Securities Related Claims

Section 510(b) of the Bankruptcy Code works to subordinates claims arising from rescission of a purchase or sale of a security of the debtor or an affiliate of the debtor for damages arising from the purchase or sale of such a security or for reimbursement or contribution. The purpose of such subordination is to prevent the elevation of damage claims arising from an ownership of a security above the level of holders of such a security—in other words, the claim to which the claimant would have been entitled as an owner of the security if not for the misconduct giving rise to the damages. If the security is common stock, the claim is subordinated to the level of common stock. Otherwise, the claim is subordinated to all claims or interests that are "senior" or equal to the claim or interest represented by the underlying security.

Equitable Subordination

Under Section 510(c) of the Bankruptcy Code, a claim may be equitably subordinated "to all or part of another allowed claim," and an interest may be subordinated "to all or part of another allowed interest" if the claimant or interest holder has engaged in some type of inequitable conduct.

Equitable subordination permits a court "to undo or to offset any inequity in the claim position of a creditor that will produce injustice or unfairness to other creditors in terms of estate distributions." In re Vietri Homes, Inc., 58 B.R. 663, 665 (Bankr. D. Del. 1986). Equitable subordination is remedial rather than penal in nature. In re Mobile Steel Co., 563 F.2d 692, 701 (5th Cir. 1977); Diasonics, Inc. v. Ingalls, 121 B.R. 626 (Bankr. N.D. Fla. 1990). Therefore, "a claim . . . should be subordinated only to the extent necessary to offset the harm which the bankrupt and its creditors suffered on account of the inequitable conduct." Mobile Steel, 563 F.2d at 701. If the claim exceeds the extent of the harm, the claim should be subordinated only to that extent. However, this general rule is not always followed, and a court may subordinate an entire claim if the injury to the other creditors is not easily quantified.

In the case of a leveraged buyout, the court looks to the substance of the transaction as opposed to its form in order to decide whether to equitably subordinate the claims of former shareholders-turned-creditors to those of general unsecured creditors. In re Structurlite Plastics Corp., 224 B.R. 27 (B.A.P. 6th Cir. 1998). The equitable subordination remedy is available not only to trustees and debtors in possession but to any creditor seeking to subordinate another creditor's claim to its own.

The widely accepted three-prong standard for equitable subordination is set forth in Mobile Steel, 563 F.2d at 699–700:

> [T]he conditions must be satisfied before exercise of the power of equitable subordination is appropriate:
>
> The claimant must have engaged in some type of inequitable conduct.
>
> The misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant.
>
> Equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Code.

The doctrine most often arises in connection with claims of corporate insiders or those who stood in a fiduciary relationship with the debtor in order to prevent them from converting equity interests into claims or from improving the priority of their claims in anticipation of bankruptcy.

The doctrine also has been applied to non-insider, non-fiduciary claims, but this generally occurs only if that creditor has engaged in very substantial misconduct or "gross misconduct tantamount to 'fraud, overreaching or spoliation or the detriment of others.'" In re Teltronics Services, Inc., 29 B.R. 139, 169 (Bankr. E.D.N.Y. 1983) (citations omitted); In re Just For the Fun of It of Tennessee, Inc., 7 B.R. 166, 180 (Bankr. E.D. Tenn. 1980). The "quality of [the] conduct that will be deemed 'inequitable' under [Section] 510(c) of the Bankruptcy Code depends on the nature of the legal relationship between the debtor and the party whose claim is subject to attack on equitable subordination grounds." In re Badger Freightways, Inc., 106 B.R. 971, 976 (Bankr. N.D. Ill. 1989).

Where the outside creditor sufficiently controls or dominates the will of the debtor, its operations, or decision-making processes and exercises that control to the detriment of others, that creditor is treated as an insider. For insider status, "[w]hat is required is operating control of the debtor's business, because only in that situation does a creditor assume the fiduciary duty owed by the officers and directors." Badger Freightways, Inc., 106 B.R. at 977. A typical commercial lender, however, owes no fiduciary duties to its customer. A court generally will not find a bank's conduct inequitable where it acted within its authority under its loan

agreement with the debtor. Kham & Nate's Shoes No.2. Inc. v. First Bank of Whiting, 908 F.2d 1351, 1356–59 (7th Cir. 1990); In re Heartland Chemicals, 136 B.R. 503 (Bankr. C.D. Ill. 1992).

Some courts have used a broader rule such that subordination may occur where there is either creditor misconduct or the claim is of a type susceptible to subordination. The U.S. Supreme Court has yet to decide if inequitable conduct is necessary for equitable subordination. U.S. v. Noland, 116 S. Ct. 1524 (1996).

Burden of Proof

With respect to the burden of proof for equitable subordination, a creditor has the initial burden of establishing the amount and legitimacy of its claim. Pursuant to Federal Rule of Bankruptcy Procedure 3001(f), a proof of claim properly executed and filed by a claimant is prima facie evidence of the validity and amount of the claim. The party seeking to equitably subordinate a claim must overcome the claimant's prima facie case. Teltronics Services, 29 B.R. at 169 ("[O]bjectant must prove by a preponderance of the evidence that the claimant engaged in such substantial inequitable conduct [such fraud or breach of fiduciary duty] to the detriment of the debtor's other creditors that subordination is warranted."). If the objecting party produces sufficient evidence to overcome the claimant's prima facie case, the burden of going forward shifts to the claimant to establish that the challenged transaction is an arm's length transaction.

The burden of proof required to subordinate claims on equitable grounds depends on whether or not the claimant is an insider. When the claimant is an insider or fiduciary, the trustee need only present material evidence of the claimant's inequitable conduct to shift the burden to the claimant to prove the fairness and good faith of such conduct. If the claimant is not an insider of the debtor, the trustee's burden is far greater: he must prove egregious or gross misconduct. In re Fabricators, Inc., 926 F.2d 1458 (5th Cir. 1991); In re Herby's Foods Inc., 2 F.3d 128, 133–34 (5th Cir. 1993); In re Granite Partners, L.P., 210 B.R. 508 (Bankr. S.D.N.Y. 1997) (holding that when a party seeks equitable subordination of non-insider, non-fiduciary claims, the level of pleading and proof is even higher than when subordination of an insider's or fiduciary's claim is sought).

Undercapitalization of Debtor as a Basis for Equitable Subordination

Undercapitalization supports but does not independently justify equitable subordination. As the court in Mobile Steel, 563 F.2d 692, stated, an adequate amount of capitalization is "what reasonably prudent men with a general background knowledge of the particular type of business and its hazards would determine was reasonable . . . in the light of any special circumstances which existed at the time of the incorporation of the now defunct enterprise." For more information, see Equitable Subordination.

Recharacterization Requirements

Section 502(b)(1) of the Bankruptcy provides the authority for a party in interest in a bankruptcy case to object to a claim asserted by a competing creditor (1) by challenging the claim under bankruptcy and non-bankruptcy law and (2) by the enforcement of any agreement between or among the parties giving rise to such claim.

The Bankruptcy Code, however, is silent with regard to the recharacterization of a purported claim as something with a lower priority than a claim (i.e., an equity security interest). (A "claim," under *Section 101(5) of the Bankruptcy Code*, includes the "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.") Because no section of the Bankruptcy Code expressly provides for recharacterization, it has been left to the courts to determine whether or not they have the authority to recharacterize. Most courts, when asked to consider recharacterization, have held that the bankruptcy courts have the authority to do so. However, there is a split among the courts that recognize recharacterization as to the legal authority permitting recharacterization.

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A majority of the courts authorizing recharacterization, including the Third, Fourth, Sixth, and Tenth Circuits, have found that bankruptcy courts may recharacterize pursuant to the broad equitable powers granted by Section 105(a) of the Bankruptcy Code. In re SubMicron Sys., 432 F.3d 448, 454 (3d Cir. 2006); Dornier Aviation (North America), Inc. v. Official Comm. of Unsecured Creditors (In re Dornier Aviation), 453 F.3d 225, 231 (4th Cir. 2006); In re AutoStyle Plastics, Inc., 269 F.3d 726, 748, 750 (6th Cir. 2001). The "bankruptcy court's equitable powers have long included the ability to look beyond form to substance." In re Dornier Aviation (North America), Inc., 453 F.3d at 233. In fact, the equitable power of the court to recharacterize is viewed as essential to effectuating the Bankruptcy Code's priority scheme. Id.; In re AutoStyle Plastics, Inc., 269 F.3d at 748; In re Hedged-Investments Assocs., Inc., 380 F.3d 1292, 1298 (10th Cir. 2004).

The Fifth and Ninth Circuits, have found that, recharacterization is required in appropriate circumstances by Butner v. United States, 440 U.S. 48, 54 (1979) when applicable non-bankruptcy law would characterize something that at first glance may look like a loan as a contribution to capital. In re Lothian Oil, Inc., 650 F.3d 539, 542–43 (5th Cir. 2011); Official Comm. of Unsecured Creditors v. Hancock Park Capital II, L.P. (In re Fitness Holdings Int'l, Inc.), 714 F.3d 1141, 1148 (9th Cir. 2013).

In *Lothian Oil*, the Fifth Circuit held that recharacterization of a purported debt as a capital contribution is permitted and that recharacterization is not limited to claims of insiders. (An equity security is defined as either "(A) share in a corporation, whether or not transferable or denominated "stock", or similar security; (B) interest of a limited partner in a limited partnership; or (C) warrant or right, other than a right to convert, to purchase, sell, or subscribe to a share, security, or interest of a kind specified in subparagraph (A) or (B) of this paragraph." 11 U.S.C. § 101(16).) As stated above, the Fifth Circuit's approach to recharacterization differs from the several circuits that rely upon the equitable powers of a bankruptcy court as the basis for recharacterization. Rather than relying on the Section 105(a) "all writs" provision of the Bankruptcy Code, the Fifth Circuit applied state law to recharacterize a claim as an equity security interest by employing Section 502(b)(1) of the Bankruptcy Code—the Bankruptcy Code section which provides for the allowance and disallowance of claims. The Fifth Circuit reasoned that resorting to the general equitable powers of the bankruptcy court was inappropriate because it was unnecessary to do so, since Section 502(b)(1) explicitly grants authority to bankruptcy courts to allow and disallow claims. Thus, the Fifth Circuit's analysis focused on the governing agreement and applicable state law, and not bankruptcy law, when deciding what rights were actually created by the agreement of the parties, despite any descriptive labels used by the parties (i.e., substance over form).

The reasoning employed by the *Lothian* court appears to be sound. Thus, insiders and non-insiders alike in jurisdictions that follow the *Lothian Oil* approach must be concerned with the recharacterization risk with respect to a transaction that at first blush may be set up to create a claim for a debt, but in reality documents a contribution of an equity security interest. Of course, under *Lothian Oil*, the risk to insiders will only exist in states like Texas that do not distinguish between insiders and non-insiders under their laws with regard to recharacterization.

The Seventh Circuit is an outlier with respect to recharacterization, as it has not "definitively stated whether [it] recognize[s] a cause of action for recharacterization. FCC v. Airadigm Commc'ns, Inc. (In re Airadigm Commc'ns, Inc.), 616 F.3d 642, 657 n. 11 (7th Cir. 2010). However, the Seventh Circuit has acknowledged that other circuits that have decided the issue have permitted recharacterization in appropriate circumstances.

One potential result of the differing approaches employed by the circuits is forum shopping. Parties with questionable loans to companies that have a choice of venue may seek to have the borrower/debtor file for bankruptcy relief in a jurisdiction where the authority of a bankruptcy court to order recharacterization is limited or uncertain. Another potential result is that the U.S. Supreme Court will be called upon to address the circuit split.

Recharacterization Factors

In *AutoStyle*, the Sixth Circuit held that a bankruptcy court has the inherent power to recharacterize a claim as an equity interest since bankruptcy courts have judicial authority to use their equitable powers to allow or disallow claims. Using Roth Steel Tube Co, v. Comm'r of Internal Revenue as a guide, the Sixth Circuit developed eleven factors to be considered when determining whether a bankruptcy court should recharacterize a claim as an equity interest. The factors to be considered are as follows:

- The wording used in the instruments evidencing the indebtedness
- The presence of a fixed maturity date and schedule of payments
- The presence of a fixed rate of interest and schedule of interest payments
- The source of repayments (whether they are fixed or tied to the success of the business)
- The adequacy of capitalization
- The identity of interest between the creditor and the stockholder (or holder of a similar ownership interest
- The security for repayment of the loan
- The borrower's ability to obtain financing from outside lending institutions (as opposed to from an Insider or Affiliate, as those terms are defined in *Section 101 of the Bankruptcy Code*
- The extent to which repayment is subordinated by the operative documents to the repayment of debts payable to other creditors of the borrower
- The extent to which an advance was used to acquire capital assets
- The presence of a sinking fund to provide repayments

No one factor controls. The courts, therefore, review the facts of each case pertaining to each of the 11 factors. Generally, a transaction negotiated at arm's length between a willing lender and an unrelated willing borrower will lead a court to defer to the transaction documents, rather than recharacterizing the transaction. See In re SubMicron Sys., 434 F.3d at 455 n.8 (listing various multifactor tests).

Although the Fifth Circuit applied state law to recharacterize and disallow a claim under 502(b)(1) of the Bankruptcy Code in *Lothian Oil*, the court analyzed the agreement in question using an analytical model that was virtually indistinguishable from the 11-factor test used by courts that recharacterize using their general equitable powers. See, e.g., In re Hedged-Invs. Assocs. Inc. 380 F.3d 1292, 1298 (10th Cir. 2004) (citing multiple other cases; citations omitted). Where, as in Texas, applicable state law directs the court to apply the prevailing multifactor test, the results achieved in the Fifth and Ninth Circuits are likely to be substantially similar to the results reached by courts that recharacterize pursuant to Section 105(a) and employ the 11-factor analytical model.

When a loan complies with the formalities for a valid loan agreement and the advanced funds are treated as a loan in the borrower's business records, courts typically are reluctant to recharacterize a loan as an equity contribution, even when the borrower was undercapitalized. In SubMicron Systems, 434 F. 3d at 457, for example, the court concluded that an existing lender's loan to an undercapitalized debtor had been properly characterized as a debt when the lending documents called the advances debt and established a fixed maturity date and fixed interest rate. Although the company was undercapitalized, the court concluded that the loan had been made to the distressed company in an attempt to protect the lender's existing loans.

The court in In re Hedged-Investments Assocs., Inc., 380 F.3d at 1298 declined to recharacterize an advance documented as a loan as equity, noting that the transaction documents fulfilled the proper formalities and that the lender had the right to enforce payment of principal and interest. Furthermore, the lender did not have control of management, and the debtor could have secured funds from other lenders at around the time of the transaction. Although the debtor was thinly capitalized, the loan did not have a fixed maturity date, the payment of interest out of a pooled investment account could have been an indication of an equity contribution, and the compliance with formalities and the parties' evident intent that the transaction was to be a loan showed that the transaction had established a debt.

Likewise, in American Twin LTD. P'ship v. Whitten, 392 F. Supp. 2d 13, 22–23 (D. Mass. 2005), the court concluded that the notes at issue were debt, not equity, emphasizing the compliance with formalities in the issuance of the notes. Although the lender was a minority shareholder, the lender did not control the debtor, and the funds were advanced for operating expenses, which is generally indicative of debt. Furthermore, although the debtor was undercapitalized, its ultimate failure was caused by its poor business model and other similar factors.

Similarly, in Gernsbacher v. Campbell (In re Equip. Equity Holdings, Inc.), 491 B.R. 792, 855–62 (Bankr. N.D. Tex. 2013), the court concluded that although several factors supported recharacterize in the advance of funds as equity, the balance of factors weighed in favor of the conclusion that the formalized notes represented debt. Despite the undercapitalization of the debtor, the tight correlation between equity interests and the values associated with the notes, and the creditor's control of the majority of the stock of the debtor, the court heavily weighed the formal characterization of the notes as debt and the debtor's business records' treatment of the notes as debt. Moreover, the funds were used to reduce senior debt and to provide working capital, which weighed in favor of characterizing the funds as a loan. Finally, although the debtor was undercapitalized, there were other causes for the debtor's ultimate financial failure.

On the other hand, when the transaction lacks formalities, especially when the party advancing funds is an insider, courts are more likely to recharacterize the alleged debt as equity. In In re Dornier Aviation (North America), Inc., 453 F.3d at 234, the Fourth Circuit concluded that an insider transaction that failed to comply with certain formalities of a loan actually constituted an equity contribution. Where the loan lacked a fixed maturity date, the debtor was not required to pay the loan until it became profitable, the debtor had a long history of unprofitability, the debtor's liabilities after restructuring far exceeded its assets, and the purported creditor assumed the debtor's losses, the transaction represented an equity investment rather than debt. Although the purported creditor argued that transfers of inventory cannot constitute an equity investment, the court concluded that adopting such a position would simply incentivize equity investors to structure their capital contributions as sales of inventory.

Even where the transaction is evidenced by a so-called "promissory note," courts may ignore nomenclature when the parties do not conduct their business as lender and borrower. In Miller v. Dow (In re Lexington Oil & Gas Ltd.), 423 B.R. 353, 366 (Bankr. E.D. Okla. 2010), the court recharacterized a claim as an equity interest, despite the execution of a promissory note, because the payment obligation in the documents was solely dependent on the profitability of the borrower. The court stated that in order

for a transaction to give rise to a true claim, there must be a reasonable expectation that the repayment obligation does not solely depend on the success of the borrower's business. Lexington, 423 B.R. at 365. In *Lexington*, the delay of the obligation to pay any principal or interest for two years period under the governing documents was further evidence that the purported lenders actually provided equity. Finally, the undercapitalization of the borrower and the failure of the capital providers (the purported lenders) to take prudent actions to protect their rights as lenders—for example, by providing for payment of accrued interest when the notes were rewritten, was evidence that the purported loan transaction was in reality a transaction that provided for an equity investment.

A decision from the U.S. Bankruptcy Court for the Eastern District of Tennessee Southern Division is instructive. Paris v. SSAB Enters. LLC (In re SIAG Aerisyn, LLC), 2014 Bankr. LEXIS 4586, *5 (Bankr. E.D. Tenn. Nov. 3, 2014). During the 90-day period prior to the SIAG bankruptcy filing, it paid a creditor, SSAB, approximately $2.6 million. After the bankruptcy filing, SIAG sued SSAB to avoid these payments as preferential under *Section 547(b) of the Bankruptcy Code*.

A trustee (including a debtor in possession in a Chapter 11 case) may avoid a transfer as a preference only if the transfer (1) was to or for the benefit of a creditor, (2) was for or on account of an antecedent debt owed by the debtor before the transfer was made, (3) was made while the debtor was insolvent, (4) was made on or within 90 days before the date of the debtor's bankruptcy filing, and (5) enables such creditor to receive more than the creditor would receive if the transfer had not been made and the debtor's bankruptcy was a Chapter 7 case. The only element of plaintiff's case at issue was whether SIAG, as debtor, was insolvent when it paid SSAB during the 90 days prior to the bankruptcy filing. The court never reached the issue of insolvency, as it was called upon first to decide whether the advances SIAG received from one of its affiliates were really a loan (debt) or actually a capital contribution, giving rise to an equity interest, rather than to a claim.

The court never actually answered the insolvency question. This is because it first had to rule on SSAB's motion for partial summary judgment as to whether advance SIAG received from an affiliate was a loan (claim) or a capital contribution (equity interest).

The relevant facts of *SIAG* are as follows: During the two years prior to the bankruptcy filing, SIAG received approximately $11.5 million in advances from an affiliate. In its schedules, SIAG listed a claim owed to its affiliate in the amount of approximately $9.9 million as "advance from parent." As of the petition date, SIAG had repaid approximately $2.4 million to its affiliate. Defendant SSAB argued that Section 547(b) did not apply because SIAG was solvent at the time the debtor made the transfers to SSAB, as the advances from SIAG's affiliate actually were an equity contribution and not a loan. SSAB relied on *AutoStyle* to support its position that the $9.9 million should be recharacterized as an equity investment.

After reviewing the *AutoStyle* factors, the Court concluded that there were genuine issues of material fact as to whether SIAG and its affiliate intended the advances to be a loan or a capital contribution. Upon consideration of the first *AutoStyle* factor, the court found the existence of the note itself was not dispositive on the recharacterization issue. The trustee provided a copy of the note evidencing the parent's advance to the debtor, corporate meeting minutes, and a unanimous written consent signed by the debtor's board of managers. SSAB challenged this evidence, arguing that the failure to create the note prior to the first advances and SIAG's failure to classify the note as a promissory note rather than an advance in its schedules meant that the transaction was an equity investment disguised as a loan. Another fact relied upon by SSAB was the failure of SIAG's affiliate to file a proof of claim. Though the court agreed that several facts raised doubt as to whether the note was truly a "note," the court held that the existence of the note itself established a genuine issue of material fact.

Upon consideration of the second *AutoStyle* factor, the court looked at the promissory note at issue, which was drafted as a demand note. Demand notes typically do not have a fixed maturity date or repayment schedule. An advance without a fixed maturity date and fixed obligation to repay looks a lot more like an equity investment than a loan. The court found that this factor weighed in favor of SSAB's position.

Upon consideration of the third *AutoStyle* factor, the presence of an interest rate and the calculation of interest were enough for the court to decide that this factor weighed against partial summary judgment that the advance was an equity contribution.

Upon consideration of the fourth *AutoStyle* factor, the court determined that as a rule, if repayment is tied to the success of a borrower's business, the transaction looks like an equity investment rather than a loan. SIAG's former vice president and CFO testified that the parties understood that SIAG would make periodic payments to an affiliate only if SIAG generated sufficient cash from operations. The court determined that was inconclusive and, therefore, this factor weighed against partial summary judgment.

Upon consideration of the fifth *AutoStyle* factor, the court considered, among other things, the testimony of the debtor's former vice president and CFO that SIAG was substantially undercapitalized and the advances at issue were necessary to operate the business. There also was evidence that another

affiliate provided SIAG with an initial investment of $5 million and that SIAG's net income was approximately $2.2 million during the first months of its operation. Based on that evidence and evidence of SIAG's solvency presented by SSAB, the court found that genuine issues of material fact existed as to whether SIAG was undercapitalized at the relevant time.

Upon consideration of the sixth *AutoStyle* factor, the court found it unclear whether the affiliate's advances to the debtor were in proportion to its equity interest in SIAG. The more proportionate a stockholder's advance is to the stockholder's ownership interest in a borrower, the more likely an advance was intended to be a capital contribution. On the other hand, a sharply disproportionate ratio between a stockholder's percentage ownership interest and the amount advanced indicates that the advances were intended to be loans. SIAG's operating agreement and other testimony suggested that the affiliate making the advances was not SIAG's owner. The demand note, however, stated that the affiliate, through one of its subsidiaries, owned a 70% equity interest in SIAG.

Upon consideration of the seventh *AutoStyle* factor, the court determined that the demand note indicated that there was no collateral provided by SIAG to secure repayment of the amount of the advances in question. Absence of security for an advance suggested to the court that the advances were in the nature of an equity contribution.

Upon consideration of the eighth *AutoStyle* factor, the court sought to determine whether an unaffiliated reasonable creditor would act in the same manner as the affiliate that made the advances. The evidence suggested SIAG would almost certainly have struggled to obtain financing from an unaffiliated lending source. There was no evidence that SIAG even tried to obtain alternative financing. Despite finding that this factor weighed in favor of recharacterization, the court noted that this factor was not dispositive because it is often the case that struggling companies can only obtain loans from an affiliate.

Upon consideration of the ninth *AutoStyle* factor, the court determined that even though SIAG made two repayments, the parties also understood that SIAG would only make repayments after it paid its vendors. An advance that is last in line behind the claims of all other creditors raises doubt as to whether such advance is a true loan, giving rise to a claim. The court found this factor neutral.

Upon consideration of the 10th *AutoStyle* factor, the court determined that when a borrower uses an advance to pay operating expenses, rather than to acquire capital assets, an advance appears to be more like bona fide debt. In this case, the court found that SIAG needed and used the advance to fund operations expenses. Thus, this factor militated in favor of a finding that the advances were a true debt obligation giving rise to a claim.

Upon consideration of the 11th and final *AutoStyle* factor, the court found that the absence of a sinking fund to secure repayment indicates that an advance was a capital contribution and not a true loan giving rise to a claim. An accountant testified that demand notes usually are not accompanied by a repayment schedule or a sinking fund because demand notes usually are paid with earnings. Thus, this final factor weighed against partial summary judgment, since it was not dispositive one way or the other on the recharacterization issue.

Unsurprisingly, due to the conflicting evidence adduced with regard to the 11 *AutoStyle* factors, the court concluded that there were genuine issues of material fact as to whether the SIAG and its parent intended the advance to be a loan or a capital contribution.

Conclusion

The law regarding recharacterization by bankruptcy courts is fluid. The analysis is fact-intensive and not always consistent. Parties entering into a transaction must be aware of the insolvency risk and document their transactions appropriately to achieve a desired outcome.

The *Lothian Oil* decision is important because variations between state laws could yield different outcomes in recharacterization cases based on underlying state law (i.e., cases litigated in the Fifth and Ninth Circuits). For example, in *Lothian Oil*, although the district court found that it could not recharacterize non-insider debt claims under federal law, the Fifth Circuit reversed because Texas law had no *per se* rule limiting recharacterization to the claims of insiders.

What makes *SIAG* such an interesting case is its clear and focused application and analysis of the evidence in relation to each of the 11 *AutoStyle* factors. The Fifth Circuit decision in *Lothian Oil* is similarly instructive. Thus, these cases can be used for guidance by (1) transactional lawyers when called upon to document a deal; and (2) bankruptcy lawyers, trial lawyers, and the courts when they next face a contest regarding the status of an advance and are asked to answer the question—is it a debt or really a capital contribution?

Although several of the *AutoStyle* factors cannot be altered at the time a transaction is being documented and closed (e.g., the identity of the creditor with the shareholder and the participation of the creditor in management) other factors can indeed be controlled. As a practical matter, and consistent with the lessons of *SIAG* and *Lothian Oil*, a party making an advance intended to be paid back as a loan would be well served to:

- Back up the loan with formal documentation, including a standard promissory note

- Make the loan only on normal business terms by imposing an interest rate and payment terms comparable to those which could be obtained from an unaffiliated lender –and–
- Avoid terms that are red flags for claim recharacterization, such as:
  - A contingency on the obligation to repay
  - Redemption provisions –and–
  - Provisions granting voting power to the note holder

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Ira Herman concentrates his practice on restructuring and bankruptcy matters with emphasis on distressed public debt issues, secured and unsecured loans, cross-border insolvency matters, distressed M&A, and corporate governance.

Restructuring & Bankruptcy
Ira regularly advises his clients, including equity investors and lenders, on the management of bankruptcy risk in their transactions, asset dispositions, inter-creditor issues, and distressed M&A. He also regularly counsels indenture trustees regarding defaulted public debt issue. Additionally, he provides restructuring and bankruptcy advice to financially distressed businesses and their management, including with regard to corporate governance issues.

Mediation & Arbitration
As a court-appointed mediator, Ira has been able to facilitate the resolution of controversies involving U.S. and non-U.S. parties concerning bankruptcy and commercial law issues. He is a skilled listener who is able to solve problems and address the needs of the parties to a dispute by employing his knowledge of the law and creativity.

With all his clients, Ira seeks to be a partner and trusted adviser who works hard to understand a client's business to achieve the best possible outcomes. He strives to be efficient, cost effective, and proactive in discussing the impact of legal trends on their businesses, managing risk, and making the client's job as stress-free as possible.

Ira annually updates "Anticipating and Managing Bankruptcy Risk," a series of articles he has written for the Financial Restructuring & Bankruptcy module of *LexisNexis Practical Guidance*®. He has served for five years on its editorial advisory board and has also served on Law360's Bankruptcy Editorial Advisory Board. In 2022, Ira updated the chapter titled "Bankruptcy" in the treatise *Negotiating and Drafting Commercial Leases* (2022, Full Court Press).

During law school, Ira served as the Articles Editor for the Boston University International Law Journal and while earning his bachelor's degree, he served as editor-in-chief of The Polis, the college political science journal.

Outside the Firm
With an English Setter of their own, Ira and his wife foster and provide hospice care (when necessary) for English Setters, in association with A Better English Setter Rescue. Ira is an avid perennial gardener and has an extensive collection of 19th century bankruptcy court documents, as well as a collection of Holy Land postal history items. He is a New York sports fan and has the dubious distinction of owning the blog *Long-Suffering Jets Fan*. In addition to these interests, he enjoys spending time with his five grandchildren.