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Ninth Circuit Holds That Debt Can Be Recharacterized as Equity

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The US Court of Appeals for the Ninth Circuit recently resolved a split within the circuit when it held that a bankruptcy court has the power to recharacterize debt as equity. In *In re Fitness Holdings International, Inc.*,¹ the Ninth Circuit held that a bankruptcy court has the authority to recharacterize debt for the purposes of determining whether a transfer was fraudulent under section 548 of the Bankruptcy Code² and “that a transaction creates a debt if it creates a ‘right to payment’ under state law.” In reaching its decision in *Fitness Holdings*, the Ninth Circuit joined the five other circuit courts that have reached the same conclusion that bankruptcy courts have the authority to recharacterize claims. Indeed, no circuit court has held to the contrary. These circuits have, however, applied varying legal standards for recharacterization.

In re Fitness Holdings International, Inc.

Background

Between 2003 and 2006, Fitness Holdings (the “Debtor”) executed 11 subordinated promissory notes in favor of Hancock Park, the Debtor’s sole shareholder, in the aggregate amount of \$24,276,065. In July 2004, Pacific Western Bank made a \$7 million revolving loan and a \$5 million term loan to the Debtor, which were secured by all of the Debtor’s assets and guaranteed by the shareholder. Over the next three years, the parties amended the secured loans on numerous occasions.

Finally, in 2007, as part of a debt restructuring the secured lender made an \$8 million revolving loan and a \$17 million term loan, which were also secured by all of the Debtor’s assets. The refinanced loans were used to pay off the secured loans (thus releasing the shareholder from its guarantee), and to partially pay down the shareholder’s subordinated notes. Ultimately these restructuring efforts were insufficient, and a little over a year later, the Debtor filed for relief under Chapter 11 of the Bankruptcy Code.

In the Chapter 11 case, the official committee of unsecured creditors (the “Committee”), acting on behalf of the Debtor and the estate, commenced an adversary proceeding against the secured lender, two members of the Debtor’s board of directors and the shareholder seeking to avoid the prepetition repayments that were made to the shareholder in connection with the refinancing. The Committee’s complaint also sought to recharacterize the financing provided by the shareholder through the subordinated notes as equity contributions to the Debtor, rather than loans. Accordingly, the Committee argued, the transfer of funds to the shareholder as part of the refinancing constituted a constructively fraudulent transfer because such funds were a return of equity and not a repayment of debt.

The bankruptcy court dismissed all claims against the shareholder and converted the case to Chapter 7. The Chapter 7 trustee replaced the Committee in the litigation and appealed from the bankruptcy court’s dismissal. The district court affirmed, holding that it was bound to follow the decision of the Ninth Circuit Bankruptcy Appellate Panel in *In re Pacific Express, Inc.*,³ and accordingly, the Chapter 7 trustee was barred from bringing a recharacterization action. Therefore the shareholder’s advances to the Debtor were debt and their repayment could not be a constructive fraudulent transfer. The Chapter 7 trustee subsequently appealed to the circuit court.

¹ 2013 WL 1800000 (9th Cir. Apr. 30, 2013).

² All section references are to the Bankruptcy Code.

³ 69 B.R. 112 (B.A.P. 9th Cir. 1986).

The Ninth Circuit's Decision

In analyzing the Chapter 7 trustee's constructive fraud claim, the *Fitness Holdings* decision addressed two related issues: (1) whether the Debtor "received less than a reasonably equivalent value in exchange for such transfer or obligation," and (2) whether the court had the authority to recharacterize the Debtor's obligation to the shareholder.

With respect to the first issue, the Ninth Circuit noted that "to the extent a transfer constitutes repayment of the debtor's antecedent or present debt, the transfer is not constructively fraudulent." The court found that the definitions of the terms "debt" and "claim" in the Bankruptcy Code are co-extensive and that a claim is broadly defined in the Bankruptcy Code as any "right to payment." "[T]o the extent a transfer is made in satisfaction of a 'claim' (i.e., 'a right to payment'), that transfer is made for 'reasonably equivalent value' for the purposes of [the constructive fraudulent transfer provision of section] 548(a)(1)(B)(i)." Accordingly, a determination that the shareholder held a claim would preclude a finding that a transfer, such as the repayment at issue in *Fitness Holdings*, was constructively fraudulent under section 548(a)(1)(B).

Turning to the second issue, the Ninth Circuit held that under Supreme Court precedent, it was not free to create a federal standard for the recharacterization of debt as equity and held that "the court must determine whether the purported 'debt' constituted a right to payment under state law." When applying such standard, "a court may recharacterize an obligation that does not constitute 'debt' under state law" as an equity contribution. In so holding, the Ninth Circuit resolved an intra-circuit split⁴ and overruled *Pacific Express*, which held that bankruptcy courts were limited to the statutory remedy of equitable subordination under section 510.⁵ Since the district court erroneously thought itself bound by *Pacific Express*, the Ninth Circuit vacated the district court's decision and remanded with instructions to apply the standard set forth in its decision.

Recharacterization Standards Applied Outside of the Ninth Circuit

Insofar as its holding concluded that recharacterization by a bankruptcy court is permissible, the Ninth Circuit reached the same conclusion as every other circuit that has ruled on the issue. The circuits, however, have adopted varying legal standards for determining whether the recharacterization is appropriate in a particular case.

For example, like the Ninth Circuit, the Fifth Circuit adopted an approach that permits a court to recharacterize debt as equity if state law would do the same.⁶ Alternatively, the Fourth, Sixth and Tenth Circuits have adopted multifactor tests that were derived from federal tax law.⁷ Finally, the Third Circuit has adopted a case-by-case approach, which governs cases in the Delaware bankruptcy court, that requires that the court determine the intent of the parties at the time the transfers were made.⁸

Although the Second Circuit has yet to issue a decision regarding the permissibility of and the applicable standard for recharacterizing debt as equity, numerous New York bankruptcy courts have ruled on the issue and followed the Sixth Circuit's 11-factor test set forth in *In re Autostyle Plastics, Inc.*⁹ when analyzing whether to recharacterize debt as equity.¹⁰

⁴ Compare *In re Daewoo Motor Am., Inc.*, 471 B.R. 721, 730 (C.D. Cal. 2012) (allowing recharacterization) with *In re Pac. Express*, 69 B.R. 112, 115 (B.A.P. 9th Cir. 1986) (holding that recharacterization is not permitted in bankruptcy cases).

⁵ *Id.* at 115. Unlike equitable subordination, which requires some inequitable conduct by the claimant whose claim is sought to be subordinated, the recharacterization of debt as equity, according to the Ninth Circuit, will depend solely on whether the claimant has a right to payment under state law.

⁶ See, e.g., *Fitness Holdings*, 2013 WL 1800000, at *1 (adopting a state law approach); *In re Lothian Oil, Inc.*, 650 F.3d 539, 543-44 (5th Cir. 2011) (same).

⁷ See, e.g., *In re Submicron Sys.*, 432 F.3d 448, 454 (3d Cir. 2006) (adopting a case-by-case approach).

⁸ See, e.g., *In re Dornier Aviation*, 453 F.3d 225, 231 (4th Cir. 2006) (adopting a 13-factor test); *In re Hedged-Invs. Assocs., Inc.*, 380 F.3d 1292, 1298 (10th Cir. 2004) (adopting an 11-factor test); *In re Autostyle Plastics, Inc.*, 269 F.3d 726, 748 (6th Cir. 2001) (same).

⁹ 269 F.3d 726, 748 (6th Cir. 2001).

¹⁰ See, e.g., *In re BH@S Holdings, LLC*, 420 B.R. 112, 157 (Bankr. S.D.N.Y. 2009); *In re Gen. Motors Corp.*, 407 B.R. 463, 498-99 (Bankr. S.D.N.Y. 2009); *In re Adelpia Comm'n Corp.*, 365 B.R. 24, 73-74 (Bankr. S.D.N.Y. 2009).

Implications of *Fitness Holdings*

Fitness Holdings is significant in that it eliminates any doubt that a bankruptcy court in the Ninth Circuit may recharacterize debt as equity. In so holding, the Ninth Circuit has joined its sister circuits in reaching such a conclusion. There remains, however, a lack of consensus among the circuits as to the standard to be applied by a bankruptcy court in determining whether or not to recharacterize debt

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