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"Recharacterizing Debt: How the Third Circuit's Recent Decision in SubMicron Systems Alters the Playing Field," The Bankruptcy Strategist, March-April 2006

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Consider the following scenario. A manufacturing company is experiencing significant financial and operational difficulties. A lender provides it with $20 million secured by a second priority lien and, in connection with this financing, is given two seats on the manufacturer's board of directors. For the next 3 years, the manufacturer continues to suffer losses and the lender continues to extend additional financing. By the third year, the lender has selected three of the company's four board members. At this point, the manufacturer is insolvent, undercapitalized and no disinterested third party will lend it additional money. Nevertheless, the lender extends new financing. No notes are issued for portions of this financing, and the lender does not obtain a valuation to determine whether the manufacturer has collateral to support the new financing. Then the lender, not management, negotiates a sale of the company to occur in the context of a prenegotiated bankruptcy, with the lender to acquire more than 30% of the stock in the newly formed buyer. The manufacturer files a bankruptcy petition and immediately moves for approval of the sale. The buyer credit bids the lender's claim at the section 363(b) sale, and acquires the company's assets over the objection of the creditors' committee. Should the lender's third-year advances – made while the company was insolvent and undercapitalized and at a time when no disinterested third parry would lend money – be recharacterized as equity? After examining all of the facts and circumstances, the Third Circuit answered no.