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Recharacterizing Debt

How the Third Circuit's Recent Decision in SubMicron Systems Alters the Playing Field

Part One of a Two-Part Article

By Paul Rubin and John M. August

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 pre-negotiated 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. *In re SubMicron Systems Corporation, et al.*, 432 F. 3d 448 (3d Cir. 2006).

Since there are few federal appellate level decisions discussing recharacterization of debt to equity in the bankruptcy context, this decision deserves careful consideration.

UNDERSTANDING RECHARACTERIZATION

Distinguishing Recharacterization From Equitable Subordination

Both recharacterization and equitable subordination are grounded in 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." 432 F.3d at 454 (quoting *Pepper v. Litton*, 308 U.S. 295, 305 (1939)). Yet recharacterization and equitable subordination address distinct concerns. Equitable subordination applies when equity demands that the payment priority of claims of an otherwise legitimate creditor be changed to fall behind those of other claimants. In contrast, recharacterization focuses on whether a debt actually exists or, put another way, what is the proper characterization of an advance in the first instance. The Third Circuit explained that the phrase "recharacterization" is actually misleading. The debt-versus-equity inquiry is not an exercise in recharacterizing a claim, bur of *characterizing* the true character of an advance, *ie*, did the transaction create a debt or equity relationship from the outset?

Although the *effect* of recharacterization and equitable subordination may be similar in that in both cases a claim is subordinated to that of other creditors, each serves a different *function*, and the *extent* to which a claim is subordinated under each process may be different. *See In re Autostyle Plastics, Inc.*, 269 F.3d 726, 748 (6th Cir. 2001) (recognizing recharacterization as a distinct claim); *In re AtlanticRancher, Inc.*, 279 B.R 411, 433 (Bankr. D. Mass. 2002) (same); *In re Hyperion Enters. Inc.*, 158 B.R 555, 560 (D.Rl. 1993) (same). As the Sixth Circuit explained:

"Recharacterization cases turn on whether a debt actually exists, not on whether the claim should be equitably subordinated. In a recharacterization analysis, if the court determines that the advance of money is equity and not debt, the claim is recharacterized and the *effect* is subordination of the claim as a proprietary interest because the corporation repays capital contributions only after satisfying all other obligations of the corporation. In an equitable subordination analysis, the court is reviewing whether a legitimate creditor engaged in inequitable conduct, in which case the remedy is subordination of the creditor's claim to that of another creditor *only to the extent necessary* to offset injury or damage suffered by the creditor in whose favor the equitable doctrine may be effective." *In re Autostyle Plastics, Inc.*, 269 F.3d at 748-49 (emphasis in original) (internal quotations and citations omitted).

That recharacterization and equitable subordination of claims often have the same effect has led some courts to conclude that bankruptcy courts lack the power to recharacterize claims. *See In re Pacific Express, Inc.*, 69 B.R 112, 115 (BAP. 9th Cir. 1986); *In re Pinetree Ptrs, Ltd*, 87 B.R. 481, 491 (Bankr. N.D. Ohio 1988) (following *Pacific Express*). These courts conclude that the actual result achieved by recharacterization, *ie*, subordination, is governed by 11 U.S,C. § 510(c). "Where there is a specific provision governing these determinations, it is inconsistent with the interpretation of the Bankruptcy Code to allow such determinations to be made under different standards through the use of the court's equitable powers." *In re Pacific Express, Inc.*, 69 B.R at

115. On the other hand, many argue that, because recharacterization determines whether an advance is debt or equity in the first instance, there is no reordering of priorities as there is in an equitable sub-ordination analysis. *In re Outboard Marine Corp.*, 2003 WL 21697357, at *4 (N.D. Ill. July 22, 2003) (finding that recharacterization does not reorder priorities or distributions). Accordingly, recharacterization would not nun afoul of the principle that bankruptcy courts may not use 11 U.S.C. § 105(a) to override the priority and distribution rules set forth in the Bankruptcy Code. *Cf., In re Kmart Corp.*, 359 F.3d 866, 871 (7th Cir. 2004) (upholding reversal of bankruptcy court order that effectively caused deviation from the Code's rules of priority and distribution). In *SubMicron*, the Third Circuit stated that "we agree with those courts that have determined that the issues of recharacterization of debt as equity capital and equitable subordination should be treated separately." *SubMicron*, 432 F.3d at 454 (citing *In re Aulostyle Plastics, Inc.*, *In re Hyperion Enters. Inc.*, and *In re AtlanticRancher*) (internal quotations and citations omitted).

Because recharacterization determines whether an advance is a loan or an equity contribution in the first instance, recharacterization issues should be addressed before equitable subordination issues. If a particular advance is a capital contribution, equitable subordination never comes into play. *SubMicron*, 432 F.3d at 455. "Determining an equitable subordination issue prior to determining whether an advance is a loan or an equity investment is similar to taking the cart before the horse." *Id*. (internal quotations and citations omitted).

The Framework of Recharacterization

The Third Circuit noted that, in making the recharacterization inquiry, courts have adopted a variety of multi-factored tests borrowed from non-bankruptcy case law. In *Roth Steel Tube Co. v. Comm'r*, 800 F.2d 625 (6th Cir. 1986), the Sixth Circuit Court of Appeals identified 11 factors used in the context of assessing income tax liability to determine whether an investment was debt or equity. *Id*. at 630. *In re Autostyle Plastics* extended the use of those factors to the bankruptcy recharacterization context. 269 F.3d at 749-50. They are: 1) the names given to the instruments, if any, evidencing the indebtedness; 2) the presence or absence of a fixed maturity date and schedule of payments; 3) the presence or absence of a fixed rate of interest and interest payments; 4) the source of repayments; 5) the adequacy or inadequacy of capitalization; 6) the identity of interest between the creditor and the stockholder; 7) the security, if any, for the advances; 8) the corporation's ability to obtain financing from outside lending institutions; 9) the extent to which the advances were subordinated to the claims of outside creditors; 10) the extent to which the advances were used to acquire capital assets; and 11) the presence or absence of a sinking fund to provide repayments. *Roth Steel Tube Co.*, 800 F.2d at 630.

The Eleventh and Fifth Circuit Courts of Appeal have employed a 13-factor recharacterization test in the tax context. These are: 1) the names given to the certificates evidencing the indebtedness; 2) the presence or absence of a fixed maturity date; 3) the source of payments; 4) the right to enforce payment of principal and interest;

5) participation in management flowing as a result; 6) the status of the contribution in relation to regular corporate creditors; 7) the intent of the parties; 8) "thin" or adequate capitalization; 9) identity of interest between creditor and stockholder; 10) source of interest payments; 11) the ability of the corporation to obtain loans from outside lending institutions; 12) the extent to which the advance was used to acquire capital assets; and 13) the failure of the debtor to repay on the due date or to seek a postponement. *Stinnett's Pontiac Serv., Inc. v. Comm'r*, 730 F.2d 634, 638 (11th Cir. 1984) (citing *Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972)).

The court in *In re Hillsborough Holdings Corp.*, 176 B.R. 223, 248 (M.D. Fla. 1994), applied these factors to recharacterization in the bankruptcy context. [The Eleventh Circuit employs a different standard when considering whether shareholder loans should be recharacterized as equity. "Shareholder loans may be deemed capital contributions in one of two circumstances: where the trustee proves initial under-capitalization or where the trustee proves that the loans were made when no other disinterested lender would have extended credit." *In re N&D Properties, Inc.*, 799 F.2d 726, 733 (11th Cir. 1986); *Diasonics, Inc. v. Ingalls*, 121 B.R. 626, 631 (Bankr. N.D. Fla. 1990) (finding the *N&D Properties* standard is the appropriate standard in the Eleventh Circuit).]

A third set of factors has been used by bankruptcy courts in the First and Seventh Circuits, as follows: 1) the adequacy of capital contributions; 2) the ratio of shareholder loans to cap-ital; 3) the amount or degree of shareholder control; 4) the availability of similar loans from outside lenders; and 5) certain relevant questions, such as: a) whether the ultimate financial failure was caused by under-capitalization; b) whether the note included payment provisions and a fixed maturity date; c) whether a note or other debt document was executed; d) whether advances were used to acquire capital assets; and e) how the debt was treated in the business records. *In re Hyperion Enters.*, 158 B.R. at 561. *See also In re AtlanticRancher*, 279 B.R at 433 (listing same factors); *In re Kids Creek Ptrs.,. L.P.*, 212 B.R. 898, 931 (Bankr. N.D. Ill. 1997) (listing same factors).

In re Cold Harbor Assocs., L.P, 204 B.R. 904, 916 (Bankr. E.D. Va. 1997), identified three themes that run through the foregoing multi-factor tests. These are: 1) the formality of the alleged loan agreement; 2) the financial situation of the corporation at the time the purported loan is made; and 3) the relationship between the equity holders and the lender.

The district court in *SubMicron* applied a seven-factor test from *Official Comm. of Unsecured Creditors of Color Tile, Inc. v. Blackstone Family Inv. P'ship. (In re Color Tile)*, No. Civ. A 98-358-SLR, 2000 WL 152129 (D. Del. Feb. 9, 2000) (Robinson, J.). Those factors are: 1) the name given to the instrument; 2) the intent of the parties; 3) the presence or absence of a fixed maturity date; 4) the right to enforce the payment of principal and interest; 5) the presence or absence of voting rights; 6) the status of the contribution in relation to regular corporate contributors; and 7) certainty of payment in the event of the corporation's insolvency or liquidation. *SubMicron Systems Corp.*, 291 B.R. 314, 323 (D. Del. 2003).

On appeal, the Third Circuit eschewed the adoption of any particular multi-factor test in favor of a fact-intensive inquiry into the intent of the parties. "While these tests undoubtedly include pertinent factors, they devolve to an overarching inquiry: [T]he characterization 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. That intent may be inferred from what the parties say in their contracts, from what they do through their actions, and from the economic reality of the surrounding circumstances. Answers lie in facts that confer context case-by-case." *SubMicron*, 432 F.3d at 455-56.

According to the Third Circuit, in the search for intent, "no mechanistic scorecard suffices. And none should, for Kabuki outcomes elude difficult fact patterns." *Id*. at 456. Rather, the characterization of an advance "is typically a common sense conclusion that the party infusing funds does so as a banker (the party expects to be repaid with interest no matter the borrower's fortunes; therefore, the funds are debt) or as an investor (the funds infused re repaid based on the borrower's fortunes; hence they are equity)." *Id*. This common-sense approach is in accord with the Third Circuit's recent important opinion on substantive consolidation in which it also refused to adopt any specific list of factors. *In re Owens Corning*, 419 F.3d 195, 210 (3d Cir. 2005). Though the Third Circuit did not say so, the following quote from *Owens Corning* could just as well appear in the *SubMicron* decision: "Too often, the factors in a check list fail to separate the unimportant from the important, or even to set out a standard to make the attempt. This often results in rote following of a form containing factors where courts tally up and spit out a score without an eye on the principles that give the rationale for [the decision]…" *Id*. Similarly, the recharacterization analysis involves a fact-intensive search for the intent of the parties in which no one factor or group of factors is always determinative.

IS RECHARACTERIZATION A QUESTION OF FACT OR OF LAW?

The standard of review on recharacterization in the bankruptcy context was a question of first impression at the federal appellate level. The Third Circuit noted that, in the tax context, the Courts of Appeal are split, with the Sixth and Ninth Circuits concluding that recharacterization is an issue of fact to be reviewed for clear error, and the Fifth and *de novo* review. *SubMicron*, 432 F.3d at 456.

Because the Third Circuit framed the determinative inquiry as the intent of the parties at the time of the transaction, it held that recharacterization is a question of fact that, once determined by a district court, cannot be overturned unless clearly erroneous. Concluding that recharacterization is a question of fact is very significant, because it is quite difficult to prove on appeal that a trial court's factual findings are clearly erroneous. Indeed, some circuit courts of appeal have stated that to be clearly erroneous, "a decision must strike the court as more than just maybe or probably wrong; it must ... strike [the court] as wrong with the force of a five-week-old, unrefrigerated dead fish." *See, eg, In re Papio Keno Club, Inc.*, 262 F. 3d 725, 729 (8th Cir. 2001); *U.S. v. Searan*, 259 F.3d 434, 447 (6th Cir. 2001); *Ocean Garden, Inc. v. Marktrade Co., Inc.*, 953 F.2d 500, 502 (9th Cir. 1991); *Parts and Electric Motors, Inc. v. Sterling Electric, Inc.*, 866 F.2d 228,

233 (7th Cir. 1988); *In re Uni-Rty Corp.*, 1998 WI. 299941, at *2 (S.D.NY June 9, 1998), *aff'd.*, 175 F.3d 1008 (2d Cir. 1999).

Part Two of this Article, which will appear in next month's issue, discusses in more detail the *SubMicron* case and the implications of the Third Circuit's decision.

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Part Two of a Two-Part Article

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The first half of this article, which appeared in last month's issue, discussed the purpose and effect of recharacterization of debt to equity, distinguished recharacterization from equitable subordination, and reviewed various approaches, including multi-factor tests, that different courts have employed in determining whether to recharacterize a claim in bankruptcy and non-bankruptcy con-texts. This concluding installment explores further the Third Circuit Court of Appeals' decision in *In re SubMicron Systems Corporation, et al.*, 432 F3d 448 (3d Cir. 2006) and discusses lessons learned from that case.

THE SUBMICRON CASE

SubMicron Systems Corporation and related entities (collectively "SubMicron") designed, manufactured and marketed automatic process tools used for cleaning and etching operations in semiconductor processing. By 1997, the company was experiencing significant financial and operational difficulties. Toward the end of 1997, SubMicron entered into a $15 million working capital facility pursuant to which it granted a secured lender first-priority liens on all of its inventory, equipment, receivables and general intangibles. The next day SubMicron raised another $20 million through the issuance of senior subordinated notes (the 1997 Notes) to KB/Equinox and Celerity (collectively, the Lenders) secured by liens on substantially all of SubMicron's assets subordinate only to the first lien lender. Despite this funding, SubMicron incurred a net loss of $47.6 million in fiscal year 1997.

The company had another difficult year in 1998. In late 1998, SubMicron restructured its debt with its first lien lender, and obtained $4 million in additional financing from the Lenders by issuing new notes (the 1998 Notes). Nevertheless, SubMicron incurred a net loss of $21.9 million for fiscal year 1998, and at year's end, its liabilities exceeded its assets by $4.2 million.

SubMicron's troubles persisted in 1999. Between March and June 1999, SubMicron issued several new notes to the Lenders to raise additional funds required to meet SubMicron's working capital needs (the 1999 Tranche One Notes). There was no question that SubMicron would not have been able to make payroll and would have been forced to cease operations if these loans had not been made. Despite these cash infusions, SubMicron incurred a net loss of $9.9 million during the first half of 1999. On June 30, 1999, the company's liabilities exceeded its assets by $3.1 million dollars. The company needed still more money to remain afloat. Accordingly, in July and August of 1999 the Lenders made payments to SubMicron of more than $4 million (the 1999 Tranche Two Funding). No notes were issued for the 1999 Tranche Two Funding (the 1999 Tranche One Notes and 1999 Tranche Two Funding are collectively referred to as the ''1999 Fundings"). The 1999 Fundings were recorded as secured debt on SubMicron's 10-Q filing with the Securities and Exchange Commission.

By June 1999, following certain resignations, employees of the Lenders represented three-quarters of SubMicron's board. SubMicron's CEO was the only board member not employed by any of the Lenders.

SOME HISTORY

Since at least 1997, SubMicron had been actively searching for a buyer or merger partner for the company. It was generally understood by 1999 that if SubMicron failed to reach a deal, it would be forced to liquidate, leaving secured creditors other than the first lien lender with "pennies on the dollar" and nothing for unsecured creditors or shareholders. In July 1999, the Lenders – not SubMicron's management – negotiated the structure of an acquisition with Sunrise Capital Partners, LP to occur in the context of a pre-negotiated bankruptcy. On Aug. 31, 1999, SubMicron entered into an asset purchase agreement with Akrion LLC, an entity created by Sunrise to function as the acquiring entity. The next day, SubMicron filed a Chapter 11 petition and a motion seeking approval of the sale of its assets to Akrion pursuant to section 363(b) of the Bankruptcy Code.

The asset purchase agreement provided that the Lenders would contribute the 1997 Notes, 1998 Notes and 1999 Fundings to Akrion so it could credit bid those claims under Code section 363(k). In return, the Lenders were to receive a 31.475% interest in Akrion. The court and the creditors' committee were fully apprised of the terms of the agreement before the sale. At the sale hearing, Akrion submitted a bid of over $55 million for SubMicron. The credit portion of the bid consisted of approximately $38.7 million outstanding under the 1997 Notes, the 1998 Notes and the 1999 Fundings. No other bid for SubMicron's assets was made, and the court approved Akrion's bid over the objection of the creditors' committee. On Oct. 15, 1999, the asset sale closed.

In April 2000, the creditors' committee brought an adversary proceeding against the Lenders seeking, *inter alia*, to recharacterize the 1999 Fundings as equity investments. In April 2001, pursuant to the debtors' liquidating plan, the plan administrator was substituted for the creditors' committee as plaintiff. Following a bench trial, the district court ruled against the plaintiff, who appealed.

THE THIRD CIRCUIT'S ANALYSIS

The Third Circuit reviewed the district court's opinion and found it included ample findings of fact to support the refusal to recharacterize the 1999 Fundings as equity. Indeed, the Third Circuit held that the district court's findings overwhelmingly supported the decision to characterize the 1999 Fundings as debt "under any framework or test." *SubMicron*, 432 F.3d at 457. Because these findings were not clearly erroneous, the Third Circuit affirmed the district court's ruling.

The district court had identified numerous facts to support its characterization of the 1999 Fundings as debt. For example, the notes issued for the March to June 1999 fundings denominated these fundings as debt. The 1999 Fundings had a fixed maturity date and interest rate. There was also evidence, aside from the loan documents themselves, of the parties' intent to create a debt. The 1999 Fundings were listed as secured debt in SubMicron's 10-Q SEC filing, and security for the advances was identified on UCC-1 financing statements.

There was not, on the other hand, convincing evidence to support characterizing the 1999 Fundings as an equity investment. Notably, the district court rejected the plaintiff's argument that the dire financial circumstances surrounding the infusion of the 1999 Fundings supported an equity characterization in this case. When a corporation is undercapitalized, a court is more skeptical of purported loans made to it because they may in reality be infusions of capital. Most significantly, however, the Third Circuit observed that "when existing lenders make loans to a distressed company, they are trying to protect their existing loans and traditional factors that lenders consider (such as capitalization, solvency, collateral, ability to pay cash interest and debt capacity ratios) do not apply as they would when lending to a financially healthy company." *SubMicron*, 432 F.3d at 457. Weighing the competing considerations, the Third Circuit agreed with the district court's finding that SubMicron's undercapitalization did not support an equity characterization.

Moreover, the district court found that the Lenders' participation on the SubMicron board did not, in and of itself, provide support for an equity characterization. Relying on expert testimony, the district court emphasized that it is "not unusual for lenders to hane designees on a company's board, particularly when the company [is] a distressed one." *Id*. at 457-58 (quoting district court opinion). The Third Circuit held that the district court's conclusion that the plaintiff did not prove that the Lenders or their designees controlled or dominated SubMicron's board was not clearly erroneous. Finally, the Third Circuit agreed with the district court that SubMicron's failure to issue notes for the 1999 Tranche Two Funding should not be construed as evidence of the parties' understanding that the fundings were in effect equity investments. SubMicron's accounting department made numerous mistakes and errors when generating notes, so the fact that notes were generated for some fundings and not others was not sufficient, in and of itself, to recharacterize the 1999 Fundings as equity.

Thus, the Third Circuit concluded, the district court found ample evidence to support a debt characterization and little evidence to support characterizing the 1999 Fundings as equity infusions. Accordingly, it was not clear error for the district court to conclude that the plaintiff had not proven by a preponderance of the evidence that the 1999 Fundings should be recharacterized as equity. *Id*. at 4S8.

LESSONS FROM THE THIRD CIRCUIT'S DECISION

The Third Circuit's opinion implicitly overrules cases such as *In re Zenith Electronics Corp.*, 241 B.R. 92, 107 (Bankr. D. Del. 1999), which blurred the distinction between recharacterization and equitable subordination and held that to recharacterize debt as equity the creditor must have engaged in inequitable conduct.

The Third Circuit's decision requiring a fact-intensive inquiry into the intent of the parties should provide comfort to lenders that bona-fide loans to distressed companies will not be recharacterized as equity contributions. A bona-fide lender infuses funds with the expectation of receiving repayment without regard to the borrower's perfonnance (*ie*, even if the borrower is liquidated), while an investor's expectation of repayment is contingent upon the borrower's fortunes.

Perhaps the most significant aspect of the decision is the Third Circuit's recognition that an existing lender may extend a loan to a distressed company with the intent of seeking to protect its existing loan position, and traditional and ordinary loan underwriting standards (such as capitalization, solvency, collateral, ability to pay cash interest and debt capacity ratios) do not apply as they would when lending to a financially-healthy company. The existing lender's due diligence standards are relaxed, and it will often make loans that a disinterested lender would not be willing to make. The Third Circuit's common-sense approach to recharacterization recognizes this distinction and pro-tects lenders who make such loans to protect their existing positions.

The Third Circuit's opinion provides protections to encourage lenders to continue to lend to distressed companies in an effort to avert a liquidation and the undesirable accompanying events. Here, the district court did find some facts that weighed in favor of recharacterizing the 1999 Fundings as equity. In 1999, SubMicron was insolvent and undercapitalized and no disinterested lenders would have loaned the company money. *SubMicron*, 291 B.R. at 319. Additionally, no sinking fund was established, and there was inadequate collateral to support the 1999 Fundings. *SubMicron*, 291 B.R. at 326. Nonetheless, the 1999 Fundings were not recharacterized. The impact of characterizing the advance as an infusion of equity was not lost on the district court. It stated that, "any other analysis would discourage loans from insiders to companies facing financial difficulty and that would be unfortunate because it is the shareholders who are most likely to have the motivation to salvage a floundering company." *Id*. at 325.

Also noteworthy is the Third Circuit's holding that the plaintiff did not prove that the Lenders controlled or dominated SubMicron's board. What evidence might a plaintiff adduce to prove that a lender con-trolled or dominated the board of its borrower? We

think it would likely need to demonstrate that the lender had interfered with or exerted control over the borrower's operations or important business decisions (such as hiring and firing employees or deciding which vendors would be paid).

Finally, while the Third Circuit's opinion could properly be construed as "lender sympathetic," the conclusion that recharacterization is a question of fact may be somewhat costly to lenders. Assuming a complaint survives a motion to dismiss, lenders might not be able to win summary judgment dismissing recharacterization claims if there exist sufficient genuine issues of material fact requiring an evidentiary hearing. Trustees, creditors committees and other plaintiffs may use the threat of trial as leverage to extract larger settlements.