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You Said You Were Going to Do What to My Loan? The Inequitable Doctrine of Recharacterization

Hilary A. Goehausen*

I. Introduction

A new development in bankruptcy law has potential lenders and financially troubled companies on edge. Bankruptcy courts are conflicted, practitioners are concerned, and potential lenders may be hitting the brakes.1 Perceived as menacing by bankruptcy practitioners, but a “tool de jour” among bankruptcy trustees, a recent judicially created device known as recharacterization may turn the commercial lending and bankruptcy worlds on their head.2 Regarded as an “equitable” remedy, recharacterization is a process by which bankruptcy courts convert a purported loan, or an advance of money that the parties have characterized as debt, into an equity contribution.3 When a court determines that a loan is actually a capital contribution, it then subordinates this “equity investment” behind all other debts and obligations of the debtor-corporation.4 In bankruptcy, an equity holder will be the last to be repaid from the bankruptcy estate and realistically has little, if any, prospect of being repaid.5

Debt-to-equity recharacterization has quickly become a fundamental weapon in the arsenal of creditors and trustees when perusing avenues through which to subordinate the claims of lenders in corporate bankruptcy proceedings.6 The device has been most commonly employed as a cause of action against corporate insiders and fiduciaries,

* The author would like to thank David Eaton of Kirkland & Ellis in Chicago for introducing her to the problem of debt to equity recharacterization.

2. Sprayregen, supra note 1, at 31.
5. Brighton, supra, note 1, at 67.
such as managers, directors, or shareholders of a corporation, who advance funds to a financially struggling corporation when no other sources of outside, arm's-length financing are available. In bankruptcy, a trustee of the bankruptcy estate or creditors committee asserts that the insider-lender's advances are, in actuality, disguised capital contributions and should be subordinated as such.

The utilization of recharacterization in bankruptcy proceedings is spawning fiery debates among bankruptcy practitioners, overreaching by bankruptcy courts, and unpredictability in lending relationships. Despite its label as "equitable," recharacterization fails to produce an outcome in accordance with the broad equitable mandate of bankruptcy courts. Moreover, recharacterization is not an authorized use of bankruptcy courts' equitable powers. The result achieved by converting debt into capital is neither fair nor just to good-faith corporate creditors who intended their funding to be a bona fide loan transaction. Most importantly, the Bankruptcy Code does not explicitly or implicitly authorize bankruptcy courts to recharacterize debt.

This Comment examines whether recharacterization is, fundamentally, an "equitable" remedy authorized by the Bankruptcy Code and within the scope of bankruptcy courts' equitable mandate. Part II examines the origins of recharacterization as a distinct legal theory and equitable remedy in bankruptcy proceedings. Part III analyzes whether bankruptcy courts' equitable powers under the Code encompass the authority to convert debt as equity. Further, this section evaluates whether the outcome achieved by recharacterization provides "equitable" results for the parties in interest. Part IV discusses the impact of recharacterization and the ramifications of allowing bankruptcy courts to recast a debt transaction as an equity contribution.

II. BACKGROUND

There is no provision in the Bankruptcy Code that explicitly or implicitly empowers bankruptcy courts with the authority to recharacter-

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8. Id. at 706.
9. Sprayregen, supra note 1, at 31; see also Brighton, supra note 1, at 66.
10. Throughout this comment "capital contribution" and "equity investment" will be used interchangeably.
ize a debt as an equity contribution. Nonetheless, a majority of bankruptcy courts across the country assert that their power as courts of equity enable them to hear claims for recharacterization. Specifically, bankruptcy courts rely on §105 of the Bankruptcy Code, which grants bankruptcy courts the equitable power to look past the form of a transaction in order to give effect to its substance. This section defines recharacterization and discusses how bankruptcy trustees, creditors, and judges have come to employ the device in bankruptcy proceedings. Furthermore, this section examines the traditional role of bankruptcy courts as courts of equity and contrasts recharacterization with the traditional equitable remedy of equitable subordination. Finally, this section examines how recharacterization is commonly utilized to subordinate the debt claims of corporate insiders and fiduciaries.

A. What is Recharacterization?

Recharacterization of debt as equity is the result of a bankruptcy court’s determination that an advance of money was intended to be an infusion of equity into a corporation and not a loan. In analyzing a claim for recharacterization, bankruptcy courts aim to provide an “equitable” remedy whereby capital contributions allegedly camouflaged as debt are recognized for their true substance and properly subordinated as a proprietary interest in a corporation. Thus, bankruptcy courts’ analysis is said to focus on whether a legitimate debt actually exists in the first place. When a claim is recharacterized as an equity investment, the funds advanced are no longer considered to be a debt that must be repaid in bankruptcy. A debt that is recharacterized as a capital contribution is subsequently subordinated behind all other claims because holders of equity are the last to be repaid from the bankruptcy estate.

12. Id. at 1.
13. See Brighton, supra note 1, 18 (stating “it is settled, for now at least, that bankruptcy courts do have the authority to hear recharacterization cases”).
16. Id. at *5.
17. Brighton supra note 1, at 66.
18. 43 BCD News and Comment 14 (September 21, 2004).
because the estate normally does not have sufficient property to satisfy unsecured creditors' claims.20

B. The Equitable Mandate of Bankruptcy Courts

Bankruptcy courts are traditionally considered courts of equity, and their proceedings are inherently deemed to be proceedings in equity.21 As courts of equity, bankruptcy courts are empowered to grant a broad spectrum of relief in accordance with fundamental notions of equity and fairness, as opposed to the "principles of black letter law."22 When administering a bankruptcy estate, bankruptcy courts' equitable jurisdiction empowers them to sift through the circumstances surrounding a claim in order to ensure that injustice or unfairness does not result.23

Consistent with bankruptcy courts' equitable mandate, judges are authorized to exercise their own discretion in order to produce just and fair results to the end that "fraud will not prevail, substance will not give way to form, and technical considerations will not preclude substantial justice from being attained."24 In carrying out their equitable mandate, bankruptcy courts are also entitled to test the validity of claims and, in doing so, are permitted to disregard the form of a transaction in order to give effect to its substance.25 However, bankruptcy courts may only exercise the equitable powers conferred to them by §105(a) in a manner that is consistent with the provisions of the Bankruptcy Code.26 Therefore, as a general rule, bankruptcy courts only

22. Douglas supra note 11, at 1.
26. In re Morristown & Erie R.R. Co., 885 F.2d 98, 100 (3d. Cir. 1989) ("Section 105(a) authorizes the bankruptcy court...to fashion such orders as are required to further the substantive provisions of the Code. Section 105(a) gives the court general equitable powers, but only insofar as those powers are applied in a manner consistent with the Code."); see also Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206 (1988)("...whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code."); New England Dairies, Inc., v. Dairy Mart Convenience Stores, Inc. (In re Dairy Mart Convenience Stores, Inc.) 351 F.3d 86, 92 (2d. Cir. 2003)("The equitable power conferred on the bankruptcy court by section 105(a) is the power to exercise equity in carrying out the provisions of the Bankruptcy Code, rather than to further the purposes of the Code generally, or otherwise to do the right thing. This language 'suggests that an exercise of section 105 power be tied to another Bankruptcy Code section and not merely to a general bankruptcy concept or objective.'")
possess the powers and jurisdiction that are expressly, or by necessary implication, conferred to them by statute. While bankruptcy courts’ authority is arguably exceptionally broad, bankruptcy courts are not entitled to craft additional substantive rights favoring debtors or creditors that are not already specifically provided for by the Code. Moreover, bankruptcy courts may not create substantive rights in favor of debtors or creditors that do not already exist under non-bankruptcy law.

The Traditional Remedy of Equitable Subordination

Today, the power of bankruptcy courts to re-order the priority of claims or interests through the equitable remedy of recharacterization is generally recognized. However, only the remedy of equitable subordination is explicitly provided for in the Bankruptcy Code. Although once considered solely in conjunction with the doctrine of equitable subordination, a majority of bankruptcy courts across the country now recognize recharacterization as a separate cause of action. Many courts and practitioners view the doctrine of recharacterization as a variation of equitable subordination regardless of the doctrine’s acceptance as a distinct legal theory and remedy.


28. Johnson, 719 F.2d at 273; see also In re Transit Group, 286 B.R. 811, 816 (Bankr. D. Fla. 2002)("... section 105(a) cannot be used to authorize relief inconsistent with a more specific provision of the Bankruptcy Code."); In re Phar-Mor, Inc. Securities Litigation, 166 Bankr. 57, 61 (W.D. Pa., 1994)("while the grant of authority is broad, a court may not create substantive rights in favor of a debtor that are in addition to the rights bestowed by the Code if such rights do not also exist outside of bankruptcy law."); Southern Railway Co. v. Johnson Bronze Co., 758 F.2d 137, 141 (3d Cir. 1985) ("section 105(a) 'does not authorize the bankruptcy court to create rights not otherwise available under applicable law.'"); United States v. Sutton, 786 F.2d 1305, 1308 (5th Cir. 1986) ("... statute does not authorize the bankruptcy courts to create substantive rights that are otherwise unavailable under applicable law, or constitute a roving commission to do equity.").

29. Johnson, 719 F.2d at 273; see also Sutton, 786 F.2d at 1308 ("While the bankruptcy courts have fashioned relief under Section 105(a) in a variety of situations, the powers granted by that statute may be exercised only in a manner consistent with the provisions of the Bankruptcy Code. That statute does not authorize the bankruptcy courts to create substantive rights that are otherwise unavailable under applicable law, or constitute a roving commission to do equity.").


31. Id.

32. See Blasbalg v. Tarro (In re Hyperion Enters.), 158 B.R. 555, 561 (D.R.I. 1993) (stating "[t]his court agrees with the Bankruptcy Court that the issues of recharacterization of debt as equity capital and equitable subordination should be treated separately").

Equitable subordination is a remedy used to penalize creditor misconduct that causes injury to other creditors and shareholders of a company.\textsuperscript{34} The doctrine is codified in §510(c) of the Bankruptcy Code, although it first developed as a judicially created remedy against fraud and breach of fiduciary duties owed to a bankrupt entity.\textsuperscript{35} Section 510(c) provides that bankruptcy courts may, “under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of allowed interest to all or part of another allowed interest.”\textsuperscript{36} In other words, under a claim for equitable subordination, bankruptcy courts are allowed to subordinate a misbehaving creditor’s claim only to the extent necessary to offset specific harm suffered by other creditors.\textsuperscript{37} Therefore, bankruptcy courts have discretion to subordinate all, or just a part, of a creditor’s claim.\textsuperscript{38} Courts view equitable subordination as a remedial, and not penal, doctrine that should only be applied in limited circumstances.\textsuperscript{39}

A claim for equitable subordination usually requires that a creditor demonstrate three elements: (1) the claimant engaged in some type of inequitable conduct; (2) the misconduct resulted in injury to the creditors or conferred an unfair advantage on the claimant; and (3) equitable subordination of the claim is not inconsistent with the provisions of the Bankruptcy Code.\textsuperscript{40} Further, bankruptcy courts recognize three general categories of inequitable conduct that warrant the equitable subordination of a claim: (1) fraud, illegality, and breach of fiduciary duties; (2) undercapitalization; and (3) a claimant’s use of the debtor as a mere instrumentality or alter ego.\textsuperscript{41}

Bankruptcy courts assert that, while recharacterization involves a factual determination as to whether or not an asserted debt is in fact a legitimate debt, equitable subordination is a remedy applied against a legitimate creditor who has acted inequitably.\textsuperscript{42} Thus, bankruptcy courts penalize creditor misconduct by subordinating an otherwise

\textsuperscript{34} Douglas, supra note 11, at 1.
\textsuperscript{35} Pepper, 308 U.S. at 311.
\textsuperscript{36} 11 U.S.C. 510(c)(2005).
\textsuperscript{37} Trone v. Smith (In re Westgate-California Corp.), 642 F.2d 1174, 1178 (9th Cir. 1981).
\textsuperscript{38} Id.
\textsuperscript{39} Holt v. FDIC (In re CTS Truss, Inc.), 868 F.2d 146, 148-149 (5th Cir. 1989).
\textsuperscript{41} In re Fabricators, Inc., 926 F.2d 1458, 1467 (5th Cir. 1991).
valid, superior claim behind those claims of unsecured creditors. On the other hand, bankruptcy courts assert that a debt is recharacterized as a capital investment after finding that there was never a valid debt in the first place. Thus, when a court recharacterizes a debt, it "recognizes" the true character of the claim and properly converts it as a proprietary interest. Therefore, recharacterization claims are said to focus on whether a legitimate debt actually exists, while equitable subordination depends on whether there was creditor misconduct.

C. The Devotees of Recharacterization

As previously discussed, there is no provision in the Bankruptcy Code that authorizes bankruptcy courts to recharacterize debt as equity. Nevertheless, a majority of bankruptcy courts across the country maintain that their equitable powers under the Bankruptcy Code authorize them to hear claims for recharacterization. Adherents of recharacterization rely on §105 of the Bankruptcy Code, which refers to the general equitable powers of bankruptcy courts. Section 105 states that bankruptcy judges have the authority to "issue any order, process or judgment that is necessary or appropriate to carry out the provisions" of the Code.

Bankruptcy courts argue that the ability to recharacterize a purported loan as an equity contribution emanates from their equitable power to ignore the form of a transaction in order to give effect to its substance. These courts assert that the issue in recharacterization is not whether funds advanced to a corporation are actually loans, but whether equity requires that they be regarded as if they were something else. As the court in Cold Harbor stated, "a court is not required to accept the label of 'debt' or 'equity' placed by the debtor upon a particular transaction, but must inquire into the actual nature

44. Id. at *6.
45. Id. at *5.
46. Id.
47. When Is Your "Debt" Claim Not a Debt Claim?, supra note 25.
48. Id.; see also In re Herby's Foods, 2 F.3d 128, 144 (5th Cir. 1993); In re Midtown Product Terminal Inc., 599 F.2d 389, 393 (10th Cir. 1979); Blasbalg v. Tarro (In re Hyperion Enterprises), 158 B.R. 555, 561-62 (D.R.I. 1993); In re Cold Harbor Assocs., 204 B.R. 904, 915 (Bankr. E.D. Va. 1997); Diasconics Inc. v. Ingalls, 121 B.R. 626, 630 (Bankr. N.D. Fla. 1990).
52. In re Mobile Steel Co., 563 F.2d 692, 702 (5th Cir. 1977).
of a transaction to determine how best to characterize it." Therefore, bankruptcy courts assert that, in analyzing claims for recharacterization, they are testing the validity of a debt and in doing so, are permitted by their powers of equity to disregard the form of a transaction in order to recognize its true substance as an equity investment.54

D. Unauthorized Use of Bankruptcy Courts’ Authority?

There do remain a few “hold-out” courts that maintain recharacterization is an unauthorized exercise of bankruptcy courts’ authority.55 These courts assert that there is no provision in the Bankruptcy Code that empowers courts with the authority to recharacterize a claim.56 Opponents of recharacterization opine that, while §105(a) of the Bankruptcy Code gives bankruptcy courts broad power to “issue any order, process or judgment that is necessary to carry out the provisions” of the Bankruptcy Code, there is no provision, or implicit reference, in the Code that allows for recharacterization.57 Further, opponents argue that bankruptcy courts’ powers under §105 are restricted to carrying out the substantive provisions of the Code, and since there is no explicit provision in the Code authorizing recharacterization, the remedy is outside the scope of bankruptcy courts’ powers.58 Accordingly, opponents argue that Congress intended to deprive bankruptcy courts of the power to recharacterize debt since §510(c) of the Bankruptcy Code contains a specific provision authorizing equitable subordination, but contains no provision pertaining to a remedy of recharacterization.59 Thus, opponents argue that, based on the principle of “expressio unius est exclusion alterius,”60 Congress did not intend to permit bankruptcy courts to possess

55. Sprayregen, supra note 1, at 30.
56. Brighton, supra note 15, at 1, citing In re Pacific Express, Inc., 69 B.R. 112, 115 (9th Cir. B.A.P. 1986) (“...the court has construed its authority too broadly. While the Code supports the court’s ability to determine the amount and the allowance or disallowance of claims, those provisions do not provide for the characterization of claims as equity or debt. The result achieved by such a determination, i.e. subordination, is governed by 11 U.S.C. Section 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.”); see also In re Pine Tree Partners, Ltd., 87 B.R. 481, 491 (Bankr. N.D. Ohio 1988) (“The equitable powers of the court derive from the Bankruptcy Code and consequently reach no further than its provisions. Accordingly, the claims of OTR are not subject to recharacterization from debt to equity absent controlling provisions of the Bankruptcy Code.”)
58. Sprayregen, supra note 1, at 30.
59. Id.
60. “The express mention of one thing implies exclusion of all others”
the power to recharacterize debt. Moreover, the hold-out courts maintain that since the result achieved by recharacterization is subordination of a claim, and such determinations are governed by the express provision of §510(c) of the Bankruptcy Code, it is inconsistent with the Code to allow such determinations to be made under different standards via the court's equitable powers.

In re Outboard Marine Corp.

In 2002, the U.S. Bankruptcy Court in the Northern District of Illinois boldly dissociated itself with the majority of courts that recognize a power to recharacterize debt and stated that recharacterization of debt as equity was outside the scope of bankruptcy courts' powers. Accordingly, the bankruptcy court refused to recharacterize the lender's debt claim. In Outboard Marine Corp., Outboard Marine granted a security interest in substantially all of its assets to secure loans made in 1998. Two years later, Quantum Industrial Partners acquired nearly all of Outboard Marine's stock for more than $40 million. Afterwards, OutBoard Marine and its lenders amended their loan agreement to add an additional debt subordinate to Outboard Marine's existing debt. Quantum then purchased a 100 percent participation interest in the subordinated debt and assigned its rights against Outboard Marine to the lead bank lender. After Outboard Marine filed for chapter 11 bankruptcy, the bank sought to collect on its secured claims. The trustee countersued the bank and Quantum, asserting that Outboard Marine's $45 million debt to Quantum be recharacterized as an equity interest in the company. The trustee argued that the transaction involving the bank, Quantum, and Outboard Marine was in reality an equity investment disguised as a participation interest in a loan.

Judge Barliant of the U.S. Bankruptcy Court for the Northern District of Illinois declined to recharacterize the debt, stating that: "There is no basis in bankruptcy law to recharacterize a debt as equity. . ..In my opinion, no bankruptcy court has the power to do any such thing

62. See In re Pinetree Partners Ltd., 87 B.R. at 491; see also In re Pacific Express Inc., 69 B.R. at 115.
64. Douglas, supra note 11, at 30.
65. Id.
66. Id.
67. Id.
68. Id.
69. Id.
under the Bankruptcy Code.”70 Judge Barliant reasoned that while §105(a) of the Bankruptcy Code grants bankruptcy courts the broad authority to “issue any order, process or judgment,” such authority may only be exercised “to carry out the provisions” of the Code.71 On appeal, however, the District Court reversed Judge Barliant’s decision and allied itself with the majority of courts that have expansively construed the scope of bankruptcy courts’ equitable powers.72 The District Court remanded the case back to the bankruptcy court and ordered it to exercise its authority to determine whether the facts and circumstances justified recharacterization.73

In 2003, Judge Doyle of the U.S. Bankruptcy Court for the Northern District of Illinois followed in Judge Barliant’s footsteps by dismissing a claim for recharacterization in In re Abtox.74 Referring to the language used by Judge Barliant in Outboard Marine, Judge Doyle stated that “there is nothing anywhere in the Bankruptcy Code that authorizes converting a claim into an equity interest for any reason whatsoever.”75 By referring to Judge Barliant’s opinion, it is argued that Judge Doyle may be resurrecting the debate that emerged early during recharacterization cases and seems to have been settled by a majority of courts.76 Despite the stance of the hold-out courts, however, it is settled, for the time being, that bankruptcy courts possess the authority to hear recharacterization claims.77

E. The Test for Recharacterization

Recharacterization involves a factual determination by bankruptcy courts as to the “real” substance and nature of the agreement between the parties.78 Primarily, bankruptcy courts are concerned with determining whether a transaction reflects the characteristics of an arm’s-
length negotiation. Thus, courts are more willing to recharacterize a transaction that does not bear the indicia or characteristics of an arm’s-length transaction.

The factors that bankruptcy courts evaluate when analyzing claims for recharacterization generally fall into three categories. First, courts consider the formality of the alleged loan agreement. For example, in In re Cold Harbor, the court stated that when parties to a transaction are more specific and complete in identifying and codifying the terms of their alleged loan agreement, the more like a loan the transaction appears. By contrast, however, if the terms of a loan agreement are vague and non-specific, the transaction will appear more like a capital contribution. Second, bankruptcy courts consider the financial situation of a company at the time a purported loan agreement is created. If investment in a corporation appears to have been especially risky or the source of funds to repay a loan was not clearly made, then a court will be persuaded that the transaction bears the earmarks of an equity contribution. Finally, bankruptcy courts consider the relationship between the creditor and the debtor. For example, when a lender obtains a right to control a company’s operations or participate in management, bankruptcy courts consider this indicative of an ownership interest in a company and not simply a debtor-creditor relationship.

In evaluating the aforementioned categories, bankruptcy courts are guided by what are known as the Autostyle Plastics factors. These factors were originally employed by the tax courts when determining whether to recharacterize a claim in the tax context. In Autostyle Plastics, Inc., the Sixth Circuit Court of Appeals drew on the tax courts’ factors in order to formulate a framework for analyzing

79. Brighton, supra note 15, at *2; see also In re Cold Harbor Assocs., 204 B.R. 904, 915(Bankr. E.D. Va. 1997) ("The primary factor this Court is to consider when evaluating whether funds advanced by a shareholder are the result of an equity contribution or a loan is whether the transaction bears the earmarks of an arm's length negotiation").
81. Id. at *3.
82. Id.
83. Id.
84. Id.
85. Id. citing In re Cold Harbor Assocs., 204 B.R. 904, 916(Bankr. E.D. Va. 1997).
86. In re Cold Harbor Assocs., 204 B.R. at 916; see also Roth Steel Tube Co. v. Commissioner, 800 F.2d 625, 631 (6th Cir. 1986).
87. see Diasonics Inc. v. Ingalls, 121 B.R. 626, 629-32 (Bankr. N.D. Fla. 1990) (holding that when the putative claimant advanced funds to the debtor, no other disinterested lender would extend equivalent credit, which holding supported the recharacterization of debt to equity).
88. In re Cold Harbor Assocs., 204 B.R. at 917.
89. Roth Steel Tube Co., 800 F.2d at 630-32.
recharacterization claims in bankruptcy contexts. The court determined that the factors formulated for analyzing recharacterization claims in the tax context were also appropriate when analyzing recharacterization claims in the bankruptcy context. Thus, bankruptcy courts adopted the following factors as guideposts in determining the "true nature" of a claim: (1) the names given to the instruments, if any, which evidence the indebtedness; (2) presence of absence of a fixed maturity date and scheduled 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 made; (8) a corporation's ability to obtain financing from outside lending institutions; (9) the extent to which the advances were used to acquire capital assets; (10) the extent to which the advances were subordinated to the claims of outside creditors; and (11) the presence or absence of a sinking fund to provide repayments. Two additional factors were adopted from Hyperion Enterprises, including (1) the ratio of shareholder loans to capital and (2) the amount or degree of shareholder control.

Bankruptcy courts quickly stress that no one factor is controlling and that recharacterization is determined on a case-by-case basis using a balancing approach. Further, courts construe the factors within the particular circumstances of each case. The problem with adopting such a broad array of factors to balance is that such an approach allows judges to make subjective decisions. For example, in In re AtlanticRancher Inc., the U.S. Bankruptcy Court for the District of Massachusetts held that an advance made to an undercapitalized debtor, which was unable to obtain financing from outside sources, was an equity investment disguised as a loan. The court was persuaded that the sophistication of the lender and the integrated set of loan documents fundamentally required the debtor to treat the creditor as if it were a substantial owner of the company rather than a simple

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90. Id. at 749-750.
93. Brighton, supra note 1, at 18; See also Roth Steel Tube Co., 800 F.2d at 800 F.2d 625; see also, In re Autostyle Plastics Inc., 269 F.3d 726, 749-50 (6th Cir. 2001); In re Cold Harbor, 204 B.R. at 915.
94. Brighton, supra note 1, at 18.
lender.\textsuperscript{97} Specifically, the court found that the terms and conditions of the loan gave the creditor control of the debtor's operations.\textsuperscript{98} However, the court also stipulated that the note and related agreements regarding the transaction were properly documented with maturity and interest rates, and the advance was treated as a debt on the debtor's books.\textsuperscript{99} Nevertheless, the court found that the lender never made any effort to collect on the promissory note or to foreclose on the collateral.\textsuperscript{100} With respect to the transaction, the court held that the claim should be properly recognized as an equity interest in the debtor.\textsuperscript{101}

On the other hand, in \textit{In re Phase I-Molecular Toxicology},\textsuperscript{102} the U.S. Bankruptcy Court for the District of New Mexico held that the transaction was not a capital contribution but indicative of a debt. In reaching its determination that the transaction involved a loan to the debtor, the court was persuaded by the facts that title was given to the instrument, a security agreement was entered into at or near the time of the advances, the debtor pledged significant assets as security for the notes, repayment of the loan was intended to be received from the sale of assets and not completely dependent on the future success of the debtor's business, and the notes contained an interest charge, although the notes were not payable on demand and did not contain a fixed maturity date.\textsuperscript{103}

\textbf{F. Corporate Insiders and Fiduciaries}

A claim for recharacterization is most often raised by creditors' committees or a trustee in bankruptcy in cases where a lender is a corporate insider, such as a shareholder, manager, or director.\textsuperscript{104} A corporation that is struggling to stay financially afloat requires additional funding in order to continue operating.\textsuperscript{105} In many cases, corporations may be unable to obtain financing from outside commercial lending institutions.\textsuperscript{106} This may be a result of having their assets al-

\textsuperscript{97} Brighton, supra note 6, at 20, citing \textit{In re AtlanticRancher Inc.}, 279 B.R. at 436.
\textsuperscript{98} Brighton, supra note 6, at 20, citing \textit{In re AtlanticRancher Inc.}, 279 B.R. at 411.
\textsuperscript{99} Brighton, supra note 6, at 20, citing \textit{In re AtlanticRancher Inc.}, 279 B.R. at 437.
\textsuperscript{100} Id.
\textsuperscript{101} Id.
\textsuperscript{102} Farr v. Phase-I Molecular Toxicology, Inc. (\textit{In re Phase-I Molecular Toxicology}), 287 B.R. 571, 578 (D. N.M. 2002).
\textsuperscript{103} Brighton, supra note 15, at 20, citing \textit{In re Phase-I Molecular Toxicology}, 287 B.R. at 577.
\textsuperscript{104} Nozemack, supra note 8, at 705-706.
\textsuperscript{106} Stadler, supra note 106, at 2.
ready over-encumbered. Under such circumstances, corporate managers, directors, and shareholders can choose to let the company die, and file for bankruptcy, or they themselves can provide the necessary financing. If insiders take the latter route, they may choose to advance the needed funds by making additional capital contributions, personally advancing funds to the company as a loan, or personally guaranteeing a loan from an outside financial source.

Insiders are not blind to the fact that, in bankruptcy, holders of proprietary interests in a corporation have the lowest priority and are only repaid after all other claims of the estate are satisfied. As a holder of a debt instrument, an insider is put on the same footing as the corporation’s general creditors and has the ability to obtain a pro-rata payment should the company file bankruptcy. Thus, aware of the financial risks, and the prospect that the company may be forced to file bankruptcy nonetheless, corporate insiders may prefer to provide the funding in the form of a loan. However, a trustee in bankruptcy or other creditor of the debtor-corporation alleges that the insider-lender’s advances were equity investments improperly camouflaged as a loan. In effect, they seek to have a bankruptcy court recharacterize the debt as equity, thus subordinating the insider’s advance to the back of the repayment line. When recharacterizing an insider’s debt claim, bankruptcy courts believe that they are achieving an equitable remedy that protects legitimate creditors from those who have attempted to improperly shift the risks of possessing an ownership interest to the company’s creditors by camouflaging their contribution as a loan.

III. ANALYSIS

This section argues that recharacterization is not an equitable remedy, despite the assertions of bankruptcy courts that recognizing such claims is an exercise of their powers as courts of equity. First, this section asserts that recharacterization is inequitable because it is an unauthorized exercise of bankruptcy courts’ powers under the Bankruptcy Code. Further, this section argues that recharacterization is fun-
damentally an inequitable remedy because it does not achieve a fair or just outcome for all parties.

A. Beyond the Scope of Bankruptcy Courts’ Equitable Powers

As a general rule, bankruptcy courts only possess the powers and jurisdiction that are expressly, or by necessary implication, conferred to them by statute. The scope of bankruptcy courts’ equitable powers are limited by the express statutory language of §105. Section 105(a) of the Code only permits bankruptcy courts to “issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of” the Code. Therefore, the exercise of bankruptcy courts’ equitable powers are circumscribed, and under §105 must be tied to another provision of the Code, and not merely used to carry out a general bankruptcy concept or objective. Thus, §105(a) does not permit bankruptcy courts to create substantive rights or expand the entitlements of creditors that are not already established under the Code or non-bankruptcy law.

Accordingly, a proper application of §105(a) will effectuate the provisions of the Code without fashioning or altering the substantive rights of debtors or creditors, and without changing the fundamentals of bankruptcy law regarding the validity of creditors’ entitlements.

115. Johnson v. First Nat’l Bank, 719 F.2d 270, 273 (8th Cir. 1983), citing Chicago Bank of Commerce 61 F.2d 986, 988 (8th Cir. 1932) (“The appropriate starting point for our analysis is to recognize the general rule that a bankruptcy court possesses only the jurisdiction and powers expressly or by necessary implication conferred by Congress.”); see also Jones v. Kansas City Garment Making Co., 1 F.2d 649, 650 (8th Cir. 1924) (“Courts of bankruptcy are of statutory origin and possess only such jurisdiction and powers as are expressly or by necessary implication conferred upon them by the Bankruptcy Act.”)

116. New England Dairies, Inc., v. Dairy Mart Convenience Stores, Inc. (In re Dairy Mart Convenience Stores, Inc.) 351 F.3d 86, 92 (2d. Cir. 2003) (“The equitable power conferred on the bankruptcy court by section 105(a) is the power to exercise equity in carrying out the provisions of the Bankruptcy Code, rather than to further the purposes of the Code generally, or otherwise to do the right thing. This language “suggests that an exercise of section 105(a) power be tied to another Bankruptcy Code section and not merely to a general bankruptcy concept or objective.”)

117. 11 U.S.C.S. §105(a) (emphasis added).

118. Phar-Mor, Inc., 166 B.R. at 61. Referring to §105(a), the court stated that “[t]his section of the Code authorizes a court to use its equity powers to “fashion such orders as are necessary to further the substantive provisions of the [Code]. . .However, while the grant of authority is broad, a court may not create substantive rights in favor of a debtor that are in addition to the rights bestowed by the Code if such rights do not also exist outside of bankruptcy law.”); see also Southern Railway Co. v. Johnson Bronze Co., 758 F.2d 137, 141 (3d Cir. 1985) (“section 105(a) ‘does not authorize the bankruptcy court to create rights not otherwise available under applicable law.’”)

119. See supra note 118.

Although a majority of courts assert that under §510(c) they are allowed to test the validity of claims, bankruptcy courts are not authorized in the name of equity to make a wholesale substitution of the underlying law that controls the validity of creditors' entitlements. Instead, the scope of bankruptcy courts' equitable powers must be understood in light of the principle of bankruptcy law that the validity of a claim is generally a function of underlying substantive law. Therefore, as mandated by §105(a), bankruptcy courts are confined to carrying out the provisions of the Code when testing the validity of claims in bankruptcy, regardless of how broad their equitable powers may be.

In consideration of the limits that §105 places on the equitable powers of bankruptcy courts, recharacterization is outside the scope of their authority under §510(c). There is no provision in the Code that explicitly establishes a right of bankruptcy courts to recharacterize a debt claim as an equity investment. Since bankruptcy courts' equitable powers may only be utilized in carrying out the substantive provisions of the Code, and there is no substantive right to recharacterize debt under the Code, debt-to-equity recharacterization is beyond the scope of bankruptcy courts' equitable powers. Thus, recharacterization is a judicially crafted "remedy" that directly contravenes §105(a).

Further, recharacterization improperly provides debtors and creditors with greater rights than they would otherwise have if confined to the provisions of the Code and non-bankruptcy law. First, the Bankruptcy Code only provides for the remedy of equitable subordination. By creating a wholly distinct remedy that is not authorized by the Code, bankruptcy courts have given debtors and creditors entitlements that exceed those explicitly set forth under the Code. As previously discussed, granting debtors and creditors greater rights than

121. When Is Your "Debt" Claim Not a Debt Claim?, supra note 25.
122. Raleigh, 530 U.S. at 24-25 ("Bankruptcy courts do indeed have some equitable powers to adjust rights between creditors. See, e.g., §510(c). That is, within the limits of the Code, courts may reorder distributions from the bankruptcy estate, in whole or in part, for the sake of treating legitimate claimants to the estate equitably. But the scope of a bankruptcy court's equitable power must be understood in the light of the principle of bankruptcy law discussed already, that the validity of a claim is generally a function of underlying substantive law. Bankruptcy courts are not authorized in the name of equity to make wholesale substitution of underlying law controlling the validity of creditors' entitlements, but are limited to what the Bankruptcy Code itself provides.")
123. Raleigh, 530 U.S. at 24-25.
124. Id.
125. Douglas, supra note 11, at 1.
126. Id.
they already have under the Code and non-bankruptcy law is not authorized. Permitting creditors and trustees in bankruptcy to bring claims for recharacterization, which is not provided for under the Bankruptcy Code, is to bestow upon them a greater basket of rights and remedies that they are not entitled to carry.

Second, while the Code-provided remedy of equitable subordination permits bankruptcy courts to subordinate some or all of a claim, recharacterization further expands the rights of creditors and debtors since courts *convert an entire* claim when they recharacterize a debt.\footnote{128. Brighton, *supra* note 1, at 67.} This conversion remands the claim to the back of the repayment line since, as previously mentioned, an equity holder is paid only after all other claims of a bankrupt corporation's estate are paid. Thus, the end result achieved in a recharacterization claim provides only trustees and complaining creditors with an "equitable" outcome. As courts of equity, bankruptcy courts must consider all the equities of a case and fashion a solution that is fair to all interested and affected parties, not just one.\footnote{129. The Honorable Marcia S. Krieger, *The Bankruptcy Court is a Court of Equity: What Does that Mean?* 50 S.C.L. Rev. 275, 308 (1999) ("Courts of equity traditionally have taken into account the equities — the concrete issues of fact and fairness of the particular situation.")} Recharacterization of a lender's *entire* claim as a capital contribution does not achieve an equitable result for the lender who intended to negotiate a debtor-creditor relationship. Recharacterization instead results in an unjustified expansion of bankruptcy courts' powers and the complaining creditors' and trustee's rights. It is not equity that guides bankruptcy courts, but their unrestricted discretion and self-expanded authority cloaked as a § 105 power.

There is no "equitable" outcome in a claim for recharacterization when the end result directly contravenes the explicit provisions of the Bankruptcy Code, creates a cause of action and remedy not authorized by the Code, and permits creditors and debtors to obtain rights they are otherwise not permitted to enjoy. Despite its reference as an "equitable" remedy, recharacterization is a judicially created device that enables creditors and trustees in bankruptcy to circumvent the explicit provisions of the Code to the detriment of the lending community.

B. *A Faulty Framework*

Despite its rough edges, debt-to-equity recharacterization is generating a rapidly developing body of case law. However, this considerably undeveloped theory has correspondingly spawned conflicting standards and inconsistent judicial decisions. The lack of a finite test
that requires plaintiffs to prove the existence of certain factors, as opposed to simply allowing courts to “balance” any number of factors, ensures the existence and development of an unpredictable and judicially subjective area of law strife with conflict. Furthermore, the framework that bankruptcy courts currently consult when analyzing claims for recharacterization fails to achieve an equitable outcome. First, there are no set elements that must be satisfied before a bankruptcy court is allowed to recharacterize a debt and no requirement that bankruptcy courts consider every Autostyle Plastics factor. Second, a claim for recharacterization does not require a showing of bad faith or misconduct on the part of a lender. Accordingly, it is easier for a trustee or creditor to be successful in a recharacterization action then in a claim for equitable subordination.130

How Judicial Subjectivity Helps Fashion Confusion

Bankruptcy courts consistently reiterate that when analyzing a claim for recharacterization no one factor is controlling or determinative, and courts are to employ a balancing approach in reaching their decision.131 While some bankruptcy courts employ all, or a majority, of the Autostyle Plastics factors, other courts do not, nor are they required to.132 In effect, there is no uniform standard that bankruptcy courts across the country are required to use when analyzing a claim for recharacterization. That is, there are no factors that a plaintiff is required to show, or that a court is mandated to find, before a debt may be recharacterized.

As a result, bankruptcy courts’ decisions are inconsistent, unpredictable, and disturbingly subjective. An examination of the standards that a court employed in one case may provide no indication of how it might rule in a different case. For instance, while a court may consider certain factors in analyzing one claim, it is in no way mandated to consider those same factors in any subsequent case analysis and may rely on wholly different factors in reaching its decision. This lack of consistency stems from the failure to establish criteria that the courts are required to fulfill before allowing a claim to be recharacterized. Even more frustrating is the fact that the Autostyle Plastics factors comprise a non-exhaustive list of criteria that courts may consider

130. Brighton, supra note 1, at 67. ("In recharacterization cases, there are no set elements that must be satisfied, but there is an overall balancing of the factors to discern whether the obligation has the indicia of debt and was an arm's length transaction. Accordingly, in some ways it may be easier to be successful in a recharacterization action.").
131. Sprayregen, supra note 1, at 31.
132. Brighton, supra note 1, at 67.
when analyzing a claim for recharacterization. Thus, bankruptcy courts are allowed to consider other factors that they feel may help them determine the "true" nature of a debt claim. Accordingly, it may be easier for a creditor or trustee to succeed if they bring a cause of action for recharacterization.\(^{133}\)

There is no fair or just result for a legitimate creditor who in good-faith intended to enter into a debt transaction, but who has failed to document the transaction according to the strictures of the bankruptcy court, and watches as its debt is recharacterized. But with bankruptcy judges subjectively fashioning their own rules regarding what they consider to be a "legitimate" debt transaction, creditors may try in good faith to fashion the transaction by following the court's approach on Monday and nevertheless miss the boat if the court looks to a different set of \textit{Autostyle Plastics} factors on Wednesday. Bankruptcy courts' subjective selection of \textit{Autostyle Plastics} factors enables them to tip the scales against lenders, such as corporate officers, who may have intended debt but watch as they slip to the back of the repayment line.

The "free reign" that bankruptcy courts have when analyzing claims for recharacterization has resulted in an area of law lacking any uniform standard. On the one hand, some bankruptcy courts engage in an intense focus on the facts and a detailed analysis of the circumstances under which advances are made to a corporation.\(^{134}\) On the other hand, some jurisdictions eschew any approach that is detailed and balanced.\(^{135}\) These courts willingly recharacterize a transaction where they find the existence of only a few factors, while disregarding the fact that every other factor may indicate that the parties intended the transaction to be a bona fide debt.\(^{136}\) Arguably, the failure to follow a finite test permits bankruptcy judges to craft opinions based on their own subjectivity. For example, some courts in the Eleventh Circuit willingly recharacterize a debt where a trustee can demonstrate that either (1) the debtor was initially undercapitalized, or (2) the advance was made during a time when no other disinterested lender would have extended credit to the debtor.\(^{137}\) However, even if every other

\begin{itemize}
\item \(^{133}\) \textit{Id.}
\item \(^{134}\) \textit{Sprayregen, supra} note 1, at 31.
\item \(^{135}\) \textit{Id.}
\item \(^{136}\) \textit{Id.}
\item \(^{137}\) \textit{Id.}, referring to \textit{Diasonic v. Ingalls}, 121 B.R. at 631 ("The Eleventh Circuit...stated that 'shareholder loans may be deemed capital contributions in one of two circumstances: where the trustee proves initial undercapitalization or where the trustee proves that the loans were made when no other disinterested lender would have extended credit.' [This] standard is now the appropriate standard to be used in this circuit.")
\end{itemize}
factor points to the existence of a genuine debt transaction, in both situations the "lender" will lose.138 Interestingly, however, this rule is not universally followed in the Eleventh Circuit, and other courts in that same jurisdiction apply the 13 Autostyle Plastics factors.139 As demonstrated by the courts of the Eleventh Circuit, there is no uniformity or consistency even within a jurisdiction.

Moreover, while some courts view certain factors as indicative of a debt transaction, other courts may find these same factors as evidence that a transaction was intended to be an equity investment. In a 2003 case decided by the United States Bankruptcy Court for the District of Delaware, the court refused to recharacterize a debt transaction as an equity investment.140 In rejecting the plaintiff's request for recharacterization, the court held that the insolvency of the debtor, undercapitalization, inability to pay cash interest, and the fact that no disinterested third-party lender other than the defendants-creditors would lend money were not dispositive of equity.141 Further, the court was not persuaded that the transaction was a capital contribution even though the lender received a seat on the company's board and never issued subsequent notes when additional funding was advanced to the debtor.142

On the other hand, the United States Bankruptcy Court for the District of Massachusetts recharacterized a debt transaction as an equity investment based on the existence of these same factors.143 The court found that inadequate capitalization at the time the funds were transferred, the lender's degree of control over the debtor, which included significant involvement in the debtor's daily operations, the inability to obtain funding from outside sources, and the lender's failure to make any attempt to collect the debt were indicative that the transaction involved a capital contribution.144 Thus, the District Court of Delaware refused to recharacterize a debt based on the existence of the same factors that the District Court of Massachusetts found indicative of a capital contribution. Such conflicting approaches illustrate the lack of predictability that accompanies bankruptcy courts' decisions to recharacterize a debt as equity.

138. Sprayregen, supra note 1, at 31.
141. When Is Your "Debt" Claim Not a Debt Claim?, supra note 25.
142. Id.
144. When Is Your "Debt" Claim Not a Debt Claim?, supra note 25.
The lack of both consistency among courts and predictability in judicial reasoning is a cause for concern not only for lenders, but for struggling companies as well. Judicial inconsistency "erodes the predictability of [the] investment mechanism," subjecting creditors and companies to unanticipated risks. The drastically differing approaches of courts cultivate a lack of certainty as to the future of transactions and affect the efforts of lenders currently structuring transactions. In order to maintain the viability of financing, lenders and debtors must be able to rely on the form of the transaction and the rights and obligations they bargained for. Recharacterization destroys parties' reasonable expectations. A lack of certainty with respect to how a transaction may later be characterized will most assuredly reduce, if not extinguish, lenders' reliance on, and trust in, the investment mechanism.

2. Where Is the Inequitable Conduct and Bad Faith?

Creditors and trustees may find that their best strategy for subordinating a lender's claim is to bring a claim for recharacterization. In some ways it is easier for a creditor or a trustee to succeed in a recharacterization action. First, a claim for recharacterization does not require a plaintiff to show misconduct on the part of the creditor. Without the requirement of bad faith or misconduct on the part of a lender, bankruptcy practitioners appear unwilling to support claims for recharacterization. Most bankruptcy courts exercise their powers of equity only after determining that a lender acted inequitably or in bad faith, such as in a claim for equitable subordination. However, debt-to-equity recharacterization does not examine conduct or harm, and there is no requirement that a trustee or creditor show the existence of bad faith, misconduct, or otherwise inequitable behavior on the part of a lender. For example, under equitable subordination, the explicit Code-provided remedy, a plaintiff must show some sort of inequitable conduct or bad faith on the part of a defendant-creditor. Further, bankruptcy courts subordinate the claim only to the extent necessary to offset injury to other creditors, which provides

146. Brighton, supra note 1, at 18.
147. Id.
148. Id.
149. Id.
150. Nozemack supra note 7, at 692-693.
151. Sprayregen, supra note 13, at 1.
bankruptcy courts discretion in determining how much a of a claim to subordinate. On the other hand, there is no requirement of bad faith or other inequitable conduct when bringing a claim for recharacterization.

Bankruptcy courts speak of recognizing the "true" substance of a "disguised" loan. That is, bankruptcy courts justify recharacterization as necessary to recognize an equity investment that has been "camouflaged" as debt. But do words such as "disguised," "true," and "camouflaged" not suggest some sort of proactive conduct and bad-faith on the part of the "lender?" To "disguise" requires that an act or practice of concealment have been undertaken.152

Moreover, as mentioned, the entire claim is converted into equity, even though there is no requirement that the lender, in bad faith, intended to camouflage the debt. Converting a lender's entire debt claim into an equity contribution without a showing of some sort of misconduct or bad faith is not consistent with bankruptcy courts' equitable mandate to produce "just and fair results to the end that fraud will not prevail."153

Second, in claims for equitable subordination, bankruptcy courts only subordinate a misbehaving creditor's claim to the extent necessary to offset specific harm suffered by creditors.154 Recharacterization, on the other hand, effectuates conversion of a lender's entire claim, and corresponding subordination to the end of the repayment line. Consequently, it is all or nothing. Either the entire debt is recast as equity or it is not. Thus, recharacterization provides complaining creditors and trustees with a far superior outcome they would not have had otherwise. Although bankruptcy courts possess some discretion in equitably subordinating only part or all of a claim, recharacterization enables a creditor or trustee to have an entire claim effectively extinguished, since it is converted into an equity contribution. Recharacterization can not be characterized as an equitable outcome for good faith lenders who watch their claims completely converted absent evidence that demonstrates they intended to deceive other creditors by acting in bad faith or otherwise inequitably.

IV. IMPACT

This section examines the negative effects that bankruptcy courts' practice of debt-to-equity recharacterization has on struggling compa-
nies. Specifically, this section addresses how the inequitable remedy of recharacterization impedes corporate and other lenders from resuscitating financially troubled companies. This section also reveals how claims for recharacterization are being fashioned in other contexts.

A. Where Is Help When You Need It?

Although corporate investors should not be permitted to enjoy the benefits of ownership while shifting the attendant risks of such investment to creditors, legitimate lenders must be protected from the risks of recharacterization. The current case law, however, creates a disincentive for corporate insiders to lend additional funding to a struggling corporation. As previously discussed, a financially troubled company’s most logical, and often only, source of additional funding usually comes from corporate insiders. In a distressed situation, these individuals are the parties most likely to advance much needed funding since they already have a vested interest in the company. However, due to the inherent risks of advancing such funds, an insider may insist that such investment be made as a loan, rather than as a capital contribution. Bankruptcy courts’ practice of debt-to-equity recharacterization discourages insiders from providing a troubled company with funding that may be necessary to keep it afloat. Thus, it is the financially troubled company that inevitably “feels the pinch.”

First, the large number of factors that bankruptcy courts sift through when analyzing the “true nature” of a transaction may deter

155. Sprayregen, supra note 1, at 47; see also Markus C. Stadler, Treatment of Shareholder Loans to Undercapitalized Corporations in Bankruptcy Proceedings, 17 J.L. & Com. 1, 2 (“A corporation facing financial trouble requires additional funds to be advanced in order to keep the business operating. In most instances, corporations in bad financial shape already have all of their assets over-encumbered with security interests. Thus, it is not possible to acquire loans from outside financial sources since adequate security is not available. In this situation, shareholders and directors have the option either to let the corporation go out of business and file a petition for bankruptcy, or to advance the necessary funds themselves.”)

156. When Is Your “Debt” Claim Not a Debt Claim?, supra note 25.

157. Sprayregen, supra note 1, at 31. (“Often, a company in financial distress may find its best avenue for additional funds to be from insiders who already have a vested interest in the company. However, while such parties may be willing to make additional investments in such companies, they also understand the risks attendant with doing so. It is therefore common for such investments to be made as loans rather than capital contributions.”)

158. When Is Your “Debt” Claim Not a Debt Claim?, supra note 25.

159. Id.

160. Nozemack, supra note 7, at 715.

161. Sprayregen, supra note 1, at 31. (“As would-be lenders tighten their purse-strings in response to this [recharacterization] risk, it is the troubled small-to-medium-sized companies who will feel the pinch.”)
insiders and other lenders from providing needed funding to a struggling corporation. As inconsistent judicial interpretations of the *Autostyle Plastics* factors demonstrate, the factors that bankruptcy courts sort through when analyzing claims for recharacterization are neither clearly dispositive of debt or equity. When evaluating the "true" nature of a debt claim, separate courts have interpreted the same *Autostyle Plastics* factors as indicative of both debt and equity. This leaves the lender without any real ability to foresee how exactly a court may view its claim. When the *Autostyle Plastics* factors can provide support for either debt or equity, lenders structuring loan transactions may be reluctant to do so.

The failure to require that a plaintiff show bad faith or other inequitable conduct on the part of a lender will further deter insiders and other corporate lenders from providing a troubled company with needed funding. An insider or other lender who faces the possibility of having their claim converted into an equity investment without any showing that the lender acted inequitably or in bad faith, or in fact intended to camouflage the transaction as debt, will be reluctant in making a loan.\footnote{162}

Recharacterization impedes investment in financially troubled companies by the parties who may be the most logical and often only source of much-needed funds. Corporate debtors and lenders need predictability and stability.\footnote{163} Further, the flow of business and finance require that courts respect and protect the parties’ reasonable expectations, especially where a creditor-debtor relationship has been formed.\footnote{164} However, the risk of recharacterization operates as a detriment to the reasonable expectations and bargain for rights and responsibilities of the parties.\footnote{165} It further operates to deter lenders from rescuing financially troubled companies from the throes of bankruptcy.

\begin{footnotes}
\footnote{162. Nozemack, *supra* note 7, at 715. ("The bankruptcy courts’ practice of recharacterizing debt transactions. . . without inequitable conduct by the creditor will discourage insiders from making loans to troubled companies. . . If the insider faces a possibility of its claim being recharacterized and subordinated even without any inequitable conduct, it will think twice before lending money to a debtor possibly nearing bankruptcy. This would make it nearly impossible for companies. . . to borrow money when they need it the most.")}
\footnote{163. Sprayregen, *supra* note 1, at 47.}
\footnote{164. *Id.* ("Companies and investors need predictability, and the flow of business and finance depends on the law’s respect for, and protection of, the players’ reasonable expectations.")}
\footnote{165. *Id.*}
\end{footnotes}
B. The Expanding Realm of Recharacterization

Practioners are crafting recharacterization claims with mounting creativity. Moreover, debt-to-equity recharacterization is being raised at an increasing rate, both informally as leverage in negotiations, plan discussions, and case management, and formally in litigation. Further, the failure of bankruptcy courts to establish concrete guidelines has provided practioners much room for ingenuity when developing a claim for recharacterization. For example, it has been found that recharacterization "has been raised in the context of securitization transactions, letters of credit, and in the provision and payment of guarantees." Recharacterization has also been raised in bad-faith lending situations. This argument entails that, to the extent there comes a "point in a lending relationship where the lender knew or should have known that there was no way the borrower could repay the obligations," and the creditor had no expectation of repayment, "then, from that point on, the obligations should be converted into an equitable contribution. . ." At that point, the lender is presumed to share in future risks of the business. However, it has been argued that all lenders presumably share in such risks of their borrower.

With an appreciation for the extent to which a claim for recharacterization can be crafted, manipulated, and asserted in varying contexts, is it unrealistic to propose that not only is recharacterization a detriment to advancement by insider-lenders, but the commercial lending world as well? It is not unfathomable to assert that recharacterization will have far-reaching implications for start-up companies and small and medium-sized companies that seek funding from the all-American Bank down on Main Street. It is not just insider-lenders who will recoil, but, anticipatorily, the commercial lending branch down the street. With a majority of bankruptcy courts ready and willing to recharacterize debt, and the creative endeavors of practioners coupled with the non-requirement that a showing of bad faith or inequitable conduct be made, the recharacterization risk is far-reaching.

166. Brighton, supra note 1, at 66.
167. Id.
168. Id.
169. Id.
170. Id.
171. Id.
172. Brighton, supra note 1, at 66.
173. Id.
Bankruptcy courts lack the statutory authority to recharacterize a debt claim as an equity investment. There is no provision in the Bankruptcy Code that implicitly or explicitly permits bankruptcy courts to recharacterize a debt as an equity investment. Further, bankruptcy courts' equitable powers do not extend to recharacterizing debt. Despite its label as an "equitable remedy" by which the alleged "true nature" of a claim is revealed, recharacterization fails to achieve an equitable result for the parties involved, especially good-faith lenders who intended to create a bona-fide debt transaction. It is a judicially crafted cause of action that impermissibly expands the rights of creditors and debtors in bankruptcy. Further, the "balancing approach" used by bankruptcy courts when analyzing a claim for recharacterization effectuates unpredictable and inequitable results, as well as inconsistent standards in an area of law that is not even codified by statute. As a result, recharacterization has disastrous implications for potential lenders and may spell the end for financially struggling companies.