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CLEARING A MINEFIELD OF INSOLVENCY LAW: TOWARD DEBT RECHARACTERIZATION AS A SUPPLEMENT TO THE BANKRUPTCY CODE

Curtis Wheaton*

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INTRODUCTION

Capitalization is an indispensable step in the creation of any business enterprise. Start-up ventures are especially challenging to finance, where investors balance the high potential yield on their capital contributions against the overwhelming probability those investments will never mature into the Powerball-esque windfalls from Initial Public Offerings (IPOs). The cunning venture capitalist (which most are), bears in mind the risk of bankruptcy in order to protect at least some piece of their investment should the enterprise fail (which most do). The present bankruptcy system, however, contains a multitude of unpredictable risks making this task exceedingly difficult. Among these risks is the power of federal bankruptcy courts to equitably subordinate loans, transforming the creditor interest in those loans from debt to equity. Under the absolute priority rule, an equity interest has only a residual priority to the assets of a corporation, whereas debt interest has first priority.

Equitable subordination was long considered the bankruptcy court’s exclusive tool to alter the nature of debt (and thus priority of a creditor to collect in bankruptcy under the absolute priority rule). However, another means for courts to transmute debt has quietly arisen. Bankruptcy courts have

3. See Gage, supra note 2.
4. See 11 U.S.C.A. § 1129(b)(2)(B); see also In re DBSD North America, Inc., 634 F.3d 79 (2d Cir. 2011) (where a bankruptcy judge invalidated a reorganization plan under which debtor's shareholders received a portion of their claims without prior consent of unsecured creditors who had priority to those assets); Bruce A. Markell, Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations, 44 STAN. L. REV. 69 (1991).
“recharacterized” debt, reclassifying loans as equity in bankruptcy regardless of any inequitable conduct on behalf of that creditor to whom the sum is owed. This power of debt recharacterization is not without debate. Several courts have found this power as impliedly reserved to federal law, while others see recharacterization as dependent solely on state law. A third contingent finds no basis whatsoever for debt to be recharacterized. These distinct views are troubling because they sow unpredictability into business decisions where stability is precious. The inability to foresee, at least to some degree, the disposition of debt financing efforts may chill the investment environment as investors hesitate to provide bridge loans or other forms of enterprise-saving debt financing.

This Comment will begin by providing background of both debt recharacterization and equitable subordination. Key features of bankruptcy in the United States will be examined, including 1) the equitable and statutory bases through which bankruptcy courts operate, 2) the congressionally mandated uniformity for which these courts strive, and 3) the role of state law in bankruptcy proceedings. Following this background, an explanation of key doctrinal issues associated with the current state of debt recharacterization will be explained, including an analysis of the practical challenges the legal community currently faces. Lastly, this comment will propose that debt recharacterization be codified within the Bankruptcy Code (the “Code”) as an express grant of power to bankruptcy courts so as to remain viable for use in bankruptcy proceedings. Codification within the Code will provide a uniform nationwide standard and serve as a stable foundation upon which corporate attorneys can structure financings. The result is a more coherent body of insolvency law that helps, not hinders, the market for business investment.

I. THE SOURCES OF BANKRUPTCY COURT POWER AND DOCTRINES OF EQUITABLE SUBORDINATION AND

7. See infra Part I(A)(5).
8. See infra Part III.
9. See infra Part III(E).
10. See infra Part IV.
DEBT RECHARACTERIZATION

The debt recharacterization issue is best conceptualized through an understanding of two central themes. First, the nature and function of the bankruptcy court system itself is vital to the analysis. The equitable and statutory functions that bind bankruptcy courts, as well as the role of state law in bankruptcy proceedings, frame an analysis of whether the current debt recharacterization doctrine furthers the base purpose of the United States bankruptcy system.

Second, in addition to an understanding of the bankruptcy regime, it is important to understand the key differences between equitable subordination and debt recharacterization. This distinction is of obvious importance in considering whether the two doctrines serve as legitimate solutions to independent problems, or impose clumsy superfluities on an already overwhelmed judiciary.

A. Sources of Bankruptcy Court Power

The United States Bankruptcy Code serves as the foundation upon which bankruptcy courts exercise their power. However, bankruptcy courts have long been considered to wield additional legal authority beyond that expressly written into the Code. These additional exercises of power above and beyond that granted by the Code can be classified as stemming from an inherent power of the courts, from federal common law, or as equitable power.

1. Inherent Powers

The inherent powers of the federal district courts arise from Article III of the United States Constitution. However, because bankruptcy court are established pursuant to Article I, they maintain no such constitutional authority. Though some courts have interpreted Bankruptcy Code section 105(a)
as granting inherent power to bankruptcy judges,\textsuperscript{13} debate remains over whether this constitutes a true inherent power or simply the exercise of broadly construed statutory authority.\textsuperscript{14}

Notwithstanding Section 105(a), courts have consistently held that bankruptcy courts have inherent powers in a variety of other situations. Bankruptcy judges have the power to sanction parties,\textsuperscript{15} enforce settlements,\textsuperscript{16} issue injunctions,\textsuperscript{17} direct disbursements of registry funds,\textsuperscript{18} set aside illegal assignments,\textsuperscript{19} reconsider interlocutory orders,\textsuperscript{20} punish abuses of process,\textsuperscript{21} correct mistakes and errors,\textsuperscript{22} dismiss cases,\textsuperscript{23} hold parties in contempt,\textsuperscript{24} suspend or disbar

\textsuperscript{13}In re Collins, 250 B.R. 645, 657 (N.D. Ill. 2000); Caldwell v. Unified Capital Corp. (In re Rainbow Magazine, Inc.), 77 F.3d 278, 284 (9th Cir. 1996) (observing that inherent power to sanction vexatious conduct is recognized in section 105(a)); Jones v. Bank of Santa Fe (In re Courtesy Inns, Ltd.), 40 F.3d 1084, 1089 (10th Cir. 1994) (stating that section 105 is intended to imbue the bankruptcy courts with the inherent power recognized by the Supreme Court in Chambers v. NASCO, Inc.); In re Marvel, 265 B.R. at 609 (noting that a bankruptcy court’s inherent power to sanction conduct recognized by section 105(a)).

\textsuperscript{14}See, e.g., Nw. Bank Worthington v. Ahlers, 485 U.S. 197, 206 (1988) (“[W]hatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code.”); but see In re GSF Corp., 938 F.2d 1467, 1474 (1st Cir. 1991) (noting a broad grant of equitable power under § 105(a)); See generally 2-105 Collier on Bankruptcy ¶ 105.01[2], p. 105–06 (16th ed. 2010).

\textsuperscript{15}See Pearson v. First NH Mortgage Corp., 200 F.3d 30, 42 (1st Cir. 1999); McGahren v. First Citizens Bank & Trust Co., 111 F.3d 1159, 1172 (4th Cir. 1997).

\textsuperscript{16}See City Equities Anaheim, Ltd. v. Lincoln Plaza Dev. Co. (In re City Equities Anaheim, Ltd.), 22 F.3d 954, 958 (9th Cir. 1994).

\textsuperscript{17}See S.I. Acquisition, Inc. v. Eastway Delivery Serv., Inc. (In re S.I. Acquisition, Inc.), 817 F.2d 1142, 1146 n.3 (5th Cir. 1987) DOC 19; A.H. Robins Co. v. Piccinin, 788 F.2d 994, 1003 (4th Cir. 1986).


\textsuperscript{19}See Dalton Dev. Project v. Unsecured Creditors Comm. (In re Unioil), 948 F.2d 678, 682 (10th Cir. 1991).

\textsuperscript{20}See Roumeliotis v. Popa (In re Popa), 214 B.R. 416, 420 (B.A.P. 1st Cir. 1997).

\textsuperscript{21}See McCravy v. Barrack (In re Barrack), 217 B.R. 598, 608 (B.A.P. 9th Cir. 1998).

\textsuperscript{22}See Canino v. Bleau (In re Canino), 185 B.R. 584, 592 (B.A.P. 9th Cir. 1995).


\textsuperscript{24}See Franchise Tax Bd. v. Lapin (In re Lapin), 226 B.R. 637, 642 (B.A.P. 9th Cir. 1998).
attorneys, review actions of state courts and enjoin further proceedings, and control the court’s dockets.

2. Federal Common Law

Federal common law is another avenue through which federal courts have been able to exert judicial power outside the scope of statutory schemes. Since bankruptcy judges are considered judicial officers of their respective district courts, it would seem appropriate that bankruptcy courts share the ability of U.S. District Courts to contribute to federal common law where such a tradition has been established. Generally, federal common law is appropriate where it is either 1) necessary to protect uniquely federal interests, or 2) where Congress has specifically given the courts the power to develop substantive law. The general precondition for the formation of federal common law is a showing that there is “significant conflict between some federal policy or interest and the use of state law.” The instances where the United States Supreme Court has deemed a federal common law appropriate are “few and restricted.” Specifically, the Court has noted that:

Absent some congressional authorization to formulate substantive rules of decision, federal common law only exists in such narrow areas as those concerned with the rights and obligations of the United States, interstate and international disputes implicating the conflicting rights of States or our relation with foreign nations or admiralty cases.

Thus far, there is a finite list of federal common law application in bankruptcy cases. This exhaustive list includes the governance of privileges, the requirement that

27. See In re Moog, 774 F. 2d 1073, 1076 (11th Cir. 1995).
permission be obtained before suing a trustee in bankruptcy,34 whether a constructive trust arises under Bankruptcy Code Section 541(d),35 and choice of law.36 Federal common law has also been applied in bankruptcy cases regarding federal government “setoff rights”37 to pension plans under the Employee Retirement Income Security Act (ERISA),38 and in recognizing liens under ERISA.39

The Supreme Court has expressly refused to allow the formulation of federal common law “to supplement a federal statutory regulation that is comprehensive and detailed,”40 stating that “matters left unaddressed in such a scheme are presumably left subject to disposition provided by state law.”41 The Bankruptcy Code is precisely this sort of comprehensive federal statutory system,42 and therefore matters left unaddressed in the Code seem subject to state law rather than substantive judicial lawmaking.43

3. Equitable Power

While bankruptcy courts are virtually unanimously considered courts of equity,44 this concept is somewhat of a misnomer.45 All courts derive their equitable powers “from . . .

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34. See Carter v. Rodgers, 220 F.3d 1249, 1252 (11th Cir. 2000).
36. See Bianco v. Erkins (In re Gaston & Snow), 243 F.3d 599, 601 (2d Cir. 2001) (“[F]ederal choice of law rules are a type of federal common law”).
41. Id.
43. Thomas E. Plank, The Erie Doctrine and Bankruptcy, 79 NOTRE DAME L. REV. 633, 639 (2004) (“[F]ederal courts may not create federal common law and must find and follow state law when confronted with a legal issue that is beyond the scope of the Bankruptcy Clause [of the Constitution.]”).
45. Courts of equity developed in England as an alternative to the common
the provisions of statutes or constitutions." Therefore, it follows that federal courts enjoy equitable powers to the extent that such ability is conferred by the Constitution. As mentioned previously, bankruptcy courts were created under Article I, not Article III, and thus are not vested with the same equitable authority the federal district courts enjoy. Consequently, the equitable powers of bankruptcy courts are derived from the Code.

Under the present iteration of the Code, a court does not have any general equitable authority. Nonetheless, some courts have construed Bankruptcy Code section 105(a) to grant equitable power. That section authorizes a bankruptcy judge to "issue any order, process, or judgment necessary or appropriate to carry out the provisions of the Code." Additionally, Congress has incorporated specific equitable principles into the Code itself. For example, a bankruptcy judge may issue an automatic injunction—an equitable

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46. JOHN NORTON POMEROY, A TREATISE ON EQUITY JURISPRUDENCE 530, 554 (4th ed. 1918); see also JOSEPH STORY, COMMENTARIES ON EQUITY JURISPRUDENCE 64 (2d ed. 1839) ("The Constitution of the United States has, in one clause, conferred on the National Judiciary cognizance of cases in equity").

47. See also McConihay v. Wright, 121 U.S. 201, 206 (1887) ("[Equity jurisdiction] is vested, as a part of the judicial power of the United States, in its courts by the constitution and the acts of congress in execution thereof"); Noonan v. Lee, 67 U.S. 499, 509 (1862) ("The equity jurisdiction of the Courts of the United States is derived from the Constitution and Laws of the United States.").

48. See Leandra Lederman, Equity and the Article I Court: Is the Tax Court's Exercise of Equitable Powers Constitutional?, 5 FLA. TAX REV. 357, 378 (2001) ("Article I courts have no general equitable powers or generalized ability to grant equitable relief purely from their existence as courts of law. However, to the extent that Congress affords to an Article I court jurisdiction over equitable causes of action or jurisdiction to grant equitable relief, the court has those powers unless the grant unconstitutionally infringes on Article III courts.").

49. See Marcia S. Krieger, "The Bankruptcy Court is a Court of Equity": What Does that Mean?, 50 SANTA CLARA L. REV. 275, 292 (1999) ("Bankruptcy remedies and insolvency rights have always been a product of legislative enactment rather than case-by-case determination in common law or equity courts."); Lederman, supra note 48, at 376 ("In general, any equitable power an Article I court exercises finds its source in a statute.").

50. See Brenham v. Deerfield Org., Inc. (In re Norman Indus., Inc.), 1 B.R. 162, 165 (Bankr. W.D. La. 1979) (stating that the predecessor of § 105(a) recognized and declared the principle that courts of bankruptcy are courts of equity).

remedy. Perhaps most pertinent to the present issue, Section 510 permits a bankruptcy court to equitably subordinate creditor claims.

Therefore, bankruptcy courts do not enjoy unbounded powers of equity; specific provisions of the Bankruptcy Code explicitly indicate when a court should evaluate the equitable side of a legal issue.

4. The Uniformity Requirement

The Constitution empowers Congress to make “uniform Laws . . . on the subject of Bankruptcies.”54 This concept is problematic in bankruptcies because state laws govern relationships between debtors and creditors. This means that a creditor in one state may likely face a different result than they would in another. At a glance, this discrepancy would seem to compromise the uniformity demanded by the Bankruptcy Clause of the Constitution. The Court, however, has ruled to the contrary.55 In the landmark decision of Hanover Int’l Bank v. Moyses,56 the Court held that the Constitution only required “geographic uniformity.”57 The Court upheld the incorporation of state transaction laws into the Bankruptcy Code, and observed that geographic uniformity was satisfied when “the trustee takes in each state whatever would have been available to the creditor if the bankrupt law had not been passed.”58

A bankruptcy law is uniform then, when i) the state substantive law applied in bankruptcy would also apply outside of bankruptcy, ii) creditors and debtors are all subject to the same law, and iii) Congress has delegated the power to states to fix such laws.59 Thus, creditors in differing states may receive disparate treatment without rendering a state law unconstitutional for violating the uniformity clause. Most

57. Id. at 188.
58. Id. at 190.
recently, lower courts have upheld Moyses when state specific exemption provisions were challenged. While the Supreme Court has not considered these specific exemption provisions, it has continued to reaffirm that “the uniformity requirement is not a straightjacket that forbids Congress to distinguish among classes of debtors, nor does it prohibit Congress from recognizing that state laws do not treat commercial transactions in a uniform manner.” Thus, the possibility remains that Congress may add specific provisions to the Bankruptcy Code to ensure uniformity nationwide.

Literal uniformity may not be available under modern bankruptcy jurisprudence since state laws may differ with respect to their treatment of the creditor-debtor relationship. Nonetheless, the underlying intent behind the Uniformity Clause to provide as equal results as possible between bankruptcy courts across the nation should still be recognized as an underlying aspiration for bankruptcy proceedings.

5. State Law in Bankruptcy Proceedings

Despite the constitutionally mandated uniformity bankruptcy courts strive to create among the nationwide class of creditors, several elements of bankruptcy proceedings remain firmly rooted in the law of individual states. Identifying these bastions of state law in federal bankruptcy proceedings is relevant to a debt recharacterization discussion because a number of courts have found debt recharacterization to be a claim rooted in state law. Further, some have advocated for debt recharacterization as state law remedy separate from federal bankruptcy law. Whether these approaches are viable depends on state law application to bankruptcy, and whether debt recharacterization fits within these areas.

Property rights are the primary area through which state law enters bankruptcy proceedings. Even in the days of Swift v. Tyson, where the Court recognized a general federal common law, state law was relied on to define property

60. See, e.g., In re Sullivan, 680 F.2d 1131 (7th Cir.).
64. Swift v. Tyson, 41 U.S. 1 (1842), overruled by Erie R.R. Co. v. Tompkins, 304 U.S. 64 (1938).
The Supreme Court has consistently held that federal statutes “create no property rights but merely attach consequences . . . to rights created under state law.” Most commonly, state laws regarding business transactions (such as state variations of the Uniform Commercial Code) govern the nature of state transactions and the rights that result from these transactions when they are evaluated later under the Bankruptcy Code.

State law causes of action are another area where bankruptcy law may be supplemented by state law. For example, the Delaware Supreme Court recently precluded a cause of action against the directors of a company after that company was declared insolvent in bankruptcy. The Delaware corporate shield statute was applied, resulting in the dismissal of the bankruptcy trustee’s action against the directors under the Delaware statute.

B. Debt Recharacterization and Equitable Subordination

1. Equitable Subordination

The principles that drive equitable subordination stem from a policy to deter fraud and breach of fiduciary duties by controlling shareholders of bankrupt entities. Two Supreme Court cases established the primary guidelines bankruptcy courts follow when equitably subordinating creditor claims that were later codified into the Bankruptcy Code itself. In Taylor v. Standard Gas and Electric Co., the Court considered the claim of a parent corporation whose subsidiary

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65. See generally Columbia Gas Transmission Corp. v. Exclusive Natural Gas Storage Easement, 962 F.2d 1192, 1198 (6th Cir. 1992) ("[P]roperty rights have traditionally been, and to a large degree are still, defined in substantial part by state law."); United States v. MidPac Lumber Co., Ltd., 976 F. Supp. 1310, 1315 (D. Haw. 1997) ("In determining whether such property or rights to property exists, federal and state courts must look to state law." (citing Aquilino v. United States, 363 U.S. 509, 513 (1960))).

66. See Butner v. United States, 440 U.S. 48, 54 (1979) ("Congress has generally left the determination of property rights in the assets of a bankrupt’s estate to state law.").


69. Id.


was in bankruptcy. The stock of the debtor company, Deep Rock Oil Corp., was owned almost entirely by Standard Gas and Electric. Standard was also Deep Rock Oil’s creditor. In the proceedings, preferred shareholders of Deep Rock Oil challenged Standard’s claim, seeking subordination of that claim in relation to those of the preferred shareholders. The Court found that not only was Deep Rock undercapitalized, but that through mismanagement, Standard improperly caused Deep Rock to enter into a series of transactions that benefitted Standard and harmed Deep Rock. Additionally, Standard caused Deep Rock to continually pay improper dividends to the preferred stockholders, which prevented their ability to take a management role in the company. The Court refused to subordinate Standard Gas and Electric’s claim simply because it exercised control over Deep Rock. However, the Court did order that in whatever form Deep Rock was reorganized into following the bankruptcy, the preferred stockholders were to have an equity interest superior to Standard’s.

The following term, the Court considered *Pepper v. Litton*. The importance of *Pepper* lies in the Court’s holding that subordination of a corporate director’s claim (in this case, for salary deficiencies) is appropriate where that director breaches his fiduciary duty. The Court reasoned that directors’ dealings with a corporation are subject to rigorous scrutiny. Thus, when agreements made between directors and the corporations are challenged, the burden lies with the director to show good faith and fairness of the transaction. *Pepper* lays the foundational principles for equitable subordination. Viewing *Taylor* and *Pepper* together, courts need not find fraudulent activity to subordinate claims. Control by a shareholder and undercapitalization of the corporation are likewise not essential prerequisites (though

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72. *Id.* at 310.
73. *Id.*
74. *See id.*
75. *Id.* at 320.
77. *See id.*
78. *Id.* at 324.
80. *Id.* at 311–12.
81. *Id.* at 306.
82. *Id.* at 307.
83. *Id.* at 312.
they constitute grounds in themselves for equitable subordination). It is sufficient that a fiduciary breach the duty of loyalty by acting for its own benefit and to the detriment of the corporation in bankruptcy. If such an occurrence is present, a court may invoke its power to subordinate the claims of the party at fault “to the end that fraud will not prevail.”

The above cases provided the foundational principles upon which Section 510 of the Bankruptcy Code was eventually based. Section 510(c)(1) provides bankruptcy courts with the express authority to subordinate claims in relation to those of others. The provisions’ legislative histories clearly indicate that Congress “intended the term ‘principles of equitable subordination’ follow existing case law and leave to the court the development of this principle.” By specifically incorporating equitable subordination into the Code, Congress rejected any per se subordination of insider debt.

2. Debt Recharacterization

Similar to equitable subordination, debt recharacterization supplies a means by which bankruptcy courts will consider debt as equity for purposes of creditor priority during bankruptcy. As with equitable subordination, when a creditor has debt recharacterized from debt to equity, they fall behind other creditors who would then have superior claims of control over the assets of a corporation during liquidation or reorganization based on the absolute priority rule. The factors through which a court will decide to recharacterize debt remain in flux. Currently, no less than three separate lines of federal case law address debt

85. Id. at 310–11.
86. Id. at 305.
89. Congress rejected the idea of blanket subordination of all insider claims; in the report accompanying the final bill, Congress endorsed existing case law and affirmed the equitable power of the bankruptcy courts to subordinate claims in circumstances consistent with current case law. H.R. Rep. No. 95–595, at 359 (1978).
recharacterization, in addition to state doctrines on the issue.

The Eleventh Circuit has adopted an objective test with respect to debt recharacterization. This two-pronged test was first established in *Estes v. N & D. Properties, Inc.* The court stated that “shareholder loans may be deemed capital contributions in 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 test is articulated for the first time in *Estes*, as no prior precedent is cited.

The court also asserts that a stockholder and lender share fiduciary obligations to one another without reference to state law (which, as stated above, would normally govern such a relationship). Lastly, the Eleventh Circuit concluded in *Estes* that a shareholder loan to a corporation should be deemed per se invalid if a disinterested third party would not have extended such a loan. The Eleventh Circuit approach has not enjoyed acceptance in any of the other courts.

In sharp contrast to the Eleventh Circuit’s approach, the Third, Fourth, Sixth and Tenth Circuits have advanced multifactored tests for debt recharacterization more flexible than that posed by the Eleventh Circuit. While each test differs semantically, the substantive basis behind each remains the same. The most commonly cited of such tests is from *Roth Steel Tube Co. v. Commissioner of Internal Revenue*, where eleven factors were considered. The court stated that not all

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93. *Id.* at 733.
94. *See generally id.*
95. *Id.* at 731–32.
96. *Id.* at 733.
98. *In re Official Comm. of Unsecured Creditors for Dornier Aviation (North America) Inc. v. The Official Comm. of Unsecured Creditors (The Plan Monitoring Comm.),* 453 F.3d 225, 234 n.6 (“The substance of all of these multifactor tests is identical.”).
100. *Id.* at 630. Factors considered were “(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
factors needed to be applied to every case,\textsuperscript{101} that the weight
given to each factor may vary, and that no single factor was controlling.\textsuperscript{102} Specifically, status as an insider creditor and
undercapitalization by themselves do not warrant debt recharacterization.\textsuperscript{103} To distinguish debt recharacterization
from equitable subordination, courts following this approach
have reasoned that debt recharacterization is a method of
determining intent rather than assigning fault.\textsuperscript{104} Creditor
conduct is still relevant though, when it is pertinent to
determining intent of the transaction at issue.\textsuperscript{105}

Debt tends to remain enforceable when the \textit{Roth Steel}
factors are applied as long as an inside creditor dealt with the
bankrupt entity in the same manner as an outsider.\textsuperscript{106} At the
same time, insiders are also generally considered fiduciaries,
so transactions that harm other creditors encounter increased
scrutiny.\textsuperscript{107} The factor that most commonly results in debt
being recharacterized is where the loan is unconventional or
poorly documented.\textsuperscript{108} Since no single factor is determinative
however, even the most poorly documented loans do not
warrant automatic recharacterization.\textsuperscript{109} In a practical sense,
the \textit{Roth Steel} factors are rarely used to recharacterize debt as
equity, out of concerns that such judicial activism would
“discourage legitimate efforts to keep a flagging business
afloat.”\textsuperscript{110} Insider loans are the sole type of situation where
courts have been willing to even consider recharacterization,
and even in a large number of such decisions,

\begin{itemize}
  \item adequacy or inadequacy of capitalization;
  \item the identity of interest between the creditor and the stockholder;
  \item the security, if any, for the advances;
  \item the corporation’s ability to obtain financing from outside lending institutions;
  \item the extent to which the advances were subordinated to the claims of outside creditors;
  \item the extent to which the advances were used to acquire capital assets; and
  \item the presence or absence of a sinking fund to provide repayments.
\end{itemize}

\textsuperscript{101} See \textit{In re} SubMicron Sys. v. KB Mezzanine Fund II, LP, 432 F.3d 448, 455
n.8 (3d Cir. 2006).
\textsuperscript{102} See \textit{id.} at 456; Dornier Aviation, 453 F.3d at 234.
\textsuperscript{103} See Dornier Aviation, 453 F.3d at 234.
\textsuperscript{104} See SubMicron Sys., 432 F.3d at 456; Dornier Aviation, 453 F.3d at 232.
\textsuperscript{105} See SubMicron Sys., 432 F.3d at 456.
\textsuperscript{106} See \textit{id.}
\textsuperscript{108} See Dornier Aviation, 453 F.3d at 236.
\textsuperscript{109} See SubMicron Sys., 432 F.3d at 458; \textit{In re} Internet Navigator, Inc., 289 B.R. 133, 137 (Bankr. N.D. Iowa 2003).
\textsuperscript{110} \textit{In re} Hedged-Inv. Assocs., 380 F.3d 1292, 1298 n.1.(10th Cir. 2004).
recharacterization was ultimately rejected.111

The Ninth Circuit, in contrast to both the Eleventh Circuit approach and the multi-factor analysis shared by the four circuits above, has traditionally held that bankruptcy courts completely lack authority to recharacterize loans.112 The Ninth Circuit Bankruptcy Appellate Panel held in Creditors’ Comms. of Pac. Express, Inc. v. Pioneer Commercial Funding Corp., Inc. that the Bankruptcy Code did not allow recharacterization of debt as capital contributions.113 The court noted that since Bankruptcy Code section 510(c) already governed equitable claim subordination, the ability of courts to recharacterize debt by different means was impermissible.114 Despite the reasoning of Pacific Express, the Ninth Circuit, in a recent decision appears to have adopted the reasoning of the four-circuit coalition and its multi-factor test.115 Thus, the Ninth Circuit serves as a perfect demonstration of the present uncertainty of debt recharacterization as applied by the courts.

In addition to the rules promulgated by the Eleventh, Ninth, Third, Fourth, Sixth, and Tenth Circuits, state law has also been utilized as a basis for debt recharacterization completely independent of federal law.116 Decisions in Massachusetts and Wisconsin serve as an illustration.

Massachusetts courts have identified two primary factors applied when considering whether to recharacterize debt. Initial undercapitalization of a business organization serves as the first basis.117 In Albert Richards, Co. v. The Mayfair Inc., the Massachusetts Supreme Judicial Court recharacterized debt as equity based on that corporation’s nominal

113. Id. at 115.
114. Id.
115. See In re Fitness Holdings Int’l, Inc., 714 F.3d 1141, 1147 (9th Cir. 2013).
This decision was later cited by the Supreme Court in *Pepper v. Litton*  
(which was the case establishing equitable subordination, not recharacterization). The *Albert Richards* decision also seemed to perform what would later become an equitable subordination analysis. The court expressly stated that under Massachusetts’s law, “the right and the duty of courts to look beyond the corporate forms are exercised only for the defeat of fraud or wrong, or the remedy of injustice.”

The second factor considered by Massachusetts state courts, inequitable conduct, further blurs the line between debt recharacterization under state law and equitable subordination under the Code. In *SFB Corp v. Cambridge Automatic, Inc.*, the Massachusetts Superior Court considered enforcement of a promissory note owned by the President and CEO of a company. The court refused to apply the *Roth Steel* factors when considering the request to recharacterize the loan. Instead, Massachusetts’s law was applied, where the loan survived recharacterization.

Wisconsin is the second state to have formulated an independent state basis for debt recharacterization. In the leading decision on the issue, *In re Mader’s Store for Men, Inc.*, the Wisconsin Supreme Court expressly rejected federal bankruptcy court precedent. The court identified three factors that almost always result in a debt being recharacterized as a capital contribution. Firstly, loans made to the corporation by individuals who can exert some degree of substantial control over the company form a basis for that debt to be recharacterized. Secondly, under an objective viewpoint, the circumstances must indicate that the loan was

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118. *Id.* at 434–35.
120. *See supra* Part I(B)(1).
124. *See id.*
125. *See infra* note 93.
127. *Id.* at 1.
129. *See id.*
130. *Id.* at 186.
131. *Id.*
never intended to be repaid in full. 132 Third, the amount of initial capitalization must be nominal or unreasonably small in view of the nature and size of the corporation for recharacterization to occur. 133 Using these three factors, the Wisconsin Supreme Court found that the corporation was sufficiently capitalized from its birth. 134 Accordingly, the debt was not recharacterized. 135

II. THE CURRENT APPROACH TO DEBT RECHARACTERIZATION IS UNWORKABLE IN BOTH THEORY AND APPLICATION

The varying rationales of the federal circuits and state courts are poorly conceived from one another and virtually impossible to reconcile.

From an academic perspective, the wide body of inconsistent debt recharacterization decisions has made it utterly impossible to determine if debt recharacterization should be a power granted to state or federal courts. 136 Additionally, whether debt recharacterization should independently exist at all warrants discussion. Further, the lines between what triggers equitable subordination and debt recharacterization are poorly defined. Some courts seem to use each remedy interchangeably, whereas others treat each as a distinct tool with different ends and means. 137 The inconsistent application of debt recharacterization combined with a multitude of approaches to the issue also fosters an impetus to forum shop, contradicting the uniformity envisioned by the Constitution. 138

Practically speaking, this doctrinal instability has created a hostile environment for business decisions. Creditors are

132. Id.
134. Id. at 189.
135. Id.
unwilling to extend potentially lifesaving loans for fear they will be unable to recoup any of their expenses. Venture capital funds will be less likely to supply loans without attaching exorbitant conditions in order to assure security of their capital. Acquisitions will be halted, while attorneys choose to wash a company through bankruptcy before risking the assumption of any questionable creditors, imposing needless strain on an already overwhelmed judiciary.

III. ANALYSIS

A. Should Debt Recharacterization Exist At All?

The first question is whether or not debt recharacterization even needs to continue existing as a doctrine independent from equitable subordination. The Massachusetts Supreme Court opinion in Albert Richards, for example, used debt recharacterization as a remedy under state law. This very same case was cited by the U.S. Supreme Court in Pepper v. Litton, a case that established federal power to equitably subordinate claims. Although the two courts used different phraseology, they accomplished identical results using near identical factors for analysis. Despite the confusion that inherently arises in reading both these cases, a close look at the true purpose behind each doctrine clearly indicates that equitable subordination and debt recharacterization provide independent remedies and can coexist with one another to provide important contributions. Firstly, as mentioned prior, equitable subordination is a doctrine that permits courts to void or subordinate the claims of creditors upon a finding of inequitable conduct or a combination of various other similar factors. There is no question that a loan had been extended, but the court considers whether that loan should stand in light of other intervening factors. Debt recharacterization, on the other hand, asks

140. Id.
143. See id. at 311–12; Albert Richards Co., 191 N.E. at 434–35.
144. See supra Part I(B)(1).
whether a bona fide loan was even made in the first place. If there were no loan ever transacted, then debt recharacterization would classify that capital contribution as equity. Of course, creditor conduct may still factor into the analysis, since such conduct can impact whether a loan is formed (such as if improper procedures are followed). While the ends may be the same, the means to reach those ends differ greatly between equitable subordination and debt recharacterization. As a result, both may serve valid legal purposes while avoiding conflict with one another. Equitable subordination serves to punish creditors that act inequitably, while debt recharacterization corrects “sham” loans by properly reclassifying as equity contributions.

B. Confusion and uncertainty among courts

Assuming, consistent with the above analysis, that debt recharacterization should exist as an independent doctrine from equitable subordination, the matter of courts’ differing formulations of the doctrine still must be addressed. At present, the Eleventh Circuit maintains an independent analysis of the doctrine that differs from that of the Ninth Circuit. Each of those Circuits are in disagreement with the Third, Fourth, Sixth and Tenth Circuits, who have all agreed on a common list of factors to be applied. State courts have also lent their voice to the issue by formulating independent multi-factor tests in addition to those already established on the federal level. Massachusetts, for example, has established two key factors in its decisions. Wisconsin, on the other hand, administers debt recharacterization using a state standard that diverges from both Massachusetts and the federal tests. The obvious consequence of this wide disparity in recharacterization standards is that creditors face different results depending on the state in which the corporation enters

147. See, e.g., Diasonics Inc. v. Ingalls, 121 B.R. 626 (Bankr. N.D. Fla. 1990).
148. Id.
149. See id.
150. See id.
151. See supra Part I(B)(2).
152. See id.
153. See id.
154. See id.
With so many differing standards of debt recharacterization, the development of any form of coherent case law on the matter is stunted, weakening the legal significance of what could otherwise be an important tool for bankruptcy lawyers and judges.

C. The Present Debt Recharacterization Approach is Inconsistent with Fundamental Bankruptcy Court Principles

The current status of debt recharacterization also contravenes a key principle of bankruptcy court function. While these courts have traditionally been viewed as courts of equity, the ability to freely formulate equitable remedies is illusory. For example, power to equitably subordinate debt is sourced from a specific provision of the Bankruptcy Code, not any inherent equitable power of the court. While such equitable powers were present nearly a century ago, the modern development of the Bankruptcy Code indicates that a statutory basis is necessary for the exercise of such legal authority. Without a statutory basis for action, bankruptcy courts are prevented from formulating remedies or developing federal common law, save several narrow exceptions. Debt recharacterization does not fit within these narrowly drawn instances. Of course, this issue has up until the present been ignored by federal cases that choose to recharacterize debt. Nonetheless, specific codification of debt recharacterization would reinforce fundamental bankruptcy principles while solving the litany of other complications addressed in this analysis.

D. The Current Approach Contravenes the Uniformity

155. See supra note 38.
156. See also, Alan M. Ahart, The Limited Scope of Implied Powers of A Bankruptcy Judge: A Statutory Court of Bankruptcy, Not A Court of Equity, 79 AM. BANKR. L. J. 1, 2 (2005).
159. See generally JOHN NORTON POMEROY, A TREATISE ON EQUITY JURISPRUDENCE 282 (4th ed. 1918).
161. Id.
162. The Ninth Circuit is alone in refusing to recognize a federal ability to recharacterize debt. See Unsecured Creditors’ Comms. of Pac. Express, Inc. v. Pioneer Commercial Funding Corp., Inc., 69 B.R. 112 (B.A.P. 9th Cir. 1986).
Clause

The final important conflict the current debt recharacterization analysis is incompatibility with the uniformity required by the Bankruptcy Clause of the Constitution. That clause, which mandates that the rules applied by all bankruptcy courts be uniform, stands in clear contrast with the current structure of debt recharacterization law.

Firstly, individual federal circuits have established differing views on the doctrine. Not only do these analyses use distinct factors, but some courts flat out refuse to recognize the validity of debt recharacterization. Such disparate treatment is inconsistent with a fundamental purpose of the Bankruptcy Code, which seeks to provide identical standards for every bankruptcy court in the nation to the extent possible. Insolvency law and bankruptcy are not areas of law in which federal common law development has been applied. There is simply no basis for the differential treatment of debt recharacterization on a federal level among the circuits where the Bankruptcy Code is designed to provide as close to uniform results as possible.

State law debt recharacterization processes also contravene the uniformity envisioned by the Constitution. While state standards may not literally contradict existing case law, it is axiomatic that a federal standard would establish a more uniform standard among bankruptcy courts than application of potentially fifty different state standards.

163. See supra Part I(A)(4).
165. The following cases, each in federal bankruptcy court, applied different standards from one another. See Cohen v. KB Mezzanine Fund II LP (In re SubMicron Sys. Corp.), 432 F.3d 448, 455 n.8 (3d Cir. 2006); Fairchild Dornier GMBH v. Official Comm. of Unsecured Creditors (In re Official Comm. of Unsecured Creditors for Dornier Aviation (North America), Inc.), 453 F.3d 225, 233 (4th Cir. 2006); In re Pacific Express, Inc. v. Pioneer Commercial Funding Corp., 69 B.R. 112 (B.A.P. 9th Cir. 1986).
166. See In re Pacific Express, Inc. v. Pioneer Commercial Funding Corp., 69 B.R. 112 (B.A.P. 9th Cir. 1986).
167. The enactment of the Bankruptcy Code itself stems in part from the Constitutional mandate of bankruptcy uniformity. See U.S. CONST. art. I, § 8 (empowering Congress to enact “uniform Laws on the subject of Bankruptcies throughout the United States”).
168. See supra Part I(A)(2).
170. See supra Part I(A)(5).
Just because this degree of uniformity is not legally required does not mean that it should be abandoned as unachievable. Codification of debt recharacterization is a step in this exact direction, and would help put bankruptcy courts on track in the direction the Constitution envisioned.

E. Practical Impact on Corporate Law

The existing instability in the application of debt recharacterization has an effect on the business environment and corporate bankruptcy attorneys.

Lender hesitancy is especially concerning in business environments like the Silicon Valley, where emerging enterprises constantly shift between terms of profitability and loss. Special “bridge loans” are often utilized to provide short-term cash infusions to these companies to keep them on their feet in periods of financial infancy. A debt recharacterization scheme that is impossible to navigate means venture funds will be less willing to extend these bridge loans, for fear that, should the enterprise go bankrupt, those loans will be recharacterized and rendered virtually unrecoverable. With recharacterization codified and accompanied by clear standards, investors are provided with the increased predictability necessary to secure their loans with other tools. These lenders would be able to see from the outset the probability of recharacterization arising, and have the ability to compensate accordingly with other legal devices to secure the integrity of their investments.

The corporate acquisitions market may also abate from the uncertainty caused by inconsistent debt recharacterization standards on both state and federal levels. While this does not necessarily place the financial health of the acquiror at immediate risk, it nonetheless presents a level of uncertainty that can endanger relationships of the acquiror with the target’s creditors. A better strategy for the acquirer is perhaps simply to let the target corporation enter into bankruptcy and have the courts interpret the loans. Following bankruptcy, the acquirer can emerge and assume control free

172. Id.
of potential infirmities of the target corporation’s debt.174

F. Judicial Expense

Judicial resources are continuously wasted in dealing with the current debt recharacterization regime. In the example provided in the preceding paragraph, using the court system as an arbiter for corporate decisions is a clear waste of resources. Corporate attorneys will use the taxpayer as a tool for private acquisitions due to the uncertainty resulting from inconsistent recharacterization standards. Companies that could be saved from bankruptcy and kept out of the courts may be intentionally allowed to default so potential investors may start with a clean slate and greater certainty regarding their position with creditors.

Furthermore, the sheer number of differing standards imposes unnecessary adjudicative complexity. Courts approaching a recharacterization analysis will be burdened with having to balance federal versus state law on an issue. Once that choice is made, the question remains regarding what factors from each standard are relevant and should apply. Recharacterization is a manner of interpreting loans in the course of a bankruptcy, and need not be an area of law devoted to complex choice of law analysis.

G. Recharacterization under State Law is Inadequate

A position among those who have considered the proper remedy for the current debt recharacterization is that recharacterization should exist only under state law.175 The basis for this proposal is stated in Travelers Casualty & Surety Co. v. Pacific Gas & Electric Co.176 There, the Court articulated that it is a “settled principle [that] [c]reditors' entitlements in bankruptcy arise in the first instance from the underlying substantive law creating the debtor’s obligation, subject to any qualifying or contrary provision of the Bankruptcy Code.”177 That case in question involved the Fobian rule.178 The rule

177. Id. (quoting Raleigh v. Illinois Dept. of Revenue, 530 U.S. 15, 20 (2000)).
178. Id. at 1203.
asserted that where the litigated issue involves bankruptcy
issues, not basic contract issues, attorneys’ fees cannot be
collected absent a showing of certain circumstances.\textsuperscript{179} That
common law rule was developed through bankruptcy court
decisions rather than the exercise of a particular statutory
provision.\textsuperscript{180} The Court reasoned that since there was no
statutory support for the \textit{Fobian} rule in Bankruptcy Code
Section 502(b)\textsuperscript{181} (which is where the Code governs
disallowance of claims), the rule could not stand.\textsuperscript{182} Thus, state
law was applied and \textit{Fobian} rule struck down.\textsuperscript{183}

Proponents of a state-based recharacterization standard
also rely on a second case, \textit{Raleigh v. Illinois Department of
Revenue}.\textsuperscript{184} In that case, the Supreme Court considered
whether claims in bankruptcy should be considered based on
federal rules or a state specific standard.\textsuperscript{185} The federal rules,
while uniform, were not codified into the Bankruptcy Code.\textsuperscript{186}
The Court again focused on the uneven results from applying
a mix of federal or state law.\textsuperscript{187} Specifically, the Court noted
that it could not have been Congress’s intent that state and
federal courts produce rules that could lead to such conflicting
results.\textsuperscript{188} Critical in the Court’s reasoning in both \textit{Raleigh}
and \textit{Traveler’s Casualty Insurance} is the rule that in the absence of
a modification to the Bankruptcy Code, claims are determined
through state law.\textsuperscript{189} This sentiment has been echoed in other
rulings as well.\textsuperscript{190}

The above reasoning forms the backbone of the argument
for debt recharacterization under a state standard. The
proponents indicate the explicit standard for equitable
subordination in the Bankruptcy Code as noted by the Court

\textsuperscript{179} \textit{Id.} at 1203.
\textsuperscript{180} \textit{Id.} at 1207.
\textsuperscript{181} 11 U.S.C.A. § 502(b).
\textsuperscript{182} \textit{Travelers Casualty}, 127 S. Ct. at 1207.
\textsuperscript{183} \textit{Id.}
\textsuperscript{185} \textit{Id.} at 20.
\textsuperscript{186} \textit{Id.}
\textsuperscript{187} \textit{Id.} at 25–26.
\textsuperscript{189} \textit{Id.} at 20.
\textsuperscript{190} \textit{See} \textit{Butner v. United States}, 440 U.S. 48, 57, 54 (1979)); \textit{see also} \textit{Vanston Bondholders Protective Comm. v. Green}, 329 U.S. 156, 161 (1946) (“What claims of creditors are valid and subsisting obligations against the bankrupt at the time a petition in bankruptcy is filed, is a question which, in the absence of overruling federal law, is to be determined by reference to state law.”).
in its decisions on the matter.\textsuperscript{191} This is considered proof that the equitable powers of the court must still be grounded within the Code in order to be effectuated.\textsuperscript{192} Thus, recharacterization as an “equitable” remedy produced by a federal court simply is not sufficient. Proponents of a state law standard argue that debt recharacterization is a form of contract interpretation and should be governed by state law in the absence of federal standards.\textsuperscript{183} Currently of course, the Bankruptcy Code does not address recharacterization.\textsuperscript{194} Thus, absent any Congressional action to the contrary, Supreme Court precedent seems to dictate that debt recharacterization fall under state law.\textsuperscript{195}

State law proponents also argue that in addition to being consistent with Supreme Court jurisprudence, state law debt recharacterization provides the doctrinal stability so keenly needed.\textsuperscript{196} These proponents also indicate, as this comment does, that this stability will brighten the business climate for creditors, business insiders, and even third party investors.\textsuperscript{197} In support of this proposition, the laws of Wisconsin and Massachusetts are put forth as examples of functioning state recharacterization standards.\textsuperscript{198}

In citing each of these state standards for support, however, advocates for the state standard reveal the precise reason such a standard fails to help the recharacterization doctrine rescue itself from the current confusion.\textsuperscript{199} State courts will develop potentially fifty different methods of recharacterizing debt. Creditors will be subject to fifty different outcomes, and forum shopping will increase as these creditors seek favorable state law (for example through the use of forum selection clauses in loan instruments).\textsuperscript{200} While this

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\textsuperscript{192} Id. at 24–25.
\textsuperscript{194} See Bayer Corp. v. MascoTech, Inc., 269 F.3d 726, 748 (6th Cir. 2001).
\textsuperscript{196} Id. at 1278–79.
\textsuperscript{197} Id.
\textsuperscript{198} Id.
\textsuperscript{199} See id.
\textsuperscript{200} See M/S Bremen v. Zapata Off-Shore Co., 407 U.S. 1 (1972) (where the Court held forum selection clauses in federal courts presumptively valid and enforceable); In re Millennium Studios, Inc., 286 B.R. 300, 306 (D. Md. 2002) (“strong showing” of exceptional facts required to void forum selection
result still would seem to fit within the “uniformity” as technically permitted by the Court, it certainly contravenes the uniformity envisioned by Article I and the creation of federal bankruptcy courts intended to provide a uniform nationwide bankruptcy system.

Finally, state law proponents criticize existing federal court decisions applying federal standards for debt recharacterization. Specifically, the Roth Steel factors are targeted as being too vague to provide any degree of useful predictability. These factors however, must necessarily possess some degree of inchoateness so bankruptcy courts have the ability to fashion case-specific remedies in the discharge of their “equitable” duties. While the court’s equitable power is granted in the modern era by statute, bankruptcy courts are expected to weigh the merits of each individual case they adjudicate. Assuming that a bankruptcy court can indeed recharacterize debt, the Roth Steel factors are capable tools for giving a court the space to fashion appropriate case specific remedies while still providing the necessary foresight for attorneys to fashion effective loan agreements.

IV. TOWARDS CODIFICATION OF DEBT RECHARACTERIZATION IN THE BANKRUPTCY CODE

Debt recharacterization deserves to exist as an independent doctrine from equitable subordination. As stated previously, equitable subordination is a remedy in which a
creditor loan is subordinated based on some inequitable conduct by the creditor. 208 Debt recharacterization, which looks to whether a loan was even made in the first place, 209 provides a unique and important tool for analysis that should be utilized by bankruptcy courts. Simply choosing to not recognize the doctrine of recharacterization is as equally unacceptable as the present doctrinal chaos.

Thus, Congress should amend the Bankruptcy Code to include debt recharacterization as an express provision within. A clear, universal standard is needed to sufficiently address the inconsistency currently plaguing the doctrine. For the reasons mentioned above, a state law standard is insufficient. 210 Further, the matter cannot be simply left to the courts to develop through case law, as bankruptcy courts are limited to only a few explicitly enumerated areas in which to develop federal common law. 211

A distinct section of the Code setting forth the circumstances for use and factors to be applied in a recharacterization analysis facilitates the greatest degree of legal clarity and practical utility. Such a section should look very much like the existing Code section that sets forth the power of a court to equitably subordinate loans. 212 More specifically, codification of the Roth Steel factors 213 into the section is appropriate, which the majority of federal circuits already apply. 214 This enumeration of specific factors is of paramount importance. Creditors can structure their financings appropriately, having a greater degree of foresight as to the potential risk of their debt interests should bankruptcy result. The fact that no single factor controls the analysis, however, also preserves the flexibility of the courts to provide individualized remedies in each proceeding.


209. Id.

210. See supra Part III(G).

211. See supra Part I(A)(2).


213. See supra note 93.

214. See Cohen v. KB Mezzanine Fund II LP, 432 F.3d 448, 455 n.8 (3d Cir. 2006); Fairchild Dornier GMBH v. Official Comm. of Unsecured, 453 F.3d 225, 233 (4th Cir. 2006); Bayer Corp. v. MascoTech, Inc., 269 F.3d 726, 747–53 (6th Cir. 2001); Sender v. The Bronze Group, Ltd., 380 F.3d 1292, 1298 (10th Cir. 2004).
The most readily apparent benefit to the codification of debt recharacterization is the resulting doctrinal clarity. Specific factors enumerated in the Bankruptcy Code mean courts can look to a single source of law with explicit means for analysis. Since the Bankruptcy Code is federal law, it would preempt state law when exercised by the bankruptcy court undertaking the recharacterization analysis. Ideally, preemptive intent should also be explicitly stated in the statute or legislative history of the codified version of recharacterization for maximal clarity. The federal standard’s uniformity, while not strictly required by current constitutional jurisprudence, is nonetheless a benefit to incorporating debt recharacterization into the Code. Under the proposed approach, creditors would have no incentive to forum shop among courts with differing outlooks towards recharacterization.

Perhaps the only drawback to the creation of a federal standard is a federalism-based argument that addition of debt recharacterization to the Code takes away what should be a domain for state law, which of course normally governs the relationships between debtor and creditor. Debt recharacterization, a tool of loan interpretation, could thus be said to properly reside in state law as a tool purposed for defining creditor relationships. However, recharacterization is a remedy most commonly sought where entities enter into bankruptcy. Its inclusion in the Bankruptcy Code, a body of law used exclusively by federal courts, is equally appropriate. Federal law, which provides the power to adjudicate bankruptcies through Article I of the Constitution, is the proper place for a bankruptcy-centric

217. Every case in which the doctrine of debt recharacterization has arisen is in the context of a bankruptcy. See, e.g., Estes v. N & D Props., Inc., 799 F.2d 726 (11th Cir. 1986); Diasons Inc. v. Ingalls, 121 B.R. 626 (Bankr. N.D. Fla. 1990); Roth Steel Tube Co. v. Commissioner of Internal Revenue, 800 F.2d 625 (6th Cir. 1986).
doctrine like debt recharacterization. Nonetheless, should individual states desire to enact debt recharacterization-like provisions for use outside of the bankruptcy context, there is nothing stopping them from doing so. Recharacterization’s use in the bankruptcy context, however, should be reserved for bankruptcy courts under the Code.

CONCLUSION

The current approach to debt recharacterization is confusing in theory and unworkable in application. Simply eliminating the doctrine of debt recharacterization, however, is an abrogation of a valuable judicial tool, one that serves an important purpose independent from equitable subordination.

While some have called for recharacterization to incorporate as a select state law element of bankruptcy law, that proposal solves but a fraction of the issues plaguing the current system. Rather, a congressional mandate to incorporate recharacterization as a section of the Bankruptcy Code provides the best solution to establish both a uniform and useful debt recharacterization system.

Codification brings theoretical clarity and practical utility to the legal community. Corporate attorneys will enjoy the certainty of a uniform federal standard applying enumerated factors. Business transactions can be more confidently pursued, with everything from acquisitions to bridge loans being expedited because of this transparent standard. Finally, bankruptcy courts are spared the murky wade through multiple independent recharacterization approaches. A single body of federal recharacterization law can be developed, promoting judicial precision and efficiency.