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## Supreme Court to Decide Bankruptcy Test for Recharacterizing Insider Debt Claims

On June 27, 2017, the U.S. Supreme Court agreed to hear an appeal brought by Ropes & Gray of the Fourth Circuit's decision in *PEM Entities LLC v. Eric M. Levin & Howard Shareff*. The Supreme Court's decision in the case will have significant implications for business owners making debt investments, including rescue loans, and purchasing the distressed third-party debt of their companies. The question often arises in bankruptcy whether debt owed to an insider retains its status as debt or whether a bankruptcy court can "recharacterize" the insider debt as equity that is not entitled to recovery. The *PEM* case will decide whether a federal rule or state rules answer this question. The predominant federal rule gives bankruptcy courts considerable discretion to recharacterize debt as equity, while state rules often favor enforcement of insider debt.

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In the *PEM* case, a group of investors sought to develop a golf course with residences in North Carolina through a portfolio company, Province Grand Old Liberty, LLC ("Province Grand"). To finance the investment, Province Grand took out a bank loan secured by the real estate. When the loan went into default, members of the original equity investment group purchased the loan from the third-party bank at a steep discount. The purchase was motivated by a desire to protect the equity owners' leveraged investment. Had they not purchased the loan, the properties would have been lost to foreclosure. Ultimately, an out-of-court restructuring was unsuccessful and Province Grand filed a chapter 11 bankruptcy petition in the Eastern District of North Carolina. The insider equity sponsors, now owners of the first priority mortgage loan, sought to enforce that claim in bankruptcy. Disgruntled junior creditors sued the sponsors in bankruptcy court, arguing that the mortgage debt claim should be recharacterized as equity.

The bankruptcy court held in favor of the junior creditors, applying the Fourth Circuit's multi-factor federal test and treating the third-party loan as a capital contribution, effectively eliminating any recovery for the equity sponsors. The bankruptcy court recharacterized the debt as equity even though the court concluded that the sponsors had not engaged in any wrongful conduct. The federal multi-factor recharacterization test as applied by the Fourth Circuit gives broad power to bankruptcy courts to decide when debt should be treated as equity, even when the debt originated as arms' length, third-party bank debt. Many states' laws are more protective of debt investors. For example, had the bankruptcy court applied North Carolina law, the sponsors' claim likely would have been recognized as valid, enforceable secured debt, and the sponsors would have obtained a first-priority recovery in the bankruptcy.

U.S. Courts of Appeals are now split 5-2 on the issue of whether federal or state law governs debt recharacterization. A petition for certiorari from the Ninth Circuit, which applied a California state law rule of decision to debt recharacterization, is being held pending the Supreme Court's decision in the *PEM Entities* case. The Supreme Court's decision to resolve the circuit split will clarify the rules that determine the enforceability of insider debt investments.

Ropes & Gray's team includes appellate & Supreme Court partner [Douglas Hallward-Driemeier](#) and business restructuring partners [Jim Wilton](#), [Ross Martin](#), and [Gregg Galardi](#), as well as senior attorney [Gabrielle Hirz](#) and associate [Meredith Parkinson](#).