Debt Recharacterization Under State Law

*By James M. Wilton and Stephen Moeller-Sally**

The doctrine of debt recharacterization, as developed in the federal courts, imposes inconsistent and sometimes irrational standards on insiders who wish to support their business enterprises through periods of financial distress. Three conflicting lines of cases have evolved in the federal jurisprudence of debt recharacterization, two holding that debt recharacterization is a viable separate cause of action under the Bankruptcy Code and one holding that any such action has no statutory basis at all. This Article examines the flaws in these approaches and analyzes state law as a rational basis for developing a principled doctrine of debt recharacterization. Under long-standing legal principles, state law provides the proper framework for determining whether debt should be recharacterized as equity in bankruptcy cases. Drawing examples from Massachusetts and Wisconsin law, this Article shows that state law offers a higher degree of predictability concerning the enforcement of insider debt and may serve as a means for reconciling the conflicting and inconsistent tests applied by the federal courts.

During the past twenty years, debt recharacterization has displaced equitable subordination as a favored cause of action for bankruptcy trustees and creditors' committees seeking to invalidate loans or other debt claims held by insiders in bankruptcy cases. The reasons for the increasing popularity of debt recharacterization lawsuits are clear. Certain federal courts have recognized debt recharacterization as a "no fault" cause of action that does not require proof of inequitable conduct by the insider/creditor. As a result, a cause of action in federal court for debt recharacterization can be easier to prove than an action for equitable subordination.

Despite the recent evolution of the doctrine in federal courts, the origins of debt recharacterization are found in state law. In state courts, debt recharacterization may be treated less as an independent cause of action than as a defense to the enforcement of claims by insiders or as a remedy in a cause of action for equitable subordination. And in certain jurisdictions, state law is more protective of insider creditors, with standards for challenging the enforceability of insider debt based on equitable principles that are more difficult to satisfy than the prevailing federal tests.

This article examines the emergence of debt recharacterization as a cause of action recognized in certain federal courts, the conflicting legal standards applied in different federal circuits, and the failure of the more prevalent of the federal

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legal tests to provide a rule of law that would allow insider lenders to predict with any accuracy when debt held by insiders will be enforceable in bankruptcy. As a contrast to the confusion that exists in federal courts, this article examines debt recharacterization under state law, focusing on two jurisdictions, Massachusetts and Wisconsin, where the law is well developed.

The article reviews United States Supreme Court precedents that require that the allowance of claims in bankruptcy must be determined under state law and argues that state law is the proper source of law for debt recharacterization. Finally, the article concludes that reference to state law and the abandonment of inconsistent and unworkable federal tests will permit a reevaluation of the doctrine of debt recharacterization that will increase financing opportunities for companies in financial distress, place the burden of proof on insiders to prove their debt claims, and permit recharacterization of insider debt based on equitable principles.

I. Introduction: Equitable Subordination and the Treatment of Insider Claims Under the Bankruptcy Code

The doctrine of equitable subordination, as developed under the Bankruptcy Act, established the general principle that money loaned by corporate insiders is as green as money loaned by non-insiders; absent inequitable conduct, an insider's claim to recover a loan to a corporation ranks *pari passu* with claims of non-insider lenders.[1] The Supreme Court in establishing this doctrine overruled a line of earlier cases that had adopted a rigid, *per se* rule subordinating insider debt regardless of whether the insider had engaged in improper or inequitable conduct.[2]

In 1978, Congress endorsed and codified the existing Supreme Court case law of equitable subordination. Bankruptcy Code section 510(c)(1) gives bankruptcy courts express authority "under principles of equitable subordination" to subordinate insider or non-insider claims to claims of other creditors.[3] The Bankruptcy Code's legislative history makes clear that Congress "intended that the term 'principles of equitable subordination' follow existing case law and leave to the courts development of this principle."[4] It is also clear that Congress, by incorporating this provision into the Bankruptcy Code, rejected any *per se* subordination of insider debt.[5]

1. The case law under the Bankruptcy Act developed through a triad of U.S. Supreme Court cases: *Taylor v. Standard Gas & Elec. Co.,* 306 U.S. 307 (1939); *Pepper v. Litton,* 308 U.S. 295 (1939); and *Comstock v. Group of Inst. Investors,* 335 U.S. 211 (1948). In *Benjamin v. Diamond (In re Mobile Steel Co.),* 563 F.2d 692 (5th Cir. 1977), the United States Court of Appeals for the Fifth Circuit synthesized the existing case law into a concise, if open-ended, standard requiring "some type of inequitable conduct" as a prerequisite for equitable subordination of insider claims. *Id.* at 700. The United States Supreme Court has acknowledged the influence of the Fifth Circuit's holding in *Mobile Steel* requiring inequitable conduct as a precondition for equitable subordination and has declined, to date, to take a contrary position. *See* United States v. Noland, 517 U.S. 535, 538 (1996).

2. *See* Gannett Co. v. Larry, 221 F.2d 269, 275 (2d Cir. 1955) (holding that the Supreme Court case of *Comstock v. Group of Inst. Investors* renders untenable a strict rule subordinating insider claims).

3. 11 U.S.C. § 510 (c)(1) (2000).

4. 124 Cong. Rec. 32398 (1978).

5. The bill developed by the Commission on the Bankruptcy Laws of the United States, first introduced in the House of Representatives as House Bill 31 (H. R. 31, 94th Cong. (1976)) and introduced in the Senate as Senate Bill 236 (S. 236, 94th Cong. (1975)) contained a blanket subordination of all claims of insiders and their affiliates. Section 4–406(a)(2) of the Commission Bill provided that "any

Insider loans play an important role in supporting developing businesses that are experiencing financial distress and in facilitating reorganizations. It is desirable, therefore, to have a clear legal rule that will uphold insider debt, except in cases involving inequitable conduct. Under the modern doctrine of equitable subordination, which rejects *per se* subordination of insider debt, venture capital firms that could be deemed insiders are better able to provide bridge loans to allow portfolio companies to engage in orderly liquidations. Private equity firms and hedge funds are able to acquire both debt and equity in a company's capital structure without undue risk that debt claims will be subordinated if the company fails to meet its business plan. Entrepreneurs are able to justify personally lending money to ease their start-up businesses through temporary liquidity crises. In this way, settled case law and statutory authority governing equitable subordination of insider claims has struck a fair balance that affords a financially distressed company access to financing from the insider investors most familiar with its business. At the same time, there is an effective remedy to address abuse by insiders; insider loans may be subordinated to claims of other creditors if the insider has engaged in inequitable conduct.

This balance is threatened by the development in recent years of a federal doctrine that permits "recharacterization" of insider loans as equity contributions, even in situations where the insider lender has engaged in no inequitable conduct. The cause of action for "debt recharacterization" as it has been recognized in federal courts is ill defined, with three separate, conflicting lines of cases, two holding, based on different legal standards, that debt recharacterization is a viable separate cause of action under the Bankruptcy Code and one holding that a cause of action for debt recharacterization is not authorized under the Bankruptcy Code. This article contends that each of these holdings is wrong. Debt recharacterization has existed for many years as a viable defense to a claim and as a remedy under state law. Two lines of federal cases are flawed in that they adopt a court-created, federal cause of action for debt recharacterization contrary to Supreme Court precedent that requires allowance or disallowance of claims based on state law. The third line of cases is flawed in that it fails to recognize the viability of debt recharacterization as a state law remedy.

The next section of this article, Part II, summarizes the split among federal cases addressing debt recharacterization. Part III examines the doctrine of debt recharacterization under state law, focusing on Massachusetts and Wisconsin state law as examples of established approaches to the enforceability of insider claims in state

claim, whether secured or unsecured, of any principal officer, director, or affiliate of a debtor, or of any member of the immediate family of such officer, director, or affiliate" would be "subordinated in payment to all other nonsubordinated but allowable claims." S. 236, 94th Cong. (1975). Congress rejected this statutory language and the concept of a blanket subordination of all claims of insiders. 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 prevailing authority: "This Section is intended to codify case law such as *Pepper v. Litton,* 308 U.S. 295 (1939)... and is not intended to limit the court's power in any way.... The court's power is broader than the general doctrine of equitable subordination, and encompasses subordination on any equitable grounds." H.R. REP. NO. 95–595, at 359 (1978).

courts. In Part IV, this article argues based on settled principles derived from a long line of Supreme Court cases, that debt recharacterization should be determined with reference to state law.[6] Finally, Parts V and VI conclude that state law provides both greater certainty concerning the enforcement of debt held by insiders and a means for reconciling the conflicting and enigmatic tests applied in federal courts.

II. Debt Recharacterization Under Federal Law

At least three separate lines of cases address the doctrine of debt recharacterization under federal law. The Court of Appeals for the Eleventh Circuit has adopted a simple test that requires recharacterization of insider debt as equity in any situation where an advance by an insider was made at a time when no other disinterested lender would have extended credit. In contrast, the Courts of Appeals for the Third, Fourth, Sixth, and Tenth Circuits endorse the use of open-ended, multifactor tests to determine whether insider loans should be recharacterized as equity. The Bankruptcy Appellate Panel for the Ninth Circuit has held that bankruptcy courts lack the authority to recharacterize debt as equity, noting correctly that no specific provision of the Bankruptcy Code authorizes debt recharacterization, and holding that the Bankruptcy Code's general equity powers do not permit recharacterization of insider loans.

A. The Eleventh Circuit's Objective, Inflexible Approach to Debt Recharacterization

In determining whether an insider loan may be recharacterized as a capital contribution, the Court of Appeals for the Eleventh Circuit in *Estes v. N & D Properties, Inc.* has adopted an alternative two-pronged test. "[S]hareholder loans may be deemed capital contributions in one of two circumstances: where the trustee proves initial under-capitalization or where the trustee proves that the loans were made when no other disinterested lender would have extended credit."[7] The *N&D Properties* court's adoption of this test is puzzling in several respects. In the first place, the test seems to have been invented without citation to relevant precedent.[8] In the second place, the *N&D Properties* court held that a minority stockholder and lender

6. *See* Travelers Cas. & Surety Co. v. Pac. Gas & Elec. Co., 127 S. Ct. 1199 (2007); Raleigh v. Ill. Dept. of Revenue, 530 U.S. 15 (2000); Butner v. United States, 440 U.S. 48 (1979); Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156 (1946).

7. Estes v. N & D Props., Inc. (*In re* N&D Props., Inc.), 799 F.2d 726, 733 (11th Cir. 1986).

8. The only case that the *N&D Properties* court cites for support is a Fifth Circuit decision under the Bankruptcy Act, *Mach. Rental, Inc. v. Herpel (In re Multiponics, Inc.),* 622 F.2d 709 (5th Cir. 1980). *N & D Props., Inc.,* 799 F.2d at 733. The *Multiponics* case, however, involved a claim for equitable subordination, not debt recharacterization. Furthermore, nothing in the *Multiponics* case can be read as establishing a *per se* rule subordinating insider loans in all situations where debt financing is unavailable from third party sources. To the contrary, the *Multiponics* court considered the non-availability of debt financing from third party sources as evidence of undercapitalization, *Multiponics,* 622 F.2d at 719, but articulated a test that required evidence of misconduct that resulted in injury to creditors or the conferring of unfair advantages on the insider/claimant before debt would be equitably subordinated. *Id.* at 713.

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was a fiduciary of creditors of the corporation, again without citation to state law precedent.[9]

Finally, the most puzzling and disturbing aspect of the *N&D Properties* test is the court's conclusion that a shareholder loan should *per se* be deemed a capital contribution if a debtor corporation could not obtain a loan from a disinterested lender on the same terms.[10] This holding, if followed, would preclude shareholders, in many circumstances, from providing debt financing except through bankruptcy court approved debtor-in-possession financing.[11] The *N&D Properties* test denies distressed corporations access to debt financing from insider investors, even when insiders may be acting in the best interests of the corporation.

The *N&D Properties* decision is distinctly a minority approach to debt recharacterization. The case has failed to gain traction and has been cited as precedent primarily by lower courts in the Eleventh Circuit.[12]

B. The Third, Fourth, Sixth, and Tenth Circuits' Subjective, Flexible, Multi-Factor Approach to Debt Recharacterization

In jurisdictions that have accepted a bankruptcy court's authority to recharacterize insider loans as capital contributions, several courts have adopted one or more multi-factor tests for determining when insider debt may be recharacterized as an equity contribution.[13] These multi-factor tests are derived from U.S. tax decisions related to the tax benefits of insider loans. The most commonly cited of these tests is the eleven-factor test first articulated in *Roth Steel Tube Co. v. Commissioner of Internal Revenue*,[14] in which consideration is given to the following factors:

9. The only facts cited by the *N&D Properties* court to support the status of the stockholder/lender in that case as a fiduciary was that the minority stockholder, a housewife without prior business experience: (i) served as secretary of the corporation, (ii) engaged legal counsel and a financial consultant to evaluate the corporation's options, although the advice of these professionals was never implemented, and (iii) took action to file a bankruptcy petition for the corporation. *N & D Props., Inc.,* 799 F.2d at 731–32.

10. *Id.* at 733.

11. Indeed, it could be argued that the *N&D Properties* standard, if applied consistently, would prevent even post-petition loans by insiders. This is because a debtor-in-possession is authorized to obtain secured credit post-petition only upon a showing that the loans are necessary and that no other credit is available on better terms. *See* 11 U.S.C. § 364(c) (2000) (authorizing court approval of secured credit only if a debtor-in-possession is unable to obtain unsecured credit); *see also In re* W. Pac. Airlines, Inc., 223 B.R. 567, 572 (Bankr. D. Colo. 1997); *In re* Aqua Assocs., 123 B.R. 192, 196 (Bankr. E.D. Pa. 1991) ("[C]redit should not be approved . . . when funds are readily available from insiders or others without providing the lender with the benefits of any priority."); *In re* Ames Dept. Stores, Inc., 115 B.R. 34, 37 (Bankr. S.D.N.Y. 1990).

12. *See, e.g.,* Diasonics Inc. v. Ingalls, 121 B.R. 626, 630 (Bankr. N.D. Fla. 1990).

13. *See* Bayer Corp. v. MascoTech, Inc. (*In re* Autostyle Plastics, Inc.), 269 F.3d 726, 747–53 (6th Cir. 2001); 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); Sender v. The Bronze Group, Ltd. (*In re* Hedged-Invs. Assocs., Inc.), 380 F.3d 1292, 1298 (10th Cir. 2004). Various multifactor tests are identified in *In re SubMicron Sys.,* 432 F.3d at 455 n. 8. The tests overlap as to the factors considered and are very similar, if not identical. *Dornier Aviation,* 453 F.3d at 234 n.6 ("The substance of all of these multifactor tests is identical.").

14. 800 F.2d 625, 630 (6th Cir. 1986), *cert. denied,* 481 U.S. 1014 (1987).

(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 interest rate and interest payments;
(4) the source of repayments;
(5) the adequacy or inadequacy of capitalization;
(6) the identity of interests between the creditor and stockholder;
(7) the security, if any, for the advances;
(8) the corporation's ability to obtain financing from outside lending institutions;
(9) the extent to which the advances were subordinated to the claims of outside creditors;
(10) the extent to which the advances were used to acquire capital assets; and
(11) the presence or absence of a sinking fund to provide repayments.

The debt recharacterization cases that engage in a multi-factor analysis emphasize that the process involves an open-ended inquiry. The number of factors reviewed varies from case to case.[15] Courts agree that the weight given to the factors can vary and that no one factor is controlling.[16] Courts also agree that a creditor's status as an insider and the undercapitalization of the debtor are, standing alone, insufficient to support debt recharacterization.[17]

The multiple factors considered by the courts focus on the circumstances and terms of the insider loans rather than the conduct of the insider in administering the loans. This is because the courts, in an effort to distinguish debt recharacterization as a cause of action that is separate and apart from equitable subordination, have concluded that debt recharacterization is a process of divining intent rather than determining fault.[18] However, courts have held that creditor behavior may be relevant to the debt recharacterization analysis if it allows an inference as to the creditor's intent that an advance was essentially debt or equity at the time it was made.[19]

One difficulty with a divination process based on intent and an evaluation of transaction terms is that modern financing concepts recognize a continuum be-

15. *See In re SubMicron Sys.,* 432 F.3d at 455 n.8 (noting use of eleven-factor, thirteen-factor, and seven-factor tests in reported cases).

16. See *id.* at 456 ("No mechanistic scorecard suffices."); *Dornier Aviation,* 453 F.3d at 234 ("This test is a highly fact-dependent inquiry that will vary in application from case to case."); *Hedged-Invs.,* 380 F.3d at 1298–99 ("None of these factors is dispositive and their significance may vary depending on circumstances.").

17. *See Dornier Aviation,* 453 F.3d at 234.

18. *See SubMicron Sys.,* 432 F.3d at 456 (the court's "overarching inquiry" is to "discern whether the parties called an instrument one thing when in fact they intended it as something else"); *Dornier Aviation,* 453 F.3d at 232 ("While a bankruptcy court's recharacterization decision rests on the *substance of the transaction* giving rise to the claimant's demand, its equitable subordination decision rests on its assessment of the *creditor's behavior.*") (emphasis in original).

19. *See SubMicron Sys.,* 432 F.3d at 456 ("intent may be inferred from what the parties say in their contracts, from what they do through their actions, and from the economic reality of the surrounding circumstances").

tween debt and equity.[20] For example, debt instruments that do not provide for current, periodic payment of interest evidence a greater reliance on the long term profitability of a business than debt instruments that require periodic interest. These instruments, therefore, have a risk profile that is closer to an equity investment. Of course, it is not unusual for a company to obtain financing through issuance of zero coupon bonds that do not require periodic interest payments. Similarly, normal loan terms for many distressed companies address cash flow constraints with discretionary deferral of interest through use of payment-in-kind or PIK debt instruments. Recently, private equity buyers have financed acquisitions with so-called PIK-toggle debt, which affords the borrower discretion to make interest payments in cash or in kind.[21] High yield subordinated debt is not only common in many bankruptcy cases, it is known colloquially as "mezzanine debt" because of its transitional place between debt and equity in the capital structure.[22] Convertible debt is also common and is routinely enforceable as debt under state law, yet the investment decision may include an analysis of both the long term prospects of the company and credit terms, in the form of lower interest rates or deferred interest, that reflect the benefits of the debt's equity conversion feature.[23] Multi-factor tests, to the extent they are applied rigidly and without regard to creditor behavior, would limit the permissible range of debt that can safely be incurred by insider creditors of distressed companies to short term, secured debt with interest that is paid currently and in cash.

Another difficulty in applying the multi-factor, *Roth Steel*-type tests is that courts differ as to the meaning and weight given to the various factors.[24] Some courts have viewed debt issued pursuant to demand notes as demonstrating that an advance is capital and not a loan.[25] Other courts have disagreed.[26] The *Cold Harbor* court viewed debt advanced by equity holders in the same proportions as their equity interests as "the most critical factor" in its analysis.[27] However, other courts have held that debt may be recharacterized as equity where the holder of the debt had no equity interest at all in the debtor but had "pervasive" *de facto*

20. *See generally* Charles P. Normandin, *The Changing Nature of Debt and Equity: A Legal Perspective,* in ARE THE DISTINCTIONS BETWEEN DEBT AND EQUITY DISAPPEARING? (Richard W. Kopcke and Eric S. Rosengren, eds., Proceedings of a Conference Held at Melvin Village, New Hampshire, Oct. 1989).

21. Henny Sender, *What's Aiding Buyout Boom: Toggle Notes*, WALL ST. J., February 21, 2007.

22. See COOPERS & LYBRAND L.L.P., GUIDE TO FINANCIAL INSTRUMENTS, at 157 (3d ed.1994) (defining "mezzanine debt" as subordinated debt in leveraged buyouts where the debt occupies a place in seniority immediately above that of common stock).

23. Michael Aneiro, *Convertible Bonds Stage Comeback*, WALL ST. J., October 25, 2006 (noting recent resurgence of interest in convertible debt driven in part by hedge funds engaging in convertible arbitrage strategies based on discrepancies between the price of an issuer's convertible bonds and its stock price).

24. Hilary A. Goehausen, Comment, *You Said You Were Going To Do What To My Loan? The Inequitable Doctrine of Recharacterization,* 4 DEPAUL BUS. & COM. L.J. 117 (2005).

25. *See In re* Cold Harbor Assocs., 204 B.R. 904, 917–18 (Bankr. E.D. Va. 1997); *see also Dornier Aviation,* 453 F.3d at 234 (citing the lack of a fixed maturity date as one of four factors deemed "particularly significant").

26. *See Autostyle Plastics,* 269 F.3d at 750 ("use of demand notes along with a fixed rate of interest and interest payments is more indicative of debt than equity"); *In re* Phase I Molecular Toxicology, Inc., 287 B.R. 571, 577 (Bankr. D. N.M. 2002).

27. *Cold Harbor,* 204 B.R. at 918.

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control over the debtor's operations.[28] One court has even indicated that debt may be recharacterized as an equity contribution where the debtor is a natural person.[29] In short, the *Roth Steel* factors have been applied inconsistently and, as a result, it may be difficult to predict or justify the outcome of debt recharacterization cases in jurisdictions applying multi-factor tests.

To the extent that generalities can be drawn from the outcome of cases, courts applying the *Roth Steel* factors tend to find debt enforceable if the insider obtained and enforced contract rights as if the insider were an arm's length creditor.[30] However, courts also seem to view insiders as fiduciaries and to express concern if an insider obtains security or enforces rights to the detriment of other creditors.[31] The single factor that is most commonly present in cases in which courts recharacterize debt as equity is belated, unconventional, or inadequate loan documentation.[32] This factor indicates a concern of the courts that insiders not adopt a revisionist and self-serving view of the terms of cash advances as a company

28. Aquino v. Black (*In re* AtlanticRancher, Inc.), 279 B.R. 411, 435 (Bankr. D. Mass. 2002); Matrix IV, Inc. v. American National Bank & Trust Co. of Chicago (*In re* S.M. Acquisition Co.), No. 05 C 7076, 2006 WL 2290990, at *5 (N.D. Ill. Aug. 7, 2006). Other courts have rejected the argument that *de facto* control by non-stockholder lenders can be a basis for debt recharacterization, at least where lenders have failed to exercise voting rights or other control pursuant to loan documents. *See* Official Comm. of Unsecured Creditors Of Radnor Holdings Corp. v. Tennenbaum Capital Partners, LLC (*In re* Radnor Holdings Corp.), 353 B.R. 820, 840–41 (Bankr. D. Del. 2006).

29. Wilson v. Moir (*In re* Wilson), Adv. No. 06–1063, 359 B.R. 123, 139–41 (Bankr. E.D. Va. Dec. 27, 2006).

30. *See SubMicron Sys.*, 432 F.3d at 456 (analysis of factors is to the end of determining whether "the party infusing funds does so as a banker (the party expects to be repaid with interest no matter what the borrower's fortunes; therefore the funds are debt) or as an investor (the funds infused are repaid based on the borrower's fortunes; hence they are equity)"); *see also* Fidelity Bond & Mortgage Co. v. Brand (*In re* Fidelity Bond & Mortgage Co.) 340 B.R. 266, 303 (Bankr. E.D. Pa. 2006) (debt issued to former shareholders in leveraged buy out for tax reasons was recharacterized as equity where company projections contemplated no amortization for five years), *aff'd,* 371 B.R. 708 (E.D. Pa. July 18, 2007).

31. *See* Cent. Coops., Inc. v. Irwin (*In re* Colonial Poultry Farms), 177 B.R. 291, 300 (Bankr. W.D. Mo. 1995) (failure to enforce unsecured notes at maturity held not to warrant recharacterization where ten year limitations period for collection had not expired, finding it "noteworthy" that insiders did not seek a judgment lien that would elevate their unsecured claims over claims of other creditors).

32. *See Dornier Aviation,* 453 F.3d at 236 (recharacterizing long-term inter-company debt as equity where prepetition audit had failed to validate an internal reconciliation of accounts and post-audit transactions had been conducted on the same basis); *Cold Harbor,* 204 B.R. at 916–17 (noting "troubling lack of formalities" where notes were drawn up seven months after advances were made, notes were payable on demand but contained superfluous provisions related to acceleration of maturity date, and notes were not asserted as basis for debt until a year and a half after commencement of the bankruptcy case); *In re* The Villas at Hacienda Del Sol, Inc., 364 B.R. 702, 708 (Bankr. D. Ariz. 2007) (evidence that alleged debt was originally treated on debtor's books as equity coupled with insider creditor's failure to document claim warranted recharacterization); Citicorp Real Estate, Inc. v. PWA, Inc. (*In re* Georgetown Bldg. Assocs., L.P.), 240 B.R. 124, 130–31 (Bankr. D. D.C. 1999) (notes issued months or years after advances in stated principal amount of advances without interest accrual; advances had previously been treated in filed tax returns as capital contributions); *In re* Union Meeting Partners, 160 B.R. 757, 774 (Bankr. E.D. Pa. 1993) (partners' "loans" to partnership not documented by notes, and contemporaneous financial statements of the debtor did not list advances as debt); Leesa Bunch & McMasker Enters., Inc. v. J.M. Capital Fin., Ltd. (*In re* Hoffinger Indus., Inc.), 327 B.R. 389, 410 (Bankr. E.D. Ark. 2005) (purported loans "poorly, inaccurately, and

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encounters financial difficulty. But even the presence of this factor does not warrant debt recharacterization in all cases.[33]

The difficulty that courts have encountered in consistently applying the *Roth Steel* factors in bankruptcy cases may arise, in part, from what some courts have opined is an improper application of tax court precedents in the very different context of priority disputes in bankruptcy.[34] Indeed, it seems misguided for bankruptcy courts to look to tax cases as precedent to recharacterize loans advanced to an insolvent corporation. This is because the focus of the tax court's inquiry is whether, as between the corporation and the investor, a loan has a valid economic basis as debt, or, in contrast, is without economic substance other than to generate a tax benefit (such as deductibility of interest or allowance of a bad debt deduction as an ordinary loss rather than a capital loss). Tax cases often involve solvent corporations where the repayment of funds advanced by insiders is never in question and the choice between debt and equity as an investment vehicle is a matter of tax planning.[35] By contrast, a loan to a corporation in difficult financial straits is normally advanced as debt in order to achieve economic parity with third party creditors (or economic seniority in the case of a secured loan). In the context of a tax case, such a loan would likely be respected as a transaction that is a loan in substance as well as form.[36]

In a bankruptcy case, application of standards from tax cases involving solvent corporations can result in an Alice in Wonderland effect such that the worse the debtor corporation's financial situation and the riskier the insider's loan, the more the application of the factors weighs in favor of deeming the creditor as having intended the loan to be a capital contribution. For example, the *Roth Steel* factors consider "adequacy or inadequacy of capitalization" at the time of an advance as a factor that bears on whether an advance is intended as debt or as an equity contribution. If a corporation is solvent but thinly capitalized, this factor may have some bearing on the investor's expectation as to the timing of repayment and the investor's choice between acquiring debt or equity. But if a corporation is insolvent,

incompletely documented"); Algonquin Power Income Fund v. Ridgewood Heights, Inc. *(In re* Franklin Indus. Complex, Inc.), No. 01-67459, Adv. No. 06-80254, 2007 WL 2509709, at * 16 (Bankr. N.D.N.Y. Aug. 30, 2007) (lack of documentation evidencing debt and existence of loan covenants prohibiting incurrence of the insider debt "argue strongly" against dismissal of complaint); *In re* Newfound Lake Marina, Inc., No. 04-12192-MWV, 2007 WL 2712960, at * 7 (Bankr. D. N.H. Sept. 14, 2007) (recharacterizing insider debt where "tax returns do not jibe with the ledgers, and the balance sheets do not always jibe witht the tax returns").

33. *See SubMicron Sys.*, 432 F.3d at 458 (debtor's failure to issue notes for one tranche of a multiple year financing and other "numerous mistakes and errors when generating notes" did not warrant debt recharacterization); *In re* Internet Navigator, Inc., 289 B.R. 133, 137 (Bankr. N.D. Iowa 2003) (refusing to recharacterize insider debt, finding lack of promissory notes or other loan documentation "not surprising" given the debtor's status as a small, closely held corporation).

34. *See* Rego Crescent Corp. v. Tymon (*In re* Rego Crescent Corp.), 23 B.R. 958, 962 (Bankr. E.D.N.Y. 1982); James H.M. Sprayregen, Jonathan Friedland & James R. Meyer, *Recharacterization from Debt to Equity: Lenders Beware,* 22 Am. Bankr. Inst. J. 30 (Nov. 2003) (quoting *In re* Outboard Marine Corp., Case No. 00-B-37405 (N.D. Ill. Jan. 14, 2002) (Barliant, J.)).

35. *See, e.g.,* Indmar Products Co. v. Comm'r of Internal Revenue, 444 F.3d 771, 781 (6th Cir. 2006).

36. *See Roth Steel,* 800 F.2d at 630 ("The determination of whether advances to a corporation are loans or capital contributions depends on whether the objective facts establish an intention to create an unconditional obligation to repay the advances.").

no rational investor would choose to buy equity that is "out of the money" and most likely worthless. At the very least, one would think that insolvency should be viewed as evidence supporting an investor's assertion that it was legitimately concerned about repayment of its advance and intended that the advance would be treated as debt. Nevertheless, bankruptcy cases continue to apply this factor as if insolvency is somehow evidence that an investor that has advanced funds nominally as debt must have intended to make an equity contribution.[37] Similarly, in tax cases, if the source of repayment of the loan depends upon liquidation of capital assets, the Internal Revenue Service views the debt as having attributes of an equity contribution. In the insolvency context, however, if the debt is a short term bridge loan, the only source of repayment may be sale of the business and liquidation of capital assets. In this way, the standards used in solvent tax cases can be worse than irrelevant in judging an insider creditor's intent in lending to an insolvent corporation.

In practice, courts applying the *Roth Steel* factors tend to be circumspect in recharacterizing debt as equity out of concern that "excessive suspicion about loans made by owners and insiders of struggling enterprises would discourage legitimate efforts to keep a flagging business afloat."[38] Debt recharacterization is applied only in cases involving insiders and a surprising number of reported decisions have refused to recharacterize insider debt as equity.[39]

For companies in financial difficulty, the flexibility of the multi-factor approach has advantages over the Eleventh Circuit's more draconian approach to debt recharacterization. Unlike the objective analysis based on the availability of financing from disinterested, third party lenders, the multi-factor test does not result in a *per se* recharacterization of insider debt in situations where debt financing from insiders is the only financing source. To the extent that insiders can trust that their loans will be enforced as debt under the more lenient, multi-factor approach, this will increase financing options for companies facing financial distress.

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37. *See Autostyle Plastics,* 269 F.3d at 751 (noting that capitalization is to be examined not only at the time of formation of the corporation, but at the time of the advances at issue, and observing that "[t]hin or inadequate capitalization is strong evidence that the advances are capital contributions rather than loans"); Official Comm. of Unsecured Creditors v. Foss (*In re* Felt Mfg. Co.), 371 B.R. 589, 632 (Bankr. D. N.H. July 27, 2007) (complaint alleging that a subordinated loan was advanced by a preferred stockholder to an undercapitalized debtor that could not obtain capital from outside lenders states a "plausible claim" for recharacterization).

38. *Hedged-Invs. Assocs.*, 380 F.3d at 1298 n.1.

39. *See e.g., SubMicron Sys.*, 432 F.3d at 458; *Autostyle Plastics,* 269 F.3d at 752; *Hedged-Invs. Assocs.,* 380 F.3d at 1299; Adelphia Communications Corp. v. Bank of Am., N.A. (***In re*** Adelphia Communications Corp.), 365 B.R. 24, 73–75 (S.D.N.Y. 2007); Viera v. AGM II, LLC (***In re*** Worldwide Wholesale Lumber, Inc.), 372 B.R 796, 811–12 (Bankr. D. S.C. May 21, 2007); ***In re*** Micro-Precision Techs., Inc., 303 B.R. 238, 247–48 (Bankr. D.N.H. 2003); Blasbalg v. Tarro (*In re* Hyperion Enters., Inc.), 158 B.R. 555, 561–62 (D. R.I. 1993); *Radnor Holdings,* 353 B.R. at 838; Congress Fin. Corp. v. Airwick Int'l, LLC (*In re* Airwalk Int'l, LLC), 305 B.R. 34, 41 (Bankr. D. Colo. 2003); *Phase-I Molecular Toxiciology,* 287 B.R. at 578; *In re* Medical Software Solutions, 286 B.R. 431, 444 (Bankr. D. Utah 2002); *Internet Navigator,* 289 B.R. at 137; *see also AtlanticRancher,* 279 B.R. at 437–38 (recharacterizing a $300,000 convertible loan by a lender that had blocked acceptance of cash offers sufficient to pay the note in full, but refusing to recharacterize a later $225,000 short term bridge loan by the same lender).

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However, the multi-factor test also has the significant drawback of uncertainty. The test is fact-specific and courts disagree as to the importance of the factors involved. Modern debt instruments that provide for loan subordination or payment-in-kind interest, or instruments that are unsecured, will fail to satisfy one or more of the *Roth Steel* factors, even though this debt would be enforceable under state law. In addition, because the multi-factor test is applicable whether or not an insider lender acts equitably or inequitably, a cause of action for debt recharacterization may not be easily resolved without a trial, even if the insider/lender can show that it acted equitably and in good faith.[40] For these reasons, debt recharacterization based on application of the *Roth Steel* factors introduces significant legal risk for insider lenders and inhibits the availability of credit to troubled companies.[41]

C. The Ninth Circuit's Rejection of the Bankruptcy Court's Authority to Recharacterize Debt as Equity

A minority of courts have held that bankruptcy courts lack authority to recharacterize insider loans as capital contributions.[42] In *Pacific Express*, the Ninth Circuit Bankruptcy Appellate Panel held that, while the Bankruptcy Code grants a bankruptcy court authority to allow or disallow claims, the law does not permit recharacterization of debt as a capital contribution.[43] The *Pacific Express* court noted that the result of debt recharacterization is subordination of a claim and held that because a specific statutory provision, Bankruptcy Code section 510(c), governs claim subordination, it is improper to allow the bankruptcy court to recharacterize debt under different legal standards based on the court's equitable powers.[44]

40. Because of the fact intensive nature of the debt recharacterization analysis, appellate courts generally will review a trial court's determination only for clear error. *See SubMicron Sys. Corp.,* 432 F.3d at 457; *Dornier Aviation,* 453 F.3d at 235. *But see* Celotex Corp. v. Hillsborough Holdings Corp. (*In re* Hillsborough Holdings Corp.), 176 B.R. 223, 248 (M.D. Fla. 1994) (citing Lane v. United States (*In re* Lane), 742 F.2d 1311 (11th Cir. 1984) in holding that appellate review is *de novo*).

41. That debt recharacterization risk affects capital markets can be seen from the fact that financing transactions are commonly structured with indirect credit support from insiders, but with the loans coming from third party lenders. These transaction structures permit equity sponsors or other insiders to minimize debt recharacterization risk by "hiding behind the skirts" of arm's length, third party lenders. Structures under which equity sponsors can provide credit support for loans advanced by third party lenders range from straightforward guarantees of bank loans (with the insider/guarantor holding enforceable subrogation rights following payment of the guaranty), to put option agreements pursuant to which a stockholder contracts with a third party lender to acquire loans in the event of a default, to credit default swaps (with delivery of debt instruments to the insider/insurer as a condition for exercise of rights), to junior participations by insiders in third party loans. Whether these transaction structures are always effective to avoid debt recharacterization risk is an open question. *See Autostyle Plastics,* 269 F.3d at 749 n.12 (holding that court must consider the *Roth Steel* factors in determining whether subordinated loan participations held by insiders should be recharacterized as equity contributions).

42. *See* Unsecured Creditors' Comms. of Pac. Express, Inc. v. Pioneer Commercial Funding Corp., Inc. (*In re* Pac. Express, Inc.), 69 B.R. 112, 115 (B.A.P. 9th Cir. 1986); Pinetree Partners, Ltd. v. State Teachers Ret. Sys. of Ohio (*In re* Pinetree Partners, Ltd.), 87 B.R. 481, 491 (Bankr. N.D. Ohio 1988).

43. *Pac. Express,* 69 B.R. at 115.

44. *Id.* In contrast, at least one district court has held that causes of action for debt recharacterization can only be brought in bankruptcy court. ***See*** Arena Dev. Group, LLC v. Naegele Communications,

III. Debt Recharacterization Under State Law

The law of many states recognizes debt recharacterization as a potential defense to the enforceability of insider loans.[45] Massachusetts and Wisconsin are two states in which the law of debt recharacterization is both well developed and in conflict with prevailing federal debt recharacterization cases.

A. Massachusetts Law

Massachusetts law has long provided that debt recharacterization can be a remedy in a cause of action for equitable subordination. Massachusetts court decisions strike a balance between public policy interests in respecting the separation of stockholders from the corporation and preventing fraud or abuse of corporate forms by insiders. As the Massachusetts Supreme Judicial Court has noted:

> We must start . . . by accepting the consequences of the theory that a corporation is an entity separate from the stockholders and officers. These may be creditors and even

Inc., No. 06-2806 ADM/AJB, 2007 WL 2506431, at * 7 (D. Minn. Aug. 30, 2007) ("Declaratory relief for recharacterization of debt to equity and equitable subordination are not cognizable causes of action in federal district court.").

45. *See, e.g.,* Weyerhaeuser Co. v. Clark's Material Supply Co., Inc., 413 P.2d 180 (Idaho 1966); Obre v. Alban Tractor Co., 179 A.2d 861 (Md. 1962); Albert Richards Co. v. The Mayfair, 191 N.E. 430 (Mass. 1934); Yankee Microwave, Inc. v. Petricca Commc'n Sys., Inc., 760 N.E.2d 739, 759 (Mass. App. Ct. 2002) (citing Friedman v. Kurker, 438 N.E.2d 76, 80 (Mass. App. Ct. 1982)); Schaub v. Kortgard, 372 N.W.2d 427, 430 (Minn. Ct. App. 1985); Anderson Excavating & Wrecking Co. v. Argus Dev. Co., No. A-01–068, 2002 WL 31747248, at *12 (Neb. Ct. App. Dec. 10, 2002); Lascsak v. Hollingsworth, No. A-04–666, 2006 WL 786455, at *6–7 (Neb. Ct. App. Mar. 28, 2006); Hanewald v. Bryan's Inc., 429 N.W.2d 414, 417 n.3 (N.D. 1988); Houston's Inc. v. Hill, 826 P.2d 644, 646–47 (Or. Ct. App.), *review denied,* 833 P.2d 1283 (Or. 1992); Tanzi v. Fiberglass Swimming Pools, Inc., 414 A.2d 484 (R.I. 1980); Waller v. American Int'l Distrib. Corp., 706 A.2d 460, 464 (Vt. 1997); Gelatt v. DeDakis (*In re* Mader's Store for Men, Inc.), 254 N.W.2d 171, 185–87 (Wis. 1977); *see also* Continental Oil Co. v. Pauley Petroleum, Inc., 251 A.2d 824, 826 (Del. 1969) (remanding for trial court to determine whether intercompany "advance" is enforceable as a loan). In addition to case law, statutes in various states are relevant to the enforceability of insider loans. *See, e.g.,* Delaware Revised Uniform Partnership Act, Del. Code Ann. tit. 6, § 15-119 (2001) ("Except as provided in the partnership agreement, a partner may lend money to . . . the limited partnership and, subject to other applicable law, has the same rights and obligations with respect thereto as a person who is not a partner."); Delaware Revised Uniform Limited Partnership Act, Del. Code Ann. tit. 6, § 17-107 (2001). One of the more interesting state statutes that addresses the enforceability of insider debt against an insolvent company is Section 5(b) of the Uniform Fraudulent Transfer Act. Unif. Fraudulent Transfer Act § 5(b), 7A U.L.A. 129 (2006). This statute provides that a transfer by an insolvent debtor to an insider for an antecedent debt is fraudulent if the insider had reasonable cause to believe that the debtor was insolvent at the time of the transfer. Arguably, a reorganization plan for an insolvent debtor that contemplates distributions on insider debt on a *pari passu* basis with third party creditors would violate the Uniform Fraudulent Transfer Act, at least in circumstances where the insider has failed to provide new value to facilitate the debtor's rehabilitation. *See* Unif. Fraudulent Transfer Act § 8(f), 7A U.L.A. 179 (2006) (creating a defense to recovery of an otherwise fraudulent transfer to an insider if the transfer is "made pursuant to a good faith effort to rehabilitate the debtor and secured present value given for that purpose as well as an antecedent debt of the debtor"). A discussion of the provisions of the Uniform Fraudulent Transfer Act related to insiders and whether violation of these provisions could (i) under Bankruptcy Code section 1129(a)(3) (11 U.S.C. § 1129(a)(3) (2000)) or otherwise, prevent confirmation of a reorganization plan that contemplates payment of insider debt, or (ii) constitute inequitable conduct sufficient to equitably subordinate insider claims under Bankruptcy Code section 510(c), is beyond the scope of this article.

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> secured creditors of the corporation, with every right that a stranger may have; except so far as in exceptional cases courts find it necessary to restrict their rights in order to prevent fraud or injustice through the use of corporate forms.[46]

As early cases in Massachusetts made clear, "exceptional cases" that warrant recharacterization of insider debt as a capital contribution fall into two categories. First, insider debt may be recharacterized if a corporation's initial capitalization is nominal and the insider debt is incurred at the same time. Second, an insider that acts inequitably or with intent to hinder or defraud creditors cannot, through enforcement of loans or security interests, gain a preference over other creditors in the distribution of corporate assets. More recent cases in Massachusetts have also recognized that characterization of an insider investment as debt or as an equity contribution also "depends to some extent on the objective intention of the contributor."[47] However, absent inequitable conduct, Massachusetts courts are not likely to go as far as federal courts have gone in debt recharacterization cases by attempting to divine "objective intention" based on multi-factor analysis of the terms of a loan.

1. Initial Undercapitalization as a Basis for Debt Recharacterization

Nominal or gross initial undercapitalization of a corporation has long been a basis for debt recharacterization under Massachusetts law. *Albert Richards, Co. v. The Mayfair Inc.*,[48] a decision of the Massachusetts Supreme Judicial Court, was cited by the United States Supreme Court in *Pepper v. Litton*,[49] in support of the proposition that:

> so-called loans or advances by the dominant or controlling stockholder will be subordinated to claims of other creditors and thus treated in effect as capital contribution by the stockholder . . . where the paid-in capital is purely nominal, the capital necessary for the scope and magnitude of the operations of the company being furnished by the stockholder as a loan.

In *Albert Richards, Co.*, the court held void a personal property mortgage granted by a corporation to secure a loan advanced by a controlling stockholder. In reaching its decision, the court did not find it necessary to determine definitely whether the funds advanced by the stockholder were loans or equity contributions, holding that the mortgage was void as a fraudulent transfer or a preference whether or not the underlying loans were enforceable.[50] The court nevertheless explained debt recharacterization based on initial undercapitalization as follows:

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46. Hanson v. Bradley, 10 N.E.2d 259, 263 (Mass. 1937).
47. Friedman v. Kurker, 438 N.E.2d 76, 80 (Mass. App. Ct.), *review denied,* 440 N.E.2d 1177 (Mass. 1982).
48. 191 N.E. 430 (Mass. 1934).
49. 308 U.S. 295, 309–10 (1939).
50. 191 N.E. at 434–35.

> Circumstances sometimes exist which permit a sole stockholder to prove his claim against the corporation in competition with other creditors, but here [the sole stockholder] tried to run the business which required expenditures of well over $75,000 on a stock investment of $100 by himself and possibly $5,000 or $6,000 by another. He entirely controlled the affairs of the corporation, and was in no proper sense a creditor, but was an owner of a substantial part of it. Such a stockholder furnishing the capital necessary to the size of the corporation as a loan cannot in the circumstances of this case gain a preference over creditors in the distribution of the assets.[51]

It is clear that under Massachusetts law "the right and duty of courts to look beyond the corporate forms are exercised only for the defeat of fraud or wrong, or the remedy of injustice."[52] If initial capitalization is merely "inadequate" but is not "purely nominal," the rule set forth in the *Albert Richards* case does not apply.[53]

2. Inequitable Conduct as a Basis for Debt Recharacterization

Massachusetts courts also recognize inequitable conduct as a basis for treating an insider loan as a contribution of capital, although state courts in discussing the issue tend to blur any distinction between debt recharacterization and equitable subordination. For example, in *SFB Corp. v. Cambridge Automatic, Inc.*,[54] the Massachusetts Superior Court considered a motion for summary judgment to enforce a demand promissory note issued to a corporation controlled by an individual who was also the President, CEO, and a director of the debtor corporation. The defendant corporation was acutely short of cash and in default with its bank at the time the note was issued. The note, which was one of three notes evidencing advances made in the same time period by different directors of the defendant corporation, was secured by a second lien on the defendant corporation's assets, although the lien was never perfected. An affidavit of a director of the defendant corporation who held another of the three notes stated that "[w]e all understood that we would not be paid unless and until Cambridge was able to pay the trade and bank debt."[55]

In considering the defendant corporation's defense based on debt recharacterization, the court rejected an invitation to apply the *Roth Steel* factors. Although acknowledging bankruptcy court precedents, the *SFB Corporation* court noted that the defendant corporation "is not in bankruptcy, and unless and until this

51. *Id.* at 433–34 (internal citations omitted).
52. *Hanson,* 10 N.E.2d at 264.
53. Brown v. Freedman, 125 F.2d 151, 156 (1st Cir. 1942); *see also Hanson,* 10 N.E.2d at 264–65 (insider loans valid where corporation was found "without substantial capital" but where plaintiff "knew the essential facts and accepted them"); *Yankee Microwave,* 760 N.E.2d at 759–60 (evidence of inequitable conduct not necessary for debt recharacterization where there is gross inadequacy in the initial capitalization, coupled with immediate shareholder loans and guarantees); Milliken & Co. v. Duro Textiles, LLC, No. BRCV2002–1364, 2005 WL 1791562, at *13 (Mass. Super. Ct. June 14, 2005) ("Re-characterization of debt as equity is intended to protect creditors dealing with a newly formed business that is grossly undercapitalized at its inception.").
54. No. 015304, 2002 WL 31481078 (Mass. Super. Ct. Oct. 1, 2002).
55. *Id.* at *1.

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changes, it may not claim the benefits of bankruptcy law and practice."[56] Turning to the issue of debt recharacterization under Massachusetts law, the *SFB Corporation* court held that the facts of the case did not approach what would be required to treat the loan as an advance of capital.[57] The court also noted that the plaintiff corporation was not a stockholder of the defendant corporation, a fact indicating that the "objective intention of the contributor" could not have been to make a capital contribution.[58] The court further noted that no particular equitable circumstances required treatment of the loan as equity capital; although the plaintiff corporation was an "insider of an insider," the corporation "advanced real money; the consideration was a demand note; no fraud is even hinted at; and there will be no injustice to other creditors or to [the debtor corporation] if it is repaid."[59]

3. Debt Recharacterization Based on "Objective Intention of the Contributor"

Debt recharacterization in Massachusetts is a developing doctrine. While Massachusetts courts have, to date, declined to adopt debt recharacterization as a "no fault" cause of action based on the *Roth Steel* factors, at least two modern cases have acknowledged that characterization of a contribution as debt "depends to some extent on the objective intention of the contributor."[60] Requiring an insider to prove its claim based on an objective standard is, in a basic sense, uncontroversial. All creditors are required to prove their claims, typically by introducing notes or other loan documents into evidence. If a creditor is a stockholder, it is reasonable to require that the loan documentation will show objectively that the creditor's intention at the time of the advance was to create an enforceable debt obligation rather than to make a capital contribution. Backdating of debt instruments, belated execution of loan documents, self-serving changes in accounting practices, inconsistent evidence of treatment of advances as debt in filed tax returns or other evidence can indicate that a stockholder-creditor did not originally intend an advance to be enforceable as debt. If a stockholder-creditor is a corporate officer, director, or otherwise in sufficient control of an insolvent debtor to be considered a fiduciary of general creditors, after-the-fact revisions of the terms or documentation of an advance can also be seen as evidence of a breach of fiduciary duties and inequitable conduct warranting recharacterization or subordination of the insider debt.

On the other hand, if corporate formalities are observed, a Massachusetts court would likely enforce loans advanced by corporate insiders as valid debt

56. *Id.* at *3. The *SFB Corporation* court is not the only court to have held that the cause of action for debt recharacterization as articulated in federal courts is viable only in bankruptcy. *Arena Dev. Group*, 2007 WL 2506431, at *7.

57. *SFB Corp.*, 2002 WL 31481078, at *3.

58. *Id.*

59. *Id.*

60. *See Yankee Microwave,* 760 N.E.2d at 759 (citing Friedman v. Kurker, 438 N.E.2d 76, 80 (Mass. App. Ct. 1982)); *see also* American Twine Ltd. P'ship v. Whitten, 392 F. Supp. 2d 13, 22 (D. Mass. 2005).

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obligations. In *American Twine Limited Partnership v. Whitten*,[61] the United States District Court for the District of Massachusetts considered whether $10,000,000 of secured bridge loans advanced by stockholders of a failing internet company should be recharacterized as equity contributions under Massachusetts law. The terms of the loans were onerous and included a 35% per annum interest rate and a prepayment premium requiring a minimum of one year of interest be paid, even if the loans were outstanding for less than a year.[62] Moreover, the loans were convertible if the debtor company were to engage in any future equity financing rounds. The lenders and the company followed normal formalities in documenting the loans; the transactions were approved by the debtor company's board of directors, promissory notes were issued and Uniform Commercial Code financing statements were filed in respect of security interests granted.[63] In applying Massachusetts state law, the *American Twine* court concluded that the objective intent of the investors was that the bridge loans created debt rather than equity.[64]

Given that Massachusetts law generally permits enforcement of debt held by insiders, except in "exceptional cases" involving fraud or injustice, it remains likely that a Massachusetts court would scrutinize insider loans to determine if an intent existed to create a debt obligation, but, if corporate formalities were observed in the authorization and documentation of the loans, the same court would not find typical modern loan terms such as demand notes, subordination provisions, lack of security for the loans, interest deferral, or conversion rights as relevant factors in a debt recharacterization analysis.

B. Wisconsin Law

The Wisconsin Supreme Court, in a seminal 1977 decision, expressly considered and rejected federal bankruptcy court precedent in formulating a test for debt recharacterization.[65] The case, *In re Mader's Store for Men, Inc.*, involved a clothing retailer in receivership. The debtor had been initially capitalized with a $15,000 investment. Four years later, and three years before the debtor was petitioned into receivership, the debtor issued stock to a new investor, Gelatt, for a purchase price of $50,000 in cash. Gelatt, having acquired half of the debtor's outstanding shares in this transaction, made a series of advances to the debtor totaling $45,000 over the next two years. The funds, which the debtor used to acquire inventory, were carried as loans on the debtor's books. The loans, which had been approved by the debtor's board of directors, were evidenced by unsecured demand notes bearing interest at a rate of six percent per annum. The parties in the receivership case had stipulated that "the banks probably would not have loaned money to the corporation" at the time when Gelatt's advances were made.[66]

61. 392 F. Supp. 2d 13 (D. Mass. 2005).
62. *Id.* at 17.
63. *Id.*
64. *Id.* at 22.
65. *See* Gelatt v. DeDakis (*In re* Mader's Store for Men, Inc.), 254 N.W.2d 171 (Wis. 1977).
66. *Id.* at 183.

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The receiver objected to Gelatt's claim in the case for recovery of $45,000, plus accrued interest. The Wisconsin trial court, although finding "absolutely no evidence of any bad faith or ill intentions" on Gelatt's part, held that the claim would be subordinated.[67] In reaching its decision, the trial court relied on an unreported federal bankruptcy court decision, *In re A.N. Brady Wholesale Hardware, Inc.*,[68] and application of a debt recharacterization test very similar to the test later adopted by the Eleventh Circuit Court of Appeals in the *N&D Properties* case.[69] The test articulated by the *Brady* court required recharacterization or subordination of insider debt:

> in those instances in which the advances are made at a time when the debtor's financial condition is in such a serious state that the advances are more related to a desire by the corporate insiders to salvage their investment on a risk basis, as contrasted with a true loan on a temporary basis with reasonable assurance of repayment in the ordinary course of business.[70]

The *Brady* court explained further:

> Indicators of the requisite serious financial condition are a prolonged series of substantial operating losses, an inability to borrow money from usual commercial sources, and being on the verge of closing down the business in the absence of the insider advances.[71]

Based on the *Brady* case, the *Mader's Store* trial court held that subordination of Gelatt's claims was justified because (1) the advances were made at a time when the debtor was in a very precarious financial position as a result of sustained heavy operating losses, (2) the needed funds could not be obtained from banks or other commercial lending institutions, and (3) the notes given by the debtor were demand notes carrying a moderate rate of interest.[72]

The Wisconsin Supreme Court expressly rejected the test applied in the *Brady* case, noting that "the cases dealing with the 'capital contribution' theory of equitable subordination do not form an altogether consistent body of law in terms of the stated rationales upon which the courts have based their decisions."[73] Conducting a thorough survey of relevant cases, the court identified three factors that are almost invariably present in cases where insider debt is recharacterized as a capital contribution:

> First, claims are based upon what are denominated loans made to the corporation by one or more stockholders in a position of control within the corporation. The individual claimant's control need not be absolute, but the facts must permit of an inference that the claimant or a group of stockholders of which he is a member were in a position to control the affairs of the company, at least to the extent of determining the form of the transaction in question. Second, the circumstances, objectively analyzed, must be such as to indicate that the advance was not intended to be repaid in

67. *Id.* at 184.

68. Case No. 70-496-BK-JLK-Y (S.D. Fla. Apr. 12, 1974), cited by *Mader's Store,* 254 N.W.2d at 185 n.16.

69. 799 F.2d 726, 733 (11th Cir. 1986).

70. *Mader's Store,* 254 N.W.2d at 185 (quoting *In re* A.N. Brady Wholesale Hardware, Inc., Case No. 70-496-BK-JLK-Y (S.D. Fla. Apr. 12, 1974)).

71. *Id.*

72. *Id.*

73. *Id.* at 186.

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> the ordinary course of the corporation's business, but rather was expected to remain outstanding as a permanent part of the corporation's financial structure. Third, and closely related to the second element, the paid-in stated capital of the corporation must have been unreasonably small in view of the nature and size of the business in which the corporation was engaged.[74]

Based on this test, the Wisconsin Supreme Court held that, because the debtor was adequately capitalized as an initial matter, Gelatt had no obligation to make further capital advances and was entitled instead to advance funds as a loan to enable the debtor to continue in business. Accordingly, the court reversed the decision of the *Mader's Store* trial court and held the insider debt to be enforceable.[75]

Thus, the law in Wisconsin, like the law in Massachusetts, is inconsistent with federal debt recharacterization cases. The Wisconsin Supreme Court has expressly rejected a debt recharacterization test substantially similar to the test that has since been adopted by the Eleventh Circuit Court of Appeals. Wisconsin law also requires initial undercapitalization or inequitable conduct by an insider before insider debt may be recharacterized as an equity contribution.[76] As a result, Wisconsin law is also inconsistent with the federal cases that attempt to divine an insider creditor's subjective intent based on *Roth Steel*-type tests that analyze the terms of a loan without regard to whether a corporation's initial paid-in capital was adequate.

IV. State Law as the Proper Substantive Basis for Debt Recharacterization

The United States Supreme Court has consistently held that claims in bankruptcy are to be determined by reference to state law. In *Travelers Casualty & Surety Co. v. Pacific Gas & Electric Co.*, a case decided in the last term, the Court observed 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 provisions of the Bankruptcy Code."[77] At issue in the *Travelers Casualty* case was the *Fobian* rule, *obiter dictum* of the Ninth Circuit, that "where the litigated issues involve not basic contract enforcement questions, but issues peculiar to federal bankruptcy law, attorneys' fees will not be awarded absent bad faith or harassment by the losing party."[78] The *Fobian* rule, because it was a court-created rule with no explicit grounding in the Bankruptcy Code, was so extraordinarily out-of-sync with established Supreme Court precedent that the appellee in the case, PG&E, made no effort to defend the rule, conceding that it was wrongly decided.[79]

74. *Id.*
75. *Id.* at 189.
76. *See id.* at 188 ("Where a corporation is once provided with a reasonably adequate fund of stated capital but subsequently requires additional funds, the stockholders may advance those funds as a loan in an attempt to enable the corporation to continue in business, and, provided no inequitableconduct is shown, the stockholders may participate with other creditors in the distribution of the insolvent estate.").
77. 127 S. Ct. 1199, 1204–05 (2007) (quoting Raleigh v. Illinois Dept. of Revenue, 530 U.S. 15, 20 (2000)).
78. *Id.* at 1203 (quoting *In re* Fobian, 951 F.2d 1149, 1153 (9th Cir. 1991)).
79. *Id.* at 1207.

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The *Travelers Casualty* Court found the absence of textual support fatal for the *Fobian* rule, noting that "we generally presume that claims enforceable under applicable state law will be allowed in bankruptcy unless they are expressly disallowed."[80] Having reviewed Bankruptcy Code section 502(b),[81] the federal statute that governs disallowance of claims in bankruptcy, and having found no express basis for disallowing contractual attorney's fees incurred while litigating issues of bankruptcy law, the *Travelers Casualty* Court held unanimously that the *Fobian* rule could not stand.[82]

The *Travelers Casualty* Court based its decision on precedents that have long recognized the principle that the "'basic federal rule' in bankruptcy is that state law governs the substance of claims, Congress having 'generally left the determination of property rights in the assets of a bankrupt's estate to state law.'"[83] The principle is based on Congressional intent, as expressed in the Bankruptcy Code, to achieve uniformity between state and federal courts. In *Butner v. United States*,[84] for example, the Supreme Court rejected the idea that court-created federal common law or rules of equity would determine creditors' rights in bankruptcy, and affirmed that, absent an express federal statute to the contrary, a creditor and mortgagee has the same rights and remedies in bankruptcy court as under state law. As the *Butner* Court noted:

> Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving "a windfall merely by reason of the happenstance of bankruptcy."[85]

80. *Id.* at 1206.
81. 11 U.S.C.A. § 502(b) (West 2004 & Supp. 2007).
82. *Travelers Casualty,* 127 S. Ct. at 1208.
83. *Id.* at 1205 (quoting Butner v. United States, 440 U.S. 48, 57, 54 (1979)). The Supreme Court's deference to state law in *Butner v. United States* was, in turn, grounded in its precedents. The *Butner* Court noted that while, under the United States Constitution, Congress is granted the power to establish uniform laws on the subject of bankruptcy throughout the United States, state laws are suspendedonly to the extent of actual conflict with federal statutes. *Butner,* 440 U.S. at 54 n.9 (citing Sturges v. Crowninshield, 4 Wheat. 122, 4 L. Ed. 529 (1918); Ogden v. Saunders, 12 Wheat. 213, 6 L. Ed. 606 (1827)). *See also* 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."). The Supreme Court's precedents with regard to application of substantive non-bankruptcy law in bankruptcy cases are also in accord with similar decisions in cases involving federal diversity jurisdiction. *See* Erie R.R. Co. v. Tompkins, 304 U.S. 64, 78 (1938); Charles W. Mooney, Jr., *A Normative Theory of Bankruptcy Law: Bankruptcy As (Is) Civil Procedure,* 61 WASH. & LEE L. REV. 931, 989 (2004) ("[The] parallel rationales for federal system of bankruptcy law and diversity jurisdiction support . . . [the] core principle that bankruptcy law, like trans-substantive civil procedure law, generally should serve the interests of and respect rightsholders' non-bankruptcy legal entitlements.").
84. 440 U.S. 48 (1979).
85. *Id.* at 55 (quoting Lewis v. Mfrs. Nat'l Bank, 364 U.S. 603 (1961)). *See also* Raleigh v. Illinois Dept. of Revenue, 530 U.S. 15, 20 (2000) ("The basic federal rule in bankruptcy is that state law governs the substance of claims.").

Similarly, in another recent case, *Raleigh v. Illinois Department of Revenue*,[86] the Supreme Court also rejected the view that claims in bankruptcy should be analyzed and allowed based on uniform federal rules, instead holding that claims should be determined consistently, whether in state or federal courts, based on state law.[87] In this case, the Court considered whether substantive state law allocating to the taxpayer the burden of proof in disputing a tax assessment should be applied in bankruptcy court. The *Raleigh* Court noted that a uniform federal substantive rule that is inconsistent with state law would create anomalous results; a claimant that obtained relief from stay and a judgment in state court would be entitled to enforcement of the judgment in bankruptcy court even if the claim would be disallowed under uniform federal law.[88] Congress, the *Raleigh* Court noted, could not have intended that a claim would be allowed if relief from stay were granted and the claim determined in state court, yet disallowed if the claim were litigated in bankruptcy court.[89] In all of these cases, the Supreme Court has endorsed a simple rule: in the absence of modification expressed in the Bankruptcy Code, a claim in bankruptcy is determined according to substantive state law.[90]

In certain circumstances, Congress has reordered bankruptcy distribution priorities or has expressly granted bankruptcy courts equitable powers to adjust rights between creditors. The Supreme Court has noted that the bankruptcy court's authority to subordinate claims under Bankruptcy Code section 510(c) is one example of these expressly granted powers.[91] However, absent a factual basis for equitable subordination, the scope of a bankruptcy court's power to allow or disallow claims must be understood in light of the general principal that the validity of a claim is a function of underlying substantive state law. "Bankruptcy courts are not authorized . . . to make wholesale substitution of underlying law controlling the validity of creditors' entitlements, but are limited to what the Bankruptcy Code provides."[92] The presumption that state law will determine the construction and enforcement

86. 530 U.S. 15 (2000).
87. *Id.* at 20.
88. *Id.* at 25–26.
89. *Id.*
90. *Id.* at 20. The state law applicable to enforcement of debt is typically the governing law specified in promissory notes or other loan documentation. However, if a defense to enforcement of debt is that an advance must be recharacterized as equity, a better argument can be made that the appropriate governing state law is the law of the jurisdiction of organization of the "borrower" organization. Debt recharacterization in many ways is similar to a cause of action to "pierce the corporate veil." Both legal theories are viable only against stockholders or other persons in control of an insolvent corporation and seek, based on actions of the controlling stockholder, to negate corporate rules that would otherwise require enforcement of agreements between stockholders and the corporations in which they own stock. The law of an entity's jurisdiction of organization establishes the baseline rule that treats equity holders as separate entities for purposes of determining liability for an organization's debts as well as the ability to hold debt in a capacity as an arm's length creditor of the organization. *See, e.g.,* Delaware Revised Uniform Limited Partnership Act, DEL. CODE ANN. tit. 6, §§ 17-107, 17-303 (2001 & Supp. 2004). In addition, if a successful debt recharacterization action is to fully determine the rights of the insider creditor, it may be necessary to determine the priority of the recharacterized debt to preferred or common stockholders of the corporation. For these reasons, the law of the jurisdiction of organization of the "debtor" entity should govern the defense of debt recharacterization.
91. *Raleigh,* 530 U.S. at 24.
92. *Id.* at 24–25.

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of private contracts is "especially robust" in circumstances where no federal statute exists to guide interpretation.[93] In the context of debt recharacterization, one of the few facts on which otherwise divided federal courts seem to agree is that the Bankruptcy Code does not specifically address the issue.[94] Given the lack of any statutory basis for a federal rule of decision, Supreme Court precedent requires that debt recharacterization in bankruptcy must be based on state law.

Despite this, the three conflicting lines of federal cases addressing the issue of debt recharacterization largely ignore state law.[95] The *Pacific Express* court, in noting that the Bankruptcy Code fails specifically to provide that claims may be recharacterized as equity contributions, overlooks state law by concluding that the only other potential basis for debt recharacterization is the court's equitable powers under Bankruptcy Code section 105(a).[96] The Bankruptcy Code, of course, expressly provides that claims that are unenforceable under state law are to be disallowed in bankruptcy.[97] In Massachusetts and Wisconsin and elsewhere, state courts have expressly recognized debt recharacterization as a defense to the enforceability of loans to corporations by corporate fiduciaries. Certainly, it cannot be the case that a loan that is unenforceable under state law becomes enforceable after a bankruptcy petition is filed. Therefore, at a minimum, courts following the *Pacific Express* approach must address the enforceability of insider loans under state law as part of the claims allowance process.

The two other conflicting lines of authority in the federal circuits that allow debt recharacterization also err by failing to consider the application and primacy of state law. As noted above, the Supreme Court looks to state law as the proper source of law for determining property rights and has specifically rejected arguments that federal bankruptcy courts should apply a uniform standard for adjudicating claims without regard to state law.[98]

The Eleventh Circuit's draconian approach to debt recharacterization in the *N&D Properties* case is manifestly inconsistent with the law of states such as Massachusetts and Wisconsin. Longstanding Massachusetts law holds that insiders may be creditors of a corporation "with every right that a stranger may have" other than in "exceptional cases" involving fraud or injustice.[99] Similarly, under Wisconsin law,

93. HSBC Bank USA v. Branch (*In re* Bank of New England Corp.), 364 F.3d 355, 363 (1st Cir.), *cert. denied,* 543 U.S. 926 (2004).

94. *See, e.g., Autostyle Plastics,* 269 F.3d at 748; *Pac. Express*, 69 B.R. at 115; Moglia v. Quantum Indus. Partners, LDC (*In re* Outboard Marine Corp.), Nos. 02-C-1594, 01-A-0471, 00-B-37405, 2003 WL 21697357, at *2 (N.D. Ill. July 22, 2003); *Pinetree Partners,* 87 B.R. at 491.

95. Only a few bankruptcy cases have acknowledged state law as a potential substantive basis for debt recharacterization. *See In re* Labelle Indus., Inc., 44 B.R. 760, 763 (Bankr. D. R.I. 1984) (citing Tanzi v. Fiberglass Swimming Pools, Inc., 414 A.2d 484 (R.I. 1980)); *AtlanticRancher,* 279 B.R. at 433 n.13 (noting that defendants failed to raise the viability of debt recharacterization as a cause of action under state law and reserving for another day an exegesis on that issue).

96. 11 U.S.C. § 105(a) (2000).

97. *See* 11 U.S.C. § 502(b)(1) (2000). Federal courts have held that a "cause of action" for debt recharacterization is effectively an objection to a claim and may be subject to limitations applicable to claims objections. Official Comm. of Unsecured Creditors v. Gen. Elec. Capital Corp. (*In re* Russell Cave Co., Inc.), 107 Fed. Appx. 449, 451 (6th Cir. 2004); *Micro-Precision Techs. Inc.*, 303 B.R. at 243.

98. *See supra* notes 77–94 and accompanying text.

99. *Hanson,* 10 N.E.2d at 263–64.

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if a company's initial capitalization is adequate, "provided no inequitable conduct is shown, the stockholders may participate with other creditors in the distribution of the insolvent estate."[100] Under the Eleventh Circuit's test, debt held by insiders must be recharacterized in any situation where debt is unavailable from third parties, even if the incurrence of the debt was proper, and, indeed, even if the proceeds of insider loans were used to repay, and thereby benefited, creditors of an insolvent corporation. The *N&D Properties* case can, of course, be criticized as implementing poor public policy by discouraging insider loans as a source of financing for financially distressed companies. However, in the final analysis, the test should be rejected simply because it is not grounded in state law precedents, the only relevant source of law under *Travelers Casualty, Raleigh v. Illinois Dept. of Revenue, Butner v. United States* and other controlling Supreme Court cases.[101]

The courts that adopt the multi-factor debt recharacterization tests of the *Roth Steel* variety may also be justly criticized. These tests fail in the most important respect that legal standards can fail—they are vague and do not permit accurate prediction of the outcome of future cases.[102] More importantly, however, the tests do not originate under state law and fail to take state law into account. Factors considered relevant to debt recharacterization in the *Roth Steel* analysis such as debt to equity conversion terms, payment-in-kind interest, and lack of guarantees or security for the insider debt may be entirely innocuous and unobjectionable under state law. Indeed, these factors are common elements of many modern debt instruments. To the extent that the *Roth Steel* factors render uncertain the enforceability of debt instruments with conventional debt terms, state law is improperly preempted. Federal courts, if they are to follow Supreme Court precedent, cannot create a separate legal standard for the enforceability of insider debt in bankruptcy and should follow the state law of debt recharacterization.

V. Toward a More Rational Legal Standard for Debt Recharacterization

The use in bankruptcy courts of inconsistent, judicially created federal common law tests for debt recharacterization has usurped state authority to regulate the enforceability and priority of debt instruments held by corporate insiders. A return to state law as the basis for enforcing insider debt claims has the potential to clarify the conditions under which insider debt will be enforceable as debt, so that investors can understand their rights when an investment is made. An investor, even an investor acquiring debt in a corporation that it controls, has a right

100. *Mader's Store,* 254 N.W.2d at 188.

101. *See supra* notes 77–94 and accompanying text.

102. Oliver Wendell Holmes, Jr., *The Path of the Law,* 10 Harv. L. Rev. 457–58 (1897) ("The means of the study [of law] are a body of reports, of treatises, and statutes in this country and in England, extending back for six hundred years, and now increasing annually by hundreds. In these sibylline leaves are gathered the scattered prophecies of the past upon the cases in which the axe will fall. These are what properly have been called the oracles of the law. Far the most important and pretty nearly the whole meaning of every new effort of legal thought is to make these prophecies more precise, and to generalize them into a thoroughly connected system.").

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to know that the debt acquired is enforceable. Otherwise, the law is a shell game. An investor lays his money down to acquire a debt claim and only learns later, in bankruptcy court, that the government has dealt him a hand of three card monte.

Uncertainty in the law is bad for commerce.[103] State law, in states such as Massachusetts and Wisconsin, recognizes this and provides that, if a corporation is adequately capitalized as an initial matter, then absent inequitable conduct by the insider or other exceptional circumstances, debt held by insiders is enforceable. At the same time, it is reasonable for the law to require that insiders prove their claims with contemporary objective evidence that both the investor and the corporation intended to create enforceable debt obligations. Such evidence would include contemporaneous resolutions of the corporation's board of directors, execution of promissory notes or other loan documentation, and proof that value supporting the obligations has been given. Further, board votes authorizing the incurrence of debt owed to insiders would normally require affirmative approval by independent directors, at least if the board's decision is to be entitled to deference in the courts under the business judgment rule. If these requirements are satisfied, state law in states such as Massachusetts and Wisconsin would take a rational position that it is in the interests of the corporation, its shareholders, its employees, its customers and its creditors that debt financing be available from investors, even if they also hold controlling equity interests in the corporation.

VI. Conclusion

Under longstanding precedent, claims of insiders against insolvent corporations are enforceable and may not be subordinated to claims of arm's length creditors, absent inequitable conduct. In 1978, Congress reaffirmed this principle; in enacting the Bankruptcy Code, Congress rejected statutory language that would have resulted in a *per se* subordination of claims of insiders. Instead, the legislative history of the Bankruptcy Code makes clear that Congress intended to codify existing case law and to permit claim subordination in bankruptcy based only on equitable principles.

In the past twenty years, some federal courts have begun to endorse a "no fault" cause of action to invalidate bankruptcy claims of insiders based not on principles of equity but on divining the subjective intent of insiders in advancing funds to financially distressed companies. The federal debt recharacterization cases are in conflict as to the proper legal test that is to be applied to determine the enforceability of insider debt. Even among the majority of courts that agree on the application of a flexible, multi-factor test, courts differ concerning the relative weight to be given to various factors, making the outcome of cases difficult to predict.

State courts, such as the courts of Massachusetts and Wisconsin, by contrast, have consistently enforced insider debt by applying principles of equity. While

103. John Tyler, Second Annual Message to the Senate and House of Representatives (Dec. 6, 1842), *available at* http://www.presidency.ucsb.edu/ws/print.php?pid = 29484. ("A prudent capitalist will never adventure his capital in manufacturing establishments, or in any other leading pursuit of life if there exists a state of uncertainty as to whether the Government will repeal to-morrow what it has enacted to-day.").

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recognizing that the enforceability of insider claims depends to some extent on the objective intention of the insider, these courts have generally allowed insiders to enforce debt claims in competition with arm's length, third party creditors. The balanced approach of Massachusetts and Wisconsin state courts permits insolvent companies to obtain debt financing from insiders under a wide variety of contract terms, including convertible debt, unsecured debt, and debt with deferred interest, payment-in-kind interest, or other flexible payment terms. Both Massachusetts and Wisconsin law, however, require some objective evidence of the terms of the insider debt, and will subordinate insider debt if an insider has breached fiduciary duties, engaged in inequitable conduct, or if initial paid-in capital is grossly inadequate.

The Supreme Court has long recognized that claims of creditors in bankruptcy must generally be allowed or disallowed in accordance with state law. As a result, debt recharacterization should not be regarded as a separate federal cause of action, but rather as a defense or remedy in disputes over the allowance of claims under state law. As an added benefit, application of state law offers a means to reconcile conflicting and inconsistent federal case law and to support capital markets by restoring predictability in the enforcement of insider debt. For these reasons, federal courts should abandon efforts to create federal substantive law of debt recharacterization and simply apply state law in determining the allowance or disallowance of insider debt claims in bankruptcy.

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