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Caution Ahead, Insider Lenders: Ninth Circuit Finds Authority To Recharacterize Through Applicable State Law In In Re Fitness Holdings

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CAUTION AHEAD, INSIDER LENDERS: NINTH CIRCUIT FINDS AUTHORITY TO RECHARACTERIZE THROUGH APPLICABLE STATE LAW IN *IN RE FITNESS HOLDINGS*

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I. INTRODUCTION

In April 2013, the Ninth Circuit joined five other circuit courts in holding that a court had the power to recharacterize debt as equity in *Official Committee of Unsecured Creditors, of the Estate of Fitness Holdings International, Inc. v. Hancock Park Capital II, L.P. (In re Fitness Holdings International, Inc.)*.[1] In doing so, however, the Ninth and Fifth Circuits recharacterized debt by applying state law while the Third, Fourth, Sixth, and Tenth Circuits created and applied their own respective tests based on federal law.[2]

The Ninth Circuit's minority approach is sounder than the majority circuits' approach because its test is rooted in bankruptcy law precedent.[3] Bankruptcy law is layered over one's existing rights, which are defined by both state and federal law.[4] When examining whether the court had power to recharacterize debt, the Ninth Circuit defined "reasonably equivalent value" through terms within the

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1. 714 F.3d 1141, 1147–48 (9th Cir. 2013).

2. *See* James M. Wilton & Stephen Moeller-Sally, *Debt Recharacterization Under State Law*, 62 BUS. LAW 1257, 1261 (2007).

3. *See generally In re Fitness*, 714 F.3d at 1144–48 (using case law and bankruptcy statutes to justify recharacterization).

4. *See generally* Grossman v. Lothian Oil Inc. (*In re* Lothian Oil Inc.), 650 F.3d 539, 539–46 (5th Cir. 2011) (combining state and federal law to explain the parties' rights in bankruptcy proceedings).

federal Bankruptcy Code, including the term "right to payment."[5] For the court to define whether someone had a "right to payment," the court had to define "claim."[6] Given that state law, and not the federal Bankruptcy Code, defines "claim," the Ninth Circuit rightfully held that state law should be used to define "claim" in crafting the test.[7]

This Comment will explore the Ninth Circuit's reasoning in *In re Fitness Holdings* that recognized the authority of bankruptcy courts to recharacterize debt as equity, and how the Ninth Circuit grounded that authority in state law.[8] Part II provides a statement of the case. Part III describes the reasoning of the court and how it ultimately relied on state law to decide whether a court should recharacterize a particular purported debt as equity. Part IV compares recharacterization with a similar yet distinct concept: equitable subordination. Part V explores the differences between the majority and minority approach to recharacterization of debt as equity and ultimately demonstrates why the minority approach is more consistent with Supreme Court precedent, while also detailing the ramifications of the Ninth Circuit's holding. Part VI concludes that the minority approach's reliance on state law in determining whether a claim should be recharacterized from debt as equity makes more sense.

II. Statement of the Case

Fitness Holdings International ("Debtor"), a home fitness corporation, received significant capital and investments from two funding entities: Hancock Park ("Hancock"), Debtor's sole shareholder, and Pacific Western Bank ("Pacific Western").[9]

From 2003 to 2006, Debtor received funding from Hancock in the form of an unsecured loan totaling approximately $24 million.[10] In 2004, Pacific Western made an additional secured loan in the amount of $12 million, secured by Debtor's assets and guaranteed by Hancock.[11] In 2007, Debtor refinanced its debt with a $17 million

5. *In re Fitness*, 714 F.3d at 1145–47.
6. *Id.*
7. *Id.* at 1145–48.
8. *Id.*
9. *Id.* at 1143.
10. *Id.*
11. *Id.*

term loan and an $8 million line of credit from Pacific Western, again secured by its assets.[12] The loan agreement required Debtor to use $9 million dollars of loan proceeds to pay off Pacific Western's existing secured loan and $12 million dollars to pay off the Hancock's unsecured loan.[13] The agreement also released Hancock from its guaranty to pay Pacific Western.[14]

Then, one year later in 2008, Debtor filed a Chapter 11 bankruptcy petition in the U.S. Bankruptcy Court for the Central District of California.[15] A committee of unsecured creditors filed a complaint against Hancock, Pacific Western, and two members of the Debtor's board of directors on behalf of Fitness Holdings and its estate.[16] The complaint sought "to recover the payments made to Hancock Park as a result of the refinancing transaction with Pacific Western Bank."[17] In addition, "[t]he complaint also requested declaratory relief, asking the court to characterize the financing Hancock provided to Fitness Holdings in connection with the promissory notes as equity investments in Fitness Holdings, rather than extensions of credit."[18]

Therefore, "the Committee argued, the transfer of funds to the shareholder as part of the refinancing constituted a constructively fraudulent transfer because such funds were a return of equity and not a repayment of debt."[19] The bankruptcy court dismissed the complaint on the merits and converted the case to Chapter 7.[20] A Chapter 7 trustee replaced the creditors' committee and appealed the court's dismissal of the claim.[21] "The district court affirmed, holding that it was bound to follow the decision of the Ninth Circuit Bankruptcy Appellate Panel in *In re Pacific Express, Inc.*, and accordingly, the Chapter 7 trustee was barred from bringing a

12. *Id.*

13. *Id.*

14. Michael L. Cook, *Ninth Circuit Allows Bankruptcy Courts to Recharacterize Loans As Equity, Applying State Law*, 130 BANKING L.J. 634, 635 (2013).

15. *Id.*

16. *In re Fitness*, 714 F.3d at 1144.

17. *Id.*

18. *Id.*

19. Katten Muchin Rosenman LLP, *Ninth Circuit Holds That Debt Can Be Recharacterized as Equity*, NAT'L L. REV. (June 5, 2013), http://www.natlawreview.com/article/ninth-circuit-holds-debt-can-be-recharacterized-equity.

20. *In re Fitness*, 714 F.3d at 1144.

21. *Id.*

recharacterization action."[22]

The trustee appealed, claiming that the "district court should have: (1) recharacterized Hancock's payment of $11,995,500 to Fitness Holdings as a payment in satisfaction of an equity interest rather than a debt, and then (2) avoided Fitness Holdings' $11,995,500 as a constructively fraudulent transfer under § 548(a)(1)(B) of the Bankruptcy Code."[23]

III. REASONING OF THE COURT

The trustee alleged in its complaint that the transfer from debtor to shareholder should be avoided as a fraudulent transfer because the transfer was not a repayment of debt, but instead a satisfaction of an equity interest.[24] In order to rule on whether the transfer was fraudulent, the court had to decide two issues.[25] First, does the court have the authority to recharacterize the purported loan as an equity investment for purposes of Bankruptcy Code § 548?[26] Second, if the court does have this authority, then the court must decide whether state or federal law should be used to determine if the transfer is debt or equity.[27]

First, the court had to determine if the purported transfer was fraudulent.[28] Under Code §§ 548 and 550, a transfer is constructively fraudulent, and thus can be avoided by the trustee, if the debtor "received less than a reasonably equivalent value in exchange for such transfer or obligation,"[29] and if one of the four conditions listed in § 548(a)(1)(B)(ii) is satisfied.[30] The Code does not define

22. Katten Muchin Rosenman LLP, *supra* note 19 (citation omitted).
23. *In re Fitness*, 714 F.3d at 1144.
24. *Id.*
25. *See* Thomson Reuters, *In re Fitness Holdings: Ninth Circuit Reverses Precedent, Holding State Law Applies to Debt Recharacterization Analysis*, PRAC. LAW (May 13, 2013), http://us.practicallaw.com/6-528-4745.
26. *Id.*
27. *Id.*
28. *In re Fitness*, 714 F.3d at 1145.
29. 11 U.S.C. § 548(a)(1)(B)(i) (2012); *see In re Fitness*, 714 F.3d at 1145.
30. 11 U.S.C. § 548(a)(1)(B)(ii). The four conditions require that the debtor

> (I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation; (II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; (III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or (IV) made such

"reasonable equivalent value," but it does define "value"[31] as "[the] satisfaction or securing of present or antecedent debt of debtor."[32] Consequently, if the transfer from the debtor is in satisfaction of present or antecedent debt, then it cannot be avoided as constructively fraudulent because the purported transfer would be of "reasonably equivalent value."[33]

Next, the court had to decide whether the transfer was made in satisfaction of a debt.[34] It did this by defining the word "debt."[35] The Bankruptcy Code defines debt as liability on a "claim," which is the "right to payment."[36] The Code does not define "right to payment," which allows the court to interpret the term.[37] Specifically, the court had to decide if the right to payment was based in state or federal law.[38]

Relying on well-established Supreme Court precedent in *Butner v. United States*[39] and later reiterated in *Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Co.*,[40] the court deferred to state law to define "right to payment."[41] The court relied on deep-rooted Supreme Court precedent, which "establishe[d] that, unless Congress has spoken, the nature and scope of a right to

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> transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.

Id.

31. *In re Fitness*, 714 F.3d at 1145.

32. 11 U.S.C. § 548(d)(2)(A). Under this definition, "[p]ayment of a preexisting debt is value, and if the payment is dollar-for-dollar, full value is given." 5 COLLIER ON BANKRUPTCY ¶ 548.03[5] (16th ed. 2012).

33. *See In re Fitness*, 714 F.3d at 1145–46.

34. *See id.* at 1146.

35. *Id.*

36. *Id.*

37. *See id.* at 1145–47.

38. *See id.* at 1146.

39. 440 U.S. 48 (1979). The Supreme Court set out to resolve a circuit split by framing a very narrow question: whether state law or federal common law governed the subsidiary question of "whether a security interest in property extends to rents and profits derived from the property." *Id.* at 52. A minority of circuits had adopted a "federal rule of equity that affords the mortgagee a secured interest in the rents even if state law would not recognize any such interest until after foreclosure." *Id.* at 53. However, the Supreme Court agreed with the majority approach that the law of the state in which the property is located should resolve the matter. *Id.* at 54. Basically, the *Butner* Court reasoned that Congress was given constitutional authority to establish bankruptcy law; if Congress elected not to exercise its authority by legislating a "mortgagee's interest in the rents and profits earned by property in a bankrupt estate," it thereby left that power to state law. *Id.*

40. 549 U.S. 443 (2007).

41. *In re Fitness*, 714 F.3d at 1146.

payment is determined by state law."[42] As *Travelers* stated (in reliance on *Butner*), "this means that when the Bankruptcy Code uses the word 'claim'—which the code itself defines as a 'right to payment'—it is usually referring to a right to payment recognized under state law."[43] Therefore, the court must decide if such an interest in the company's assets is a "right to payment," while still considering any applicable provisions of the Bankruptcy Code.[44] Thus, because the trustee wanted to avoid an action as constructively fraudulent and Hancock argued that the transfer "constituted the repayment of a debt (and thus was a transfer for 'reasonably equivalent value')."[45] the court had to re-examine § 548(a)(1)(B) in light of state law.[46] Specifically the court had to consider, "whether the purported 'debt' constituted a right to payment under state law."[47] The court held that if the purported debt did not create a right to payment under state law, then the debtor's obligation to the transferee could be recharacterized under state law principles.[48] Consequently, "a court considering a motion to avoid a transfer as constructively fraudulent under § 548(a)(1)(B) must determine whether the transfer is for the repayment of a 'claim' at all."[49]

Instead of ruling on the recharacterization issue, the court vacated the district court's dismissal of the trustee's constructively fraudulent claim and remanded the case back to the bankruptcy court with the new framework it had just established.[50]

The court expressly rejected the district court's reliance on the Bankruptcy Appellate Panel's (BAP) holding in *Unsecured Creditors' Committees of Pacific Express, Inc., and Pacific Express Holding, Inc. v. Pioneer Commercial Funding Corp. (In re Pacific Express, Inc.)*[51] that the Code "did not authorize courts to

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42. *Id.*
43. *Id.* (citing *Travelers*, 549 U.S. at 451).
44. *Id.* at 1147.
45. *Id.*
46. *Id.*
47. *Id.*
48. *Id.*
49. *Id.*
50. *See* Jordan A. Kroop & K. Derek Judd, *Ninth Circuit Court of Appeals Reverses Precedent—Courts Can Recharacterize Debt as Equity to the Extent Allowed Under State Law*, SQUIRE SANDERS (May 2013), http://www.squiresanders.com/ninth-circuit-court-of-appeals-reverses-precedent-courts-can-recharacterize-debt-as-equity-to-the-extent-allowed-under-state-law/.
51. 69 B.R. 112 (B.A.P. 9th Cir. 1986). The BAP vacated the bankruptcy court's finding that

characterize claims as equity or debt" but instead "limited courts to statutory remedy of equitable subordination under 11 U.S.C. § 510."[52] Instead, the court joined five other circuits and held that courts have the power to recharacterize an obligation that, functionally, more closely resembles equity rather than debt under state law.[53]

IV. A HISTORICAL PERSPECTIVE: COMPARING EQUITABLE SUBORDINATION TO RECHARACTERIZATION

Since 1986 when the BAP decided *In re Pacific Express, Inc.*,[54] the Ninth Circuit has consistently held that it did not have the authority to recharacterize loans as debt, and instead courts were limited in their equitable power to subordinate claims under § 510(c).[55] However, recharacterization can be functionally similar to the concept of equitable subordination under § 510(c)(1) because both allow the court to take something that is purported debt and, in essence, "subordinate" the purported debt to all other general unsecured claims.[56] Although these principles may be confused, they are vastly different in concept. In subordination, the court is subordinating debt as the lowest priority to be paid after other debt.[57] In recharacterization, the court is redefining or renaming some purported debt as equity; thus, the court recharacterizes the transfer from debt to equity rather than subordinating it from general unsecured debt to lowest priority debt.[58] The two concepts result in different outcomes only if there is enough money in the estate to fully pay off general secured debts with money left over for the

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a purported loan was in fact an equity investment. *Id.* at 115. The BAP reasoned that, although the bankruptcy court has broad equitable powers, those powers do not permit it to apply a standard inconsistent with a specific, applicable provision of the Bankruptcy Code. *Id.* The court held that "the Code supports the court's ability to determine the amount and the allowance or disallowance of claims" but those same provisions "do not provide for the characterization of claims as equity or debt." *Id.* The court held that the district court's recharacterization amounted to "subordination," which is governed by § 510. *Id.*

52. *In re Fitness*, 714 F.3d at 1147–48; *see* Cook, *supra* note 14, at 636.

53. *In re Fitness*, 714 F.3d at 1148.

54. *See supra* note 51.

55. *See In re Fitness*, 714 F.3d at 1144–48.

56. *See* Cohen v. KB Mezzanine Fund II, LP (*In re* SubMicron Sys. Corp.), 432 F.3d 448, 454–55 (3d Cir. 2006).

57. JOAN N. FEENEY, BANKRUPTCY LAW MANUAL § 6:75 (5th ed. 2014).

58. *In re SubMicron Sys. Corp.*, 432 F.3d at 454–56.

subordinate debt.[59]

There are many different types of subordination, but the most relevant in this context is equitable subordination.[60] Under § 501(c)(1), the court may "under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest."[61] This subordination is based on fairness; even if the claim is correctly defined as debt, the court may choose to subordinate the claim if the creditor acts in an inequitable way.[62] "In an equitable subordination action, the analysis focuses on the behavior of a creditor, knocking down the status of a claim where a creditor engages in inequitable conduct."[63]

In contrast, in recharacterization, the court focuses on the substance of the claim when deciding if the alleged debtor and creditor mislabeled the purported debt as equity within the confines of the Code.[64] "In other words, recharacterization is a definitional attack."[65] If a purported debt is recharacterized as equity, then there is no need for a subordination analysis: under equitable subordination, the claim is presumed to be a "claim" within the confines of the Code.[66]

Another notable difference is how the court treats the party's formal rights in either action.[67] "[W]hen a claim is equitably subordinated, a court disregards a party's formal rights," but "when a claim is recharacterized, a court determines what those formal rights are in the first instance."[68] The court does this by focusing on definitions within the Code and, depending on which circuit the claim is filed in, using either an equitable federal test (in the majority circuits) or interpreting applicable state law (in the minority

59. *See* FEENEY, *supra* note 57, § 6:75.

60. *See id.*

61. 11 U.S.C. § 510(c)(1) (2012).

62. Fed. Commc'ns Comm'n v. Airadigm Commc'ns, Inc. (*In re* Airadigm Commc'ns, Inc.), 616 F.3d 642, 658 (7th Cir. 2010).

63. *Id.*

64. *See id.* In the Fifth and Ninth Circuits, courts also use state law to determine whether the purported debt was mislabeled as equity.

65. *Id.*

66. *Id.*

67. *See id.*

68. *Id.*

circuits).[69]

V. ANALYSIS

The Ninth Circuit joined five other circuits in holding that bankruptcy courts have the authority to recharacterize claims.[70] However, circuits are split over what a court should look to or what law to apply in determining whether a claim can be recharacterized.[71] Circuits in the majority created different federal equitable tests in contrast to the minority's uniform reliance on respective state law to decide the issue of recharacterization.[72] Between the majority and minority approaches, the Ninth Circuit correctly aligned with the minority because it followed Supreme Court precedent, specifically *Butner*, in the absence of an applicable code provision.[73] However, there are unique ramifications to the minority's decision to recharacterize debt as equity. For all of the circuits, recharacterization will affect the distribution of the assets for the recharacterized interest.[74] Specific to the minority approach, lawyers must be conscious of choice-of-law clauses in loan agreements and the potential for increased scrutiny of insider loans by the bankruptcy courts within the Ninth Circuit.[75]

A. Majority Circuits' Approach: Equitable Tests

The Third, Fourth, Sixth, and Tenth Circuits created and applied various federal law tests to analyze whether to recharacterize a purported loan as equity.[76] Although the multi-factored tests vary, the Third, Fourth, Sixth, and Tenth Circuits all relied on "authority vested in the bankruptcy courts to use their equitable powers to test

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69. *See* Wilton & Moeller-Sally, *supra* note 2, at 1261.

70. *See* Cook, *supra* note 14, at 636–37.

71. *See id.* at 637.

72. *See* Wilton & Moeller-Sally, *supra* note 2, at 1261.

73. *Compare* Official Comm. of Unsecured Creditors, of the Estate of Fitness Holdings Int'l, Inc. v. Hancock Park Capital II, L.P. (*In re* Fitness Holdings Int'l, Inc.), 714 F.3d 1141, 1146–47 (9th Cir. 2013) ("We now construe § 548(a)(1)(B) in light of the *Butner* principle."), *with* Grossman v. Lothian Oil Inc. (*In re* Lothian Oil Inc.), 650 F.3d 539, 543 (5th Cir. 2011) ("The Supreme Court has held that the 'applicable law' is *state* law . . . ." (citing Butner v. United States, 440 U.S. 48, 54 (1979)).

74. *See* Wilton & Moeller-Sally, *supra* note 2.

75. Thomson Reuters, *supra* note 25.

76. Wilton & Moeller-Sally, *supra* note 2, at 1261.

the validity of debts."[77] These general equitable powers are defined in § 105, "which states that bankruptcy judges have the authority to 'issue any order, process or judgment that is necessary or appropriate to carry out the provisions' of the Code."[78]

These circuits modeled their multi-factored tests after "factors derived from U.S. tax decisions related to the tax benefits of insider loans."[79] The most commonly cited multi-factor test is the Sixth Circuit's eleven-factor test in the tax case of *Roth Steel Tube Co. v. Commissioner of Internal Revenue*.[80] In *Roth*, the Court weighed the following factors:

> (1) [T]he names given to the instruments, if any, evidencing the indebtedness; (2) the presence or absence of a fixed maturity date and schedule of payments; (3) the presence or absence of a fixed rate of interest and interest payments; (4) the source of repayments; (5) the adequacy or inadequacy of capitalization; (6) the identity of interest between the creditor and the stockholder; (7) the security, if any, for the advances; (8) the corporation's ability to obtain financing from outside lending institutions; (9) the extent to which the advances were subordinated to the claims of outside creditors; (10) the extent to which the advances were used to acquire capital assets; and (11) the presence or absence of a sinking fund to provide repayments.[81]

The Sixth Circuit adopted Roth's eleven-factor test, which was then adopted by *Bayer Corp. v. MascoTech, Inc. (In re AutoStyle Plastics, Inc.)*.[82] Since then, circuits have employed seven-factor, eleven-factor, and thirteen-factor tests.[83] Though the majority circuits have not decided on one single test, each court emphasized how its respective test was to be applied on a case-by-case basis, focusing on the specific facts of each case.[84] Additionally, although each circuit has included or excluded different factors over others, there is one

77. Bayer Corp. v. MascoTech, Inc. (*In re* AutoStyle Plastics, Inc.), 269 F.3d 726, 748 (6th Cir. 2001).

78. *Id.*

79. Wilton & Moeller-Sally, *supra* note 2.

80. 800 F.2d 625, 630 (6th Cir. 1986).

81. *Id.*

82. 269 F.3d at 750.

83. Wilton & Moeller-Sally, *supra* note 2, at 1262 n.15.

84. *In re* Cohen v. KB Mezzanine Fund II, LP (*In re* SubMicron Sys. Corp.), 432 F.3d 448, 455–56 (3d Cir. 2006).

"overarching inquiry" to each test.[85] The common inquiry is "whether the parties called an instrument one thing when in fact they intended it as something else."[86]

To summarize, the majority courts all identified the same source of authority—U.S. tax decisions—to create these federal tests.[87] However, the courts within the majority all relied on this authority to create different multi-factor tests that derive from tax law.[88]

B. Minority View

As explained above, the Ninth and Fifth Circuits are the minority view, finding their answer to the issue of recharacterization through applicable state law.[89] Specifically, the Ninth Circuit interpreted the meaning of "right to payment," starting with interpreting the Bankruptcy Code statutes to define "debt" and "value," and defaulting to state law to define "right to payment."[90]

C. Why the Minority View Is Correct

The Ninth Circuit correctly approached this issue by deferring to applicable state law because state law is consistent with existing legal precedent within the bankruptcy court.[91] In order to understand why the minority view is more consistent with bankruptcy precedent, it is important to understand the aforementioned key case within bankruptcy law, *Butner*.[92] As described above, *Butner* focused on a very specific issue: "whether the right to such rents [collected during a period of bankruptcy/foreclosure] is determined by a federal rule of equity or by the law of State where the property is located."[93] At the time, there existed a circuit split between the majority group—the Second, Fourth, Sixth, Eighth, and Ninth Circuits—and the minority

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85. *Id.*

86. *Id.*

87. *See* Thomson Reuters, *supra* note 25.

88. *Id.*

89. Official Comm. of Unsecured Creditors, of the Estate of Fitness Holdings Int'l, Inc. v. Hancock Park Capital II, L.P. (*In re* Fitness Holdings Int'l, Inc.), 714 F.3d 1141, 1142–47 (9th Cir. 2013) ("Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law[.]") (quoting Butner v. United States, 440 U.S. 48, 54 (1979)).

90. *Id.* at 1145–47.

91. *E.g.*, Grossman v. Lothian Oil Inc. (*In re* Lothian Oil Inc.), 650 F.3d 539, 543 (5th Cir. 2011) (citing the Supreme Court's holding that the "applicable law" is state law).

92. Butner v. United States, 440 U.S. 48 (1979).

93. *Id.* at 49.

group—the Third and Seventh Circuits.[94] The majority group determined that applicable state law should answer this issue.[95] The minority group "adopted a federal rule of equity that affords the mortgagee a secured interest in the rents even if state law would not recognize any such interest until after foreclosure."[96]

Butner vehemently rejected the minority approach for several reasons. First, *Butner* stated that the Constitution gives Congress the right to create this statute, and if it chooses not to exercise that right, then Congress has generally left this specific determination to state law.[97] Next, *Butner* noted that "property interests are created and defined by state law," and "[u]nless 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."[98] The court's reliance on state law will "reduce uncertainty, discourage forum shopping and prevent a party from 'receiving a windfall merely by reason of the happenstance of bankruptcy.'"[99] Lastly, *Butner* recognized the general equitable powers of the bankruptcy court but explained that these equitable powers are best used on a case-by-case basis, instead of creating a uniform federal rule based upon "undefined considerations of equity."[100] *Butner* encompasses the sentiment of bankruptcy law in general: "[i]n the absence of some specific bankruptcy interest or provision, bankruptcy courts will take non-bankruptcy rights as they are found."[101]

As evidenced by *Butner*, the minority circuits' holdings are consistent with established bankruptcy principles. First, Congress has the constitutional power to enact a statute to address this very issue of recharacterization.[102] However, it has not yet done so and thus, the natural step is to default to state law as *Butner* clearly explained.[103]

94. *Id.* at 51–52.
95. *Id.* at 52.
96. *Id.* at 53.
97. *Id.* at 54.
98. *Id.* at 55.
99. *Id.*
100. *Id.* at 56.
101. Rich Mullen, *Bankruptcy 101, Back to Basics with Butner*, WEIL BANKR. BLOG (Oct. 27, 2011), http://business-finance-restructuring.weil.com/throwback-thursday/bankruptcy-101-%E2%80%93-back-to-basics-with-butner/.
102. *See Butner*, 440 U.S. at 54.
103. *See id.*

Second, "right to payment" is defined by state law, and under *Butner*, "[u]nless 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."[104]

A major theme of bankruptcy law is, when a court is faced with making a decision, it must take bankruptcy law and layer it over existing federal or state-law rights.[105] Unless there is a federal statute that says otherwise, established legal precedent requires that the court defer to state law.[106] As of now, there is no provision within the Code that discusses the topic of recharacterization.[107] Therefore, the Ninth Circuit's approach of defaulting to state law when faced with defining a "claim" stems naturally from legal precedent clearly established in *Butner*.[108]

Lastly, *Butner* rejected the notion of a bankruptcy court creating a uniform equitable test without some specific power vested to it through a statute.[109] Using this same reasoning, *Butner* would reject the majority courts' differing equitable tests because, similar to the minority in *Butner*, the tests are founded on some undefined equitable power.[110]

Perhaps the majority's approach of creating a federal test would make more sense if the tests were consistent throughout the circuits, but instead, each circuit differentiates from one another.[111] Moreover, if a Code provision addressed recharacterization, then federal courts would naturally adopt a uniform test that would help determine when a claim should be recharacterized. Since this issue of recharacterization is unique to bankruptcy, a Code provision instigating a uniform federal test might be most efficient. However, because the majority circuits each have their own unique tests and

104. *Id.* at 55.

105. *See* Grossman v. Lothian Oil Inc. (*In re* Lothian Oil Inc.), 650 F.3d 539, 543–46 (5th Cir. 2011).

106. Mullen, *supra* note 101.

107. *See* Official Comm. of Unsecured Creditors, of the Estate of Fitness Holdings Int'l, Inc. v. Hancock Park Capital II, L.P. (*In re* Fitness Holdings Int'l, Inc.), 714 F.3d 1141, 1142–44 (9th Cir. 2013).

108. *Id.*

109. *Butner*, 440 U.S. at 49–53.

110. *Id.*

111. *See* Wilton & Moeller-Sally, *supra* note 2.

the Code does not contain a specific statute for recharacterization,[112] the Ninth Circuit approach is more logical. Without the presence of a federal statute to specifically govern the recharacterization, the Ninth Circuit followed bankruptcy precedent by relying on the *Butner* principle and defaulting to state law to determine applicable rights.[113]

D. Ramifications of Recharacterization Within the Ninth Circuit

The Ninth Circuit's decision to recharacterize a purported debt as equity has three significant consequences: (1) the obvious change in the order of distribution, (2) closer scrutiny of insider trading, and (3) the increased importance of a choice of law clause in any loan agreement.

First, if a court recharacterizes debt as equity, then the liquidated assets of the estate are distributed accordingly.[114] "Recharacterization ensures that non-insider creditor claims will be paid first from the available assets of the corporation."[115] Consider the following example. Someone may have intended to make a loan and extended credit. However, the court decides that the transfer more closely resembles an equity interest rather than an extension of credit (despite the formal title) and decides to recharacterize the debt as equity. Consequently, in the case of bankruptcy, that person's claim is subordinated significantly below other true creditors' claims, and there is the risk that he may not receive any money if there is nothing left after the estate pays back the creditors.

Second, the Ninth Circuit's holding will most significantly impact insider loans and similar transactions because the courts now can review and recharacterize these specific types of transactions, despite what the alleged creditor and debtor formally titled the transaction.[116] As a remedy, recharacterization is "most commonly invoked when an insider purports to loan money to a company when

112. *Butner*, 440 U.S. at 54.

113. *See generally* Mullen, *supra* note 101 ("Although the Bankruptcy Code has since superseded the Bankruptcy Act, under which *Butner* was decided, the proposition set forth in *Butner* remains at the heart of the federal bankruptcy framework.").

114. *See generally* Mark G. Douglas, *Bankruptcy Court Empowered to Recharacterize Debt as Equity*, JONES DAY BUS. RESTRUCTURING REV. (October 2003), http://www.jonesday.com/newsknowledge/publicationdetail.aspx?publication=1414 (explaining how liquidated assets are distributed if debt is recharacterized as equity).

115. *Id.*

116. Kroop & Judd, *supra* note 50.

it is undercapitalized and the cash infusion should have taken the form of a capital contribution."[117] Thus, claims involving allegations of insider loans have an available remedy within the Ninth Circuit: recharacterization.[118] As a result of both the Fifth and Ninth Circuits requiring application of state law to determine whether an alleged insider loan should be recharacterized as equity, choice-of-law statements are now very important in drafting transactions or legal agreements.[119] As a result, how state law evolves and how a court determines which state's law governs the case will affect the level of scrutiny applied to cases on insider loans.[120]

Lastly, because the Ninth and Fifth Circuits held that they had the power to recharacterize by looking to state law, choice-of-law provisions within loan contracts will be very helpful if there is potential for a recharacterization claim.[121] This is because one state law may be more favorable or developed than another.[122]

The Ninth Circuit's holding in *In re Fitness Holdings* is a "cautionary tale to corporate insiders (including private equity sponsors) that make loans to a company or attempt to cash out in a refinancing or dividend recapitalization transaction shortly before the company files for bankruptcy."[123]

VI. CONCLUSION

In conclusion, the Fifth and Ninth Circuits' state-law approach to recharacterization is superior to the majority circuits' approach of employing various self-created equitable tests because it adheres more strictly to Supreme Court precedent, best established in *Butner*. However, the Ninth Circuit's reliance on state law poses potential problems that attorneys should carefully draft around and take into

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117. Douglas, *supra* note 114.

118. Kroop & Judd, *supra* note 50.

119. *Ninth Circuit Widens Circuit Split Over Application of State or Federal Bankruptcy Law To Determine Whether Claims of Insider-Lenders Should be Recharacterized as Equity*, ROPES & GRAY ALERT (May 3, 2013), http://www.ropesgray.com/~/media/Files/alerts/2013/05/20130503_BBR_Alert.pdf.

120. *See id.*

121. *See* Lisa G. Laukitis and Mark G. Douglas, *A Cautionary Tale for Insider Lenders: Ninth Circuit Endorses Recharacterization Remedy in Bankruptcy*, JONES DAY (July/Aug. 2013), http://www.jonesday.com/a-cautionary-tale-for-insider-lenders-ninth-circuit-endorses-recharacterization-remedy-in-bankruptcy-07-31-2013/.

122. *See id.*

123. *Id.*

account when advising their clients.[124] Specifically, attorneys should pay close attention to choice-of-law clauses in loan agreements, depending on which state law the client finds preferable. Also, attorneys should advise clients knowing that courts will look at insider loans with closer scrutiny now that courts have the authority to recharacterize the purported debt into equity. Ultimately, the newly recognized remedy of recharacterization in the Ninth Circuit will make lenders think twice before signing any loan agreement.

124. *See id.*