WHITHER RECHARACTERIZATION

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"Things are not always as they seem; the first appearance deceives many."[1]

Abstract

The ability of bankruptcy courts to recharacterize a putative debt claim as an equity interest in order to ensure that form does not prevail over substance is beyond cavil. There is considerable uncertainty, however, over whether this power derives from the inherent equitable authority of the bankruptcy courts to subordinate a purported claim to ensure attainment of system-wide objectives or from the courts' statutory authority to allow and disallow claims. The answer to that question has significant ramifications far beyond the question of debt recharacterization, implicating both the division of authority between state and federal law in bankruptcy cases and the policies and purposes of the bankruptcy regime. This Article takes the position that "subordination," not "disallowance," is the most accurate metaphorical concept for understanding recharacterization and that by locating the source of the courts' authority under the statutory power to equitably subordinate claims, the issue will properly be resolved under a federal framework and with specific attention to the unique aims of the bankruptcy system.

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1. PHAEDRUS, 444–393 BC.

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INTRODUCTION

Equality of distribution is a core policy of American bankruptcy law.[2] In a sense, creditors trade their potential but uncertain prospect

2. *See, e.g.*, Begier v. IRS, 496 U.S. 53, 58 (1990) (noting equality of distribution among creditors as a central concern of the Federal Bankruptcy Code); Nathanson v. NLRB, 344 U.S. 25, 29 (1952) ("The theme of the Bankruptcy Act is 'equality of distribution'; and if one claimant is to be preferred over others, the purpose should be clear from the statute." (citation omitted) (quoting Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215, 219 (1941))); *see also* COMM'N OF THE BANKR. LAWS OF THE U.S., REPORT OF THE COMM'N OF THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, pt. 1, at 75 (1973) (discussing internal and external goals of the bankruptcy system, including, among the most critical, equality of distribution among creditors). Of course, the statement "equality of distribution" is not an entirely accurate (or perhaps it is an oversimplified) description of the distributional norms that pertain to a bankruptcy

of being paid in full under state law, for the right to take—*pari passu* with similarly situated claimants—a lesser but assured amount in bankruptcy.[3] This places an enormous premium on making certain that claims against the debtor are not only what they purport to be in fact but also that the claimholders are "entitled" to the status and priority to which, on their face, they lay entitlement. In turn, this means that the federal bankruptcy courts must not only determine that claims are "good" in the sense that they are not subject to any valid defenses that might result in their reduction in whole or in part and good in the sense of not "naughty,"[4] but also good in the sense that they are what they proclaim to be in the first instance.

As for the last of the above three tasks, seven circuit courts of appeals have now addressed the question of whether the bankruptcy courts possess the authority to recharacterize a transaction branded as a loan to the entity-debtor from a debt to an equity contribution, thereby effectively subordinating that interest to the claims of the debtor's general unsecured creditors.[5] All seven courts have responded affirmatively,[6] but that is where the unanimity of opinion comes to an abrupt halt. The circuit courts have yet to agree on whether the appropriate conceptual equivalent for recharacterization is subordination or disallowance,[7] and the absence of concurrence over that ideation has significant consequences not just with respect to how the doctrine is understood, but also in terms of when the remedy is properly invoked.

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case as bankruptcy policy must be reconciled with other social policies with which it from time-to-time competes. *See generally* Alec P. Ostrow, *The Animal Farm of Administrative Insolvency*, 11 AM. BANKR. INST. L. REV. 339 (2003).

3. THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 11–13 (1986) (offering the analogy of a lake filled with fish and one hundred fishermen to illustrate how bankruptcy is designed to make competing creditors act as one for their mutual advantage). Equality is no less important in rehabilitation proceedings than in liquidations. *See* Lawrence Ponoroff, *Bankruptcy Preferences: Recalcitrant Passengers Aboard the Flight from Creditor Equality*, 90 AM. BANKR. L.J. (forthcoming 2016) (manuscript at 66) (on file with author) ("[T]he fact that equality policy operates in conjunction with other policy considerations in Chapter 11 that do not attend a Chapter 7 case does not make equality policy, properly understood, less compelling in the reorganization context.").

4. "Naughty" for these purposes meaning not the product of the sort of inequitable conduct that might, under the prevailing approach to the doctrine, trigger equitable subordination. *See infra* text accompanying notes 178–80.

5. *See infra* Part III.

6. These cases are cited and discussed in Part I of this Article. Moreover, one additional court of appeals has signaled its receptivity to recharacterization theory but did not actually so hold in the case. *See infra* note 110.

7. *See infra* Part III.

To begin with, there is a split of opinion among the circuit decisions as to the source of the bankruptcy courts' authority to recharacterize debt and, deriving from that division, a further disagreement over the standards governing when it is fitting for a court to exercise that power. Insofar as the latter question is concerned, the principal source of contention relates to the allocation of authority between state and federal law, implicating a much larger question regarding the extent to which private state law rights should be preserved in bankruptcy, a question that has resisted efforts to supply a definitive answer around which any consensus might develop.[8] If this were not travail enough, the authority of the bankruptcy courts to engage in the recharacterization of debt under their general equity jurisdiction[9]

8. The disagreement over the extent to which private state law rights should be respected in bankruptcy mirrors the disagreement in the academic commentary over the ideological basis for bankruptcy law. For convenience sake, Professor Baird lumped legal scholars into two camps. Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 576–77 (1998). Those who view bankruptcy as more of a minimalist procedural structure shun the notion that substantive policies and rules should inhere in the bankruptcy system separate and apart from state law, except to the very limited extent necessary to accommodate a collective proceeding. *See, e.g.*, Charles W. Mooney, Jr., *A Normative Theory of Bankruptcy Law: Bankruptcy as (Is) Civil Procedure*, 61 WASH. & LEE L. REV. 931, 931 (2004) (proposing a purely procedure-oriented theory of bankruptcy under which it would be "wrong . . . to redistribute a debtor's wealth away from its [cognizable] rightsholders to benefit third-party interests"); Thomas E. Plank, *The Erie Doctrine and Bankruptcy*, 79 NOTRE DAME L. REV. 633, 691–92 (2004) (suggesting the desirability, to the extent feasible, of following *Erie* in bankruptcy cases so as to advance the development of a coherent body of national commercial law). In the other camp is the group that Baird refers to as the traditionalists, who understand bankruptcy as harboring unique distributional policies designed to serve substantive bankruptcy goals distinct from state law. *See, e.g.*, Vern Countryman, *The Use of State Law in Bankruptcy Cases (Part 1*), 47 N.Y.U. L. REV. 407, 408–09 (1972) ("Also in the category of judicial errors, in my judgment, are those decisions which treat *Erie Railroad Co. v. Tompkins* as requiring the application of state law in bankruptcy cases." (footnote omitted)); Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717, 766 (1991) (describing bankruptcy as "provid[ing] a forum in which competing and various interests and values accompanying financial distress may be expressed and sometimes recognized"). As I have stated in another context, "[t]he need to honor creditors' state law rights, interests, and entitlements—and the need from time-to-time to modify those rights . . . in pursuit of the goals of equality, fresh start, and debtor survival—generate an essential and inescapable tension in bankruptcy law." Ponoroff, *supra* note 3 (manuscript at 56); *see also infra* notes 242–43, 253 and accompanying text (discussing further the disagreement in the academic literature as it relates to this issue).

9. 11 U.S.C. § 105(a) (2012). The equitable powers of the bankruptcy courts may also stem from 28 U.S.C. § 1481, which provided: "A bankruptcy court shall have the powers of a court of equity, law, and admiralty, but may not enjoin another court or punish a criminal contempt not committed in the presence of the judge of the court or warranting a punishment of imprisonment." 28 U.S.C. § 1481 (1982) (repealed 1984). However, that provision no longer appears in the current compilation (or the previous two) of the United

(which remains the majority position in the circuits)[10] may now be in doubt as a consequence of the Supreme Court's decision in *Law v. Siegel*.[11]

Historically, it has been quite frequently said that bankruptcy courts are "courts of equity,"[12] though some have questioned the

States Code, and there is serious doubt as to whether that provision survived the enactment of the Bankruptcy Amendments and Federal Judgeship Act of 1984, 98 P.L. 353, 98 Stat. 333 (1984). Indeed, the strong majority view is that it did not. *See, e.g.*, *In re* Avery, Nos. 01-28602 EEB, 06-16033 EEB, 11-30256 EEB, 2012 WL 1021348, at *7 & n.9 (Bankr. D. Colo. Mar. 20, 2012) (stating that 28 U.S.C. § 1481 "was repealed in 1984, and no comparable provision has been enacted" but also observing that the legislative history does not indicate why it was repealed). If it has been repealed, one explanation is that it was probably just an oversight, as Congress's focus at the time was on resolving the constitutional crisis that had been created by *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982). *See* Adam J. Levitin, *Toward a Federal Common Law of Bankruptcy: Judicial Lawmaking in a Statutory Regime*, 80 AM. BANKR. L.J. 1, 29 (2006) ("The most likely answer is that Congress simply did not notice the equity jurisdiction issue when it passed BAFJA.").

10. *See infra* Part I.B–C.

11. 134 S. Ct. 1188 (2014). See *infra* notes 20–22 and accompanying text for further discussion of the case.

12. *See, e.g.*, Pepper v. Litton, 308 U.S. 295, 304 (1939) ("[F]or many purposes 'courts of bankruptcy are essentially courts of equity, and their proceedings inherently proceedings in equity.'" (quoting Local Loan Co. v. Hunt, 292 U.S. 234, 240 (1934))). A very early statement that the bankruptcy proceedings are essentially equitable in nature was made on the heels of the enactment of the Bankruptcy Act of 1898 ("1898 Act"), Ch. 541, 30 Stat. 544, 548 (repealed 1978), in *Bardes v. First National Bank of Hawarden*. 178 U.S. 524 (1900) (referring to section 2 of the 1898 Act in stating that proceedings in bankruptcy are "in the nature of proceedings in equity"); *see also* Bank of Marin v. England, 385 U.S. 99, 103 (1966) (observing "that equitable principles govern the exercise of bankruptcy jurisdiction" (citing *Pepper*, 308 U.S. at 304–05; SEC v. U.S. Realty & Improvement Co., 310 U.S. 434, 455 (1940))); Heiser v. Woodruff, 327 U.S. 726, 732 (1946) (first citing *Hunt*, 292 U.S. at 240; and then citing *Pepper*, 308 U.S. at 306) (outlining the legal and equitable powers of the bankruptcy courts under the 1898 Act); Young v. Higbee Co., 324 U.S. 204, 214 (1945) (citing *U.S. Realty & Improvement Co.*, 310 U.S. at 455). Judge Ahart has traced the origins of the maxim that the "bankruptcy court is a court of equity" to the Bankruptcy Act of 1841 ("1841 Act"), ch. 9, 5 Stat. 440 (repealed 1843). Alan M. Ahart, *The Limited Scope of Implied Powers of a Bankruptcy Judge: A Statutory Court of Bankruptcy, Not a Court of Equity*, 79 AM. BANKR. L.J. 1, 13–16 (2005); *see also* Levitin, *supra* note 9, at 6 n.29, 7 n.34 (citing authorities holding that the bankruptcy courts are courts of equity under both the 1841 Act and the Bankruptcy Act of 1867, ch. 176, 14 Stat. 517, 517 (repealed 1878)). For two examples of the scores of cases under the current law of bankruptcy expressing the same opinion, see *Young v. United States*, 535 U.S. 43, 49–50 (2002) ("Congress must be presumed to draft limitations periods in light of this background principle [of equitable tolling, especially] when it is enacting limitations periods to be applied by bankruptcy courts, which are courts of equity and 'appl[y] the principles and rules of equity jurisprudence.'" (alteration in original) (first citing Nat'l Private Truck Council, Inc. v. Okla. Tax Comm'n, 515 U.S. 582, 589–90 (1995); United States v. Shabani, 513 U.S. 10, 13 (1994); and then quoting *Pepper*, 308 U.S. at 304)) and *Langenkamp v. Culp*, 498 U.S. 42, 44 (1990) ("[T]he creditor's claim and the ensuing

veracity of that statement under the current bankruptcy law,[13] as well as in connection with earlier national legislation.[14] In any case, the bankruptcy courts' general equitable authority under § 105(a)[15] has taken something of a drubbing in recent years as appellate courts have, for the most part, sought to constrain the scope of the bankruptcy courts' ability to fashion non-Bankruptcy Code rules or practices in order to more effectively carry out their statutory duties.[16] Recently

preference action by the trustee become integral to the restructuring of the debtor-creditor relationship through the bankruptcy court's *equity jurisdiction*." (citing Granfinanciera v. Nordberg, 492 U.S. 33, 57–58 (1989))).

Of course, those equitable powers can only be exercised within the parameters of bankruptcy law. That was the case under the 1898 Act, *see, e.g.*, Luther v. United States, 225 F.2d 495, 499 (1954), and it is likewise the case under current bankruptcy law. *See, e.g.*, Raleigh v. Ill. Dep't of Revenue, 530 U.S. 15, 24–25 (2000); Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206 (1988).

13. The current law of bankruptcy is found at 11 U.S.C. §§ 101–1532. It was enacted on November 6, 1978 as the Bankruptcy Reform Act of 1978 ("1978 Act") and governs all cases filed on or after October 1, 1979. Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C.). In this Article, except where otherwise indicated, all references herein to the "Code" or the "Bankruptcy Code" are to 11 U.S.C. §§ 101–1532 as amended through January 1, 2015.

14. *See, e.g.*, Ahart, *supra* note 12, at 32 ("[A] bankruptcy court should not be referred to as a court of equity. Supreme Court and other decisions rendered under the Bankruptcy Code stating that the bankruptcy court possesses all equitable authority or powers are incorrect—at least where a bankruptcy judge is the presiding judicial officer."); Marcia S. Krieger, "*The Bankruptcy Court Is a Court of Equity": What Does That Mean?*, 50 S.C. L. REV. 275, 310 (1999) (arguing that while the shibboleth that bankruptcy courts are courts of equity is among the most frequently uttered in the court room, "[f]rom historical, procedural, jurisprudential, and practical perspectives the bankruptcy court is not a court of equity. It is, instead, a specialized court of limited jurisdiction applying statutory law"). Both Judge Ahart and Judge Krieger argue that the assignment of general equitable authority to the bankruptcy courts is purely a judicial creation without statutory support. *See* Ahart, *supra* note 12, at 32; Krieger, *supra*, at 310; *see also* Alan M. Ahart, *A Stern Reminder that the Bankruptcy Court Is Not a Court of Equity*, 86 AM. BANKR. L.J. 191, 191 (2012) (asserting that the Supreme Court's decision in *Stern v. Marshall*, 164 U.S. 462 (2011) corroborated his 2005 conclusion that the bankruptcy courts are not courts of equity); Steve H. Nickles & David G. Epstein, *Another Way of Thinking About Section 105(a) and Other Sources of Supplemental Law Under the Bankruptcy Code*, 3 CHAP. L. REV. 7, 15–17 (2000) (questioning the assertion that bankruptcy courts are courts of equity).

15. Section 105(a) of the Code states, in pertinent part: "The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Code]." 11 U.S.C. § 105. It derives from section 2(a)(15) of the 1898 Act, and, according to the legislative history, is intended to operate similarly to the Federal All Writs Act, 28 U.S.C. § 1651 (2012). H.R. REP. NO. 95-595, at 316–17 (1977), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 5973.

16. *See, e.g.*, Anwar v. Johnson, 720 F.3d 1183, 1187 (9th Cir. 2013) (citing Childress v. Middleton Arms, L.P. (*In re* Middleton Arms, Ltd. P'ship), 934 F.2d 723, 725 (6th Cir. 1991)) (finding that bankruptcy courts lack the authority under § 105(a) to grant a

retired Bankruptcy Judge Randy Haines may have put it most plainly and directly when he stated:

> [T]he driving philosophy underlying the *Stern* result may be neither individual rights nor even separation of powers, but rather an agenda to narrow federal equity jurisdiction and powers, at least in commercial disputes, and in that case to do so by restricting the power of the primary federal court of equity

retroactive extension of the time to file a nondischargeability complaint in light of the clear language of the Federal Rules of Bankruptcy Procedure sections 4007(c) and 9006(b)(3)); Wells Fargo Bank of Tex. N.A. v. Sommers (*In re* Amco Ins.), 444 F.3d 690, 692 (5th Cir. 2006) (holding that a bankruptcy court's use of § 105(a) to order substantive consolidation with a nondebtor represented an abuse of discretion); Smart World Techs., LLC v. Juno Online Servs., Inc. (*In re* Smart World Techs., LLC), 423 F.3d 166, 184 (2d Cir. 2005) (concluding that the bankruptcy court did not have authority under § 105(a) to approve a creditor's motion to settle a cause of action brought by the Chapter 11 debtor in possession over the debtor's objection); *In re* Combustion Eng'g, 391 F.3d 190, 236 (3d Cir. 2004) (vacating a confirmation order providing for a channeling injunction under § 105(a) and noting, consistently with *Law*, that "the general grant of equitable power contained in § 105(a) cannot trump specific provisions of the Bankruptcy Code" (citing *Ahlers*, 485 U.S. at 206)); *In re* Kmart Corp., 359 F.3d 866, 871 (7th Cir. 2004) (holding that § 105(a) provides no authority for the issuance of critical vendor orders); *see also* Rosenberg v. DVI Receivables (*In re* Rosenberg), 471 B.R. 307, 315 (Bankr. S.D. Fla. 2012) (holding that § 105(a) could not be invoked by an involuntary debtor to recover fees and costs from principals of the petitioning creditors). *See generally* Nicholas B. Malito, *Recent Developments: Section 105(a) of the Bankruptcy Code*, *in* 2014 NORTON ANNUAL SURVEY OF BANKRUPTCY LAW 13 (2014) (noting that each year the appellate courts decide at least one case aimed at reinforcing the limitations of the equitable authority of the bankruptcy courts under § 105(a)). While the appellate courts have been more attentive in recent years to limiting the scope of the bankruptcy courts' authority under § 105(a), the intellectual justification for the effort undoubtedly finds its moorings in Judge Posner's opinion in *In re Chicago, Milwaukee, St. Paul, & Pacific Railroad Co.*, decided under the 1898 Act, in which Judge Posner wrote: "The fact that a proceeding is equitable does not give the judge a free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness, however enlightened those views may be." 791 F.2d 524, 528 (7th Cir. 1986) (citing Shondel v. McDermott, 775 F.2d 859, 867–68 (7th Cir. 1985); Piper Aircraft Corp. v. Wag-Aero, Inc., 741 F.2d 925, 939 (7th Cir. 1984)). Commentators have also gotten on the bandwagon. *See, e.g.*, Daniel B. Bogart, *Resisting the Expansion of Bankruptcy Court Power Under Section 105 of the Bankruptcy Code: The All Writs Act and an Admonition from Chief Justice Marshall*, 35 ARIZ. ST. L.J. 793, 825 (2003) (making the case that non-Code powers exercised by the bankruptcy courts in order to resolve cases as expeditiously as possible cannot be justified under the authority of § 105(a)); Levitin, *supra* note 9, at 31–35 (arguing that the statutory language of § 105(a) does not authorize equity powers for the bankruptcy court and that the current statutory authorization of general bankruptcy equity powers is highly questionable). The decision in *Law* reflects a sharp reversal in course from the direction that some thought the Supreme Court was signaling in *Marrama v. Citizens Bank of Massachusetts*, 549 U.S. 365 (2007), concerning the scope of the bankruptcy courts' discretion under § 105(a). *See infra* text accompanying notes 273–76.

in the financial realm, the bankruptcy court.[17]

While the federal circuit courts remain far from in accord on just how broadly (or not) to construe § 105(a), it has become widely accepted that its exercise must be tied to another Bankruptcy Code ("Code") provision and not merely to a general bankruptcy concept or objective.[18] It has also become clear that § 105(a) cannot be pressed into service by the courts in order to create a new substantive right; it can only operate in aid of an existing right.[19] Then, the Supreme Court in *Law* placed the cherry on top of the sundae, holding that a bankruptcy court's surcharge of a debtor's exempt property (so-called equitable disallowance),[20] even in the face of extreme bad faith,[21] cannot be

17. Randolph J. Haines, *The Conservative Assault on Federal Equity*, 88 AM. BANKR. L.J. 451, 455 (2014) (speaking of the Supreme Court's decision in *Stern v. Marshall*, 564 U.S. 462 (2011)). Judge Haines also quibbles with some of the more recent arguments, *see supra* note 14 (questioning whether bankruptcy courts are courts of equity), referring to these arguments as "formulistic" and observing that the jurisdictional amendments in 1978 and 1984 were intended to broaden, not narrow, bankruptcy courts' jurisdiction. Haines, *supra*, at 455 n.23.

18. *See, e.g.*, *Kmart*, 359 F.3d at 871 (citing *Ahlers*, 485 U.S. at 206; *In re* Fesco Plastics Corp., 996 F.2d 152, 154 (7th Cir. 1993)) (stating that the power of the bankruptcy court under § 105(a) is to implement the Code, not override its provisions); New Eng. Dairies, Inc. v. Dairy Mart Convenience Stores, Inc. (*In re* Dairy Mart Convenience Stores, Inc.), 351 F.3d 86, 92 (2d Cir. 2003).

19. United States v. Sutton, 786 F.2d 1305, 1308 (5th Cir. 1986); *accord Smart World Techs.*, 423 F.3d at 184 (citing *New Eng. Diaries*, 351 F.3d at 91–92) (describing bankruptcy courts' § 105(a) powers as generally limited to filling gaps in the statutory language). The "statute does not authorize the bankruptcy courts to create substantive rights that are otherwise unavailable under applicable law, or constitute a roving commission to do equity." *Sutton*, 786 F.2d at 1308 (citing S. Ry. Co. v. Johnson Bronze Co., 758 F.2d 137, 141 (3d Cir. 1985)).

20. So-called equitable disallowance is a controversial doctrine and is discussed further in Part I.D.2 of this Article in the context of the claims allowance process under § 502. Some concern has been expressed over the implications of *Law* in areas where, historically, § 105(a) has been used as authority for action not specifically contemplated by the Code in business as well as consumer cases. These situations include, most commonly: (1) extension of the automatic stay to nondebtor parties, *see, e.g.*, Solidus Networks, Inc. v. Excel Innovations, Inc. (*In re* Excel Innovations, Inc.), 502 F.3d 1086, 1094 (9th Cir. 2007); (2) release of nonconsensual nondebtor third party releases in Chapter 11, *see, e.g.*, Behrmann v. Nat'l Heritage Found., Inc., 663 F.3d 704, 710 (4th Cir. 2011); and (3) exercise of the civil contempt power. *See, e.g.*, Solow v. Kalikow (*In re* Kalikow), 602 F.3d 82, 96–97 (2d Cir. 2010). These questions remain unresolved, although it should be noted that the Eleventh Circuit recently joined the majority view that courts may release nondebtor affiliates under a Chapter 11 plan, despite the language of § 524(e), in an opinion that did not even mention *Law*. SE Prop. Holdings, LLC v. Seaside Eng'g & Surveying, Inc. (*In re* Seaside Eng'g & Surveying, Inc.), 780 F.3d 1070, 1081 (11th Cir.), *cert. denied*, 136 S. Ct. 109 (2015). There is also some uncertainty over the implications of *Law* on the controversial doctrine of equitable disallowance of claims (as

justified under § 105(a) because the effect of doing so would be to override a specific provision of the Code.[22]

Although the ultimate scope of the bankruptcy courts' § 105(a) powers in a post-*Law* environment is still a work in progress, at least one circuit has reaffirmed that its earlier holding—to the effect that the bankruptcy courts' authority to recharacterize a putative debt as equity arises under § 105(a)—remains good law in the circuit.[23] This decision represents a hopeful preliminary sign. Nonetheless, given the increasingly rickety state of § 105(a) in general,[24] particularly when considered in light of other recent efforts to limit the discretion of bankruptcy judges,[25] it might be prudent for the courts to consider an alternative statutory basis under which a cause of action for debt

opposed to exemptions). *See infra* Part I.D.2.

21. The debtor in *Law* engaged in fraudulent conduct, lied to the court, and created sham transactions that cost the trustee over $500,000 in legal fees to unwind. Law v. Siegel, 134 S. Ct. 1188, 1193 (2014).

22. *Id.* at 1194–95. Specifically, the Court ruled in a unanimous decision that neither § 105(a) nor any inherent authority of the bankruptcy court could contravene a specific Code provision—in this case, § 522(k), which expressly prohibited the application of a debtor's exempt property to the payment of any administrative expenses. *Id.* Although allowing that the bankruptcy court has statutory authority to issue any order that is "necessary or appropriate" to carry out the provisions of the Bankruptcy Code, in the words of Justice Scalia, "[i]t is hornbook law that § 105(a) 'does not allow [a] bankruptcy court to override explicit mandates of other sections of the Bankruptcy Code.'" *Id.* at 1194 (quoting 2 COLLIER ON BANKRUPTCY ¶ 105.01[02], at 105–06 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2013)). On its facts, *Law* was not a difficult case, and the result hardly a surprise. However, the precedential reach of the Court's holding in other areas where, historically, § 105(a) has been invoked, is unclear. *See supra* note 20; *infra* note 270 and accompanying text; *see also* Neil C. Gordon & Jonathan H. Azoff, Law v. Siegel *Dicta Leads Lower Courts Astray*, AM. BANKR. INST. J., Feb. 2015, at 34, 34 (arguing that the lower courts that hold bad faith and fraud are no longer grounds for disallowing an exemption give the specific holding in *Law* an overly broad construction).

23. Redmond v. Jenkins (*In re* Alt. Fuels, Inc.), 789 F.3d 1139, 1148–49 (10th Cir. 2015).

24. *See, e.g.*, Seaver v. Ashenfelter (*In re* MSP Aviation, LLC), 531 B.R. 795, 804–05 (Bankr. D. Minn. 2015) (discussing whether equitable recharacterization—upon a proper showing—remains a remedy available to the bankruptcy courts after *Law*).

25. The most far-reaching of these efforts to limit judicial discretion can be found, of course, in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"). Pub. L. No. 109-8, 119 Stat. 23 (codified as amended in scattered sections of 11 U.S.C.). Moreover, while the personal bankruptcy provisions of the Act received the bulk of the attention in this respect, the limitations extended to business cases as well. *See infra* note 270. For instance, the BAPCPA eliminated the authority of a bankruptcy judge to extend either the plan exclusivity period under § 1121 or the timeframe to assume or reject a lease under § 365(d)(4). BAPCPA §§ 404, 437. The Act also limited a bankruptcy judge's discretion to approve key employee retention plans under § 503(c). *Id.* § 331. Also, as Judge Haines has observed, the Supreme Court, too, has gotten into the Act. *See supra* note 17 and accompanying text.

recharacterization may be authorized that not only assures its continuation in the proper circumstances, but does so in a manner that does not entail ceding the determination of when those circumstances exist to the vagaries of state law, as the current minority view on recharacterization endorses.[26] It is my intention in this Article to offer such an alternative.

The determination of the nature of capital contributed by an owner or other insider of an entity debtor has always been a tricky undertaking.[27] The temptation to clothe equity contributions in the form of loans is prompted by multiple considerations. First, equity stands behind debt upon liquidation of the firm.[28] Thus, it is inherently riskier than debt in the sense that, in the event of insolvency, an owner stands to lose her entire investment in the company rather than just a pro rata share. Second, payments on a loan obligation are typically deductible to the firm, but dividend distributions to equity owners are not.[29] This means, assuming the company is profitable, a higher ratio of debt to equity will produce lower taxes, or, if the company is not profitable, potentially valuable loss carryforwards. For these reasons, the failure to capitalize a business with adequate equity funding to support operations and the foreseeable risks of doing business has always been a pivotal factor under state law piercing analysis.[30]

26. *See infra* Part I.D.

27. The concern over the mischaracterization of an equity contribution in the case of a traditional arms-length lender is ordinarily less. However, when funds denominated as a loan are extended to a financially distressed debtor, or an earlier loan is refinanced after the borrower has encountered financially turbulent waters, questions about the true character of the investment can become no less thorny than in the case of insider investments, since it is common for the "lender" in these situations to require more than a fixed interest payment in return for the added risk being undertaken. *See generally* Smith v. Assocs. Commercial Corp. (*In re* Clark Pipe & Supply Co.), 893 F.2d 693, 702–03 (5th Cir. 1990) (reasoning that covenants in a loan agreement permitting greater control over the borrower's financial affairs once its financial condition is in peril are common and their exercise does not rise to the level of inequitable conduct).

28. Section 726(a) of the Code provides that all unsecured claims must be paid in full before the holders of equity interest receive anything from the estate. The principle is not limited to bankruptcy law; it is a fundamental axiom of business and commercial law followed as a matter of general practice under state law. For example, the Model Business Corporation Act requires that, upon dissolution, the directors discharge all of the corporation's liabilities before making any distributions to shareholders. § 14.09(a) (2010).

29. For this reason, many of the cases examining the character of a capital contribution as debt or equity are tax court cases, and these cases have proved influential in many of the recharacterization decisions that have arisen in the bankruptcy context. *See, e.g.*, Lane v. United States (*In re* Lane), 742 F.2d 1311 (11th Cir. 1984); *see also infra* notes 83–84, 94 and accompanying text.

30. There are a myriad of decisions that cite undercapitalization as one of several factors bearing on the piercing analysis. *See, e.g.*, E. Minerals & Chems. Co. v. Mahan,

Inadequate capitalization, often a consequence of too much insider debt in the initial capitalization of the company, has also played a central role in the development and analysis of equitable subordination under Code § 510(c).[31] Though closely related, in recent years, the doctrine of equitable subordination has not played a prominent role in the analysis of the recharacterization question.[32] In this Article, I suggest that perhaps the rigid separation of equitable subordination and recharacterization that has developed over the past twenty years should be reconsidered, if not necessarily as a matter of doctrinal purity, then to ensure that the issue of whether a particular contribution to a debtor-firm is treated as debt or equity in bankruptcy continues to be decided under a federal standard and with a sensitivity to the policies implicated by a bankruptcy proceeding.

In advancing this proposal, Part I of the Article begins by reviewing the current state of the law regarding debt recharacterization and the circuit split that has developed in the past few years over the source of the courts' authority under the Code to recharacterize debt as equity. Part II briefly examines the history of the related doctrine of equitable

225 F.3d 330, 333 nn.6–7 (3d Cir. 2000); Sea-Land Servs., Inc. v. Pepper Source, 993 F.2d 1309, 1312 (7th Cir. 1993). It is, however, generally understood that undercapitalization alone (whether at the onset or due to a draining of assets in dividends and salary) is insufficient to warrant piecing the corporate veil. *See, e.g.*, Arnold v. Browne, 103 Cal. Rptr. 775, 782 (Ct. App. 1972). Undercapitalization of a company may also be relevant under non-piercing state law. *See, e.g.*, Kendall Yacht Corp. v. United Cal. Bank, 123 Cal. Rptr. 848, 853 (Ct. App. 1975) (finding undercapitalization relevant in determining the bank's "customer" under the Uniform Commercial Code); Boyle v. Gen. Motors Corp., 661 N.W.2d 557, 558 (Mich. 2003) (finding inadequate capitalization bearing on fraud claim). Likewise, undercapitalization will occasionally arise, as in bankruptcy cases, in the context of characterizing a capital advance to a company as debt or equity. *See* James M. Wilton & Stephen Moeller-Sally, *Debt Recharacterization Under State Law*, 62 BUS. LAW. 1257, 1269–70 (2007). *See generally* William P. Hackney & Tracey G. Benson, *Shareholder Liability for Inadequate Capital*, 43 U. PITT. L. REV. 837 (1982). Of course, because state collection remedies are based generally on the principle of first-come, first-served, this will only be relevant in connection with proceedings involving matters such as a receivership, dissolution of the company, and an assignment for the benefit of creditors.

31. *See, e.g.*, Arnold v. Phillips, 117 F.2d 497, 502–03 (5th Cir. 1941); *see also infra* notes 165, 295 and accompanying text (discussing the pre-Code case law giving rise to § 510(c)).

32. The suggestion that a recharacterization claim is essentially the same as an equitable subordination claim is, today, regarded as "misguided." *See* Official Comm. of Unsecured Creditors of Russell Cave Co. v. Gen. Elec. Capital Corp. (*In re* Russell Cave Co.), 107 F. App'x 449, 452 (6th Cir. 2004). Historically, however, that has not been true, as the doctrine of equitable subordination evolved from cases involving the recharacterization of debt to equity and the recharacterization remedy itself was "considered solely in conjunction with the doctrine of equitable subordination." *See* Aquino v. Black (*In re* AtlanticRancher, Inc.), 279 B.R. 411, 433 (Bankr. D. Mass. 2002).

subordination and assesses how it has fared in the decisional law since its codification in 1978. Next, Part III returns to debt recharacterization in order to identify what I consider to be the weaknesses in the emerging minority approach and the threat to the majority view posed by recent decisions circumscribing the reach of the bankruptcy courts' equitable jurisdiction under § 105(a). Finally, Part IV proposes an expansion of the doctrine of equitable subordination beyond its currently understood contours to cover debt recharacterization in appropriate cases, thereby supplying an alternative source of authority that preserves a federal framework within which to analyze the issue.

I. THE RECHARACTERIZATION JURISPRUDENCE

A. The Early Authority

The treatment of debt recharacterization in the United States federal courts of appeals as an independent cause of action in bankruptcy cases is largely a twenty-first century phenomenon.[33] Nevertheless, the first decisions to hint at the possibility date back at least to the 1980s.[34] In *In re N & D Properties*, for example, the plaintiff, Ms. Estes, who had recently inherited several hundred thousand dollars, was approached by her accountant to invest in a furniture company that he was forming.[35] Accordingly, Ms. Estes lent $40,000 to what would eventually become the debtor corporation.[36] Several months later, Ms. Estes pledged $100,000 worth of bonds to assist the company in obtaining a bank loan and, in return, received shares representing a 47.4% ownership interest in the firm.[37] Subsequently, Ms. Estes pledged shares of stock that she owned in another corporation to secure what eventually amounted to over $389,000 in bank loans to the company.[38] Management of the business was left to Ms. Estes's accountant, who apparently botched it badly.[39]

33. *See infra* Part I.B–D; *see also infra* note 313 and accompanying text.

34. The history of the decisional law scrutinizing the proper characterization of a corporate contribution has even deeper roots, but the examination typically proceeded under the aegis of doctrines other than recharacterization per se. *See infra* notes 176–78, 313 and accompanying text.

35. Estes v. N & D Props., Inc. (*In re* N & D Props., Inc.), 799 F.2d 726, 728 (11th Cir. 1986).

36. *Id.*

37. *Id.* Subsequently, Ms. Estes hypothecated additional assets to facilitate the company's ability to acquire further debt financing. *Id.* at 729.

38. *Id.*

39. *Id.*

Upon finally learning of her accountant's perfidy and ineptitude, Ms. Estes, on the advice of a consultant she had retained to advise her, paid off the bank loans and took an assignment of its security interest in the company's furniture.[40] Thereafter, having assumed control of the company, Ms. Estes was advised that the firm should seek bankruptcy protection, and she advanced the funds necessary to cover the filing fees.[41] Ms. Estes filed a claim for $320,000 in the company's bankruptcy case.[42] The bankruptcy court determined that only $192,858 of loans could be "verified" and concluded that $60,000 of this amount represented a contribution of equity capital.[43] As for the balance of $132,858, the court ordered this amount subordinated to the claims of other creditors under § 510(c) based on Ms. Estes's assumption of the bank's security interest at a time when the debtor was insolvent and on the brink of collapse.[44] On appeal, the district court determined that, because Ms. Estes had paid off the bank's claim, her assumption of its secured position was not improper under ordinary principles of suretyship law.[45] Thus, given the absence of any finding of unfair dealings between the debtor and Ms. Estes, coupled with her all but recent lack of an active role in management, the district court ruled that the priority of her claim should be restored.[46] On further appeal to the Eleventh Circuit, the trustee urged that Ms. Estes and her accountant had conspired to obtain the benefits of ownership without incurring the correlative risks associated with a capital contribution.[47] Thus, he urged that Ms. Estes's claim be subordinated based on her inequitable conduct and further, given the corporation's lack of adequate capitalization, that all of her loans be invalidated as disguised equity investments.[48] Initially, the court agreed that Ms. Estes had

40. *Id.* at 729–30.

41. *Id.* at 730. This loan to cover filing fees and expenses was only $1200, but it was also secured with a second position security interest in the debtor's remaining assets. *Id.*

42. *Id.* at 728. Defined in § 101(5), "claim" means a right to payment, 11 U.S.C. § 101(5) (2012), and is distinguished from an "interest," which is not specifically defined in the Code, but refers to the rights of an equity security holder as can be seen from §§ 101(16) and 501(a).

43. *N & D Props.*, 799 F.2d at 728.

44. *Id.* at 730.

45. *Id.*

46. *Id.* at 730–31. The district court focused on Ms. Estes's lack of business acumen and the fact that, at the time of the challenged transactions, she was a passive minority shareholder. *Id.* at 731. The district court also disagreed with the bankruptcy court's treatment of a portion of her claim as equity but for reasons not expounded upon in the opinion. *Id.* at 730.

47. *Id.* at 731.

48. *Id.*

engaged in inequitable conduct after taking control of the business by virtue of the fact that, with her knowledge, the company continued to take cash deposits from customers despite the fact that suppliers had cutoff new shipments and there was no hope those orders could be filled.[49] However, because only consumer creditors, and not trade creditors, were harmed by this conduct, the court concluded that the portion of Ms. Estes's claim based on the bank's secured status should retain its priority status *except* with respect to the consumer creditors.[50]

As for recharacterization of Ms. Estes's claim as a capital investment, the court acknowledged the bankruptcy courts' power to do so under proper circumstances.[51] Specifically, relying on the Fifth Circuit's decision in *In re Multiponics*,[52] a case decided under the 1898 Act, the court observed that recharacterization of debt as equity requires that the trustee prove either (1) initial undercapitalization or (2) that "the loans [in question] were made when no other disinterested lender would have extended credit."[53] Given the absence of proof of either set of facts, the court stated that "invalidation of appellee's claim [on this basis] would be improper."[54] *N & D Properties* was principally a case about equitable subordination, but with a passing reference to

49. *Id.* at 732–33. The court found she was also aware that the debtor was not maintaining a trust account for such deposits and that the company was deceiving customers about delivery times and the reasons for delay. *Id.* at 732.

50. *Id.* at 733. The court did, however, agree with the bankruptcy court that Ms. Estes's second claim for the $1200 she had loaned the debtor to cover the filing fee should be subordinated to both groups of creditors. *Id.*

51. *Id.*

52. Mach. Rental, Inc. v. Herpel (*In re* Multiponics, Inc.), 622 F.2d 709 (5th Cir. 1980). Because *Multiponics* was decided prior to the creation of the Eleventh Circuit, it represented binding precedent for the court.

53. *N & D Props.*, 799 F.2d. at 733. As to the latter circumstance, while not made explicit by the court in either *N & D Properties* or *Multiponics*, the requirement would be that a similar amount could not have been borrowed from an informed outside source *on similar terms*. It also bears noting, reflective of the approach of the courts at the time, *Multiponics* conflated the question of subordination based on § 510(c) and subordination based on undercapitalization as a species of the single issue of whether the defendant engaged in inequitable conduct. 622 F.2d at 713. Indeed, the heading of this section of the *Multiponics* court's decision is titled "Undercapitalization and Other Inequitable Conduct," and the authorities cited in this section are all 1898 Act cases that were the precursors of § 510(c). *Id.* at 716–20; *see also infra* note 295 and accompanying text. There is no mention of "recharacterization" at all, and certainly no indication that it might be asserted as an independent cause of action. In other words, *Multiponics* is really an equitable subordination case. Commentators have criticized the Eleventh Circuit's per se approach to recharacterization in *N & D Properties* as impeding a corporation's access to debt financing from insiders and have suggested that the approach has not gained much traction outside of the circuit. *See, e.g.*, Wilton & Moeller-Sally, *supra* note 30, at 1260–61.

54. *N & D Props.*, 799 F.2d at 733.

recharacterization as a separate claim. Similarly, in *In re Herby's Foods*, a case in which the Fifth Circuit affirmed the subordination of insider creditors' claims under § 510(c), the appellants urged that the bankruptcy court had erred by recharacterizing their advances as equity.[55] In the course of addressing the argument, the court acknowledged the existence of the bankruptcy courts' authority to recharacterize a loan as an equity contribution even when the circumstances would not support equitable subordination.[56] However, the court glossed over the point, as well as the propriety of recharacterization in the case, on the alternative bases either that the bankruptcy court's judgment was in fact predicated on equitable subordination, or that, in any event, the practical effect of application of the two remedies was the same.[57]

B. AutoStyle *and the Majority Approach*

The Sixth Circuit was the first circuit court of appeals to examine, in depth, debt recharacterization arising out of a bankruptcy case in *In re AutoStyle Plastics*.[58] It signaled the emergence of recharacterization

55. Summit Coffee Co. v. Herby's Foods, Inc. (*In re* Herby's Foods, Inc.), 2 F.3d 128, 133 (5th Cir. 1993).

56. *Id.* at 132.

57. *Id.* The fact that the practical effect would be identical is an important part of the explanation of why the circuit decisions on recharacterization are, if not flawed, at least susceptible to a more principled alternative analysis. *See infra* text accompanying notes 234–38.

58. Bayer Corp. v. MascoTech, Inc. (*In re* AutoStyle Plastics, Inc.), 269 F.3d 726 (6th Cir. 2001). While *AutoStyle* was the first court of appeals case to address recharacterization in depth, there were certainly a number of lower court decisions that had grappled with the issue. *See, e.g.*, Fett v. Moore (*In re* Fett Roofing & Sheet Metal Co.), 438 F. Supp. 726, 729 (E.D. Va. 1977) ("[A] bankruptcy court, sitting as a court of equity, will disregard the outward appearances of the transaction and determine its actual character and effect."); Herzog v. Leighton Holdings, Ltd. (*In re* Kids Creek Partners, L.P.), 212 B.R. 898, 931 (Bankr. N.D. Ill. 1997) (citing Blasbalg v. Tarro (*In re* Hyperion Enters., Inc.), 158 B.R. 555, 560 (D.R.I. 1993); *In re* Union Meeting Partners, 160 B.R. 757, 774 (Bankr. E.D. Pa. 1993)) (recognizing recharacterization as a separate cause of action from equitable subordination); *In re* Cold Harbor Assocs., L.P., 204 B.R. 904, 915 (Bankr. E.D. Va. 1997) (holding that a court "is not required to accept the label of 'debt' or 'equity' placed by the debtor upon a particular transaction, but must inquire into the actual nature of a transaction to determine how best to characterize it"); *Blasbalg*, 158 B.R. at 561 (providing that recharacterization of a disputed insider transaction requires consideration of numerous factors); Diasonics, Inc. v. Ingalls, 121 B.R. 626, 631 (Bankr. N.D. Fla. 1990) (citing the Eleventh Circuit's decision in *N & D Properties* in support of recharacterization). Of course, there were also some decisions that went the opposite way. *See, e.g.*, Unsecured Creditors' Comms. of Pac. Express, Inc. v. Pioneer Commercial Funding Corp. (*In re* Pac. Express, Inc.), 69 B.R. 112, 115 (B.A.P. 9th Cir. 1986) (holding

theory from the shadow of equitable subordination as a full-blown alternative to the stringent standards that had come to define the interpretation and application of § 510(c).[59] In *AutoStyle*, the plaintiff contended that the defendants' claims arising out of their participation interests in a senior secured loan should be subordinated to the plaintiff's priority in the proceeds from the sale of the common collateral.[60] The plaintiff offered four separate legal theories in support of the relief sought, including equitable subordination and debt recharacterization.[61] The bankruptcy court granted (and the district court affirmed) summary judgment in favor of the defendants on both claims.[62]

As to the equitable subordination theory, the court cautioned that, while particularly careful scrutiny is required in connection with insider claims[63] (which were at issue in this case), "equitable subordination is an unusual remedy" that must be applied with "great caution" and only "in limited circumstances."[64] The court stated that

that no specific provision of the Code allows courts to recharacterize claims); Pinetree Partners, Ltd. v. OTR *ex rel.* State Teachers Ret. Sys. (*In re* Pinetree Partners, Ltd.), 87 B.R. 481, 491 (Bankr. N.D. Ohio 1988).

59. As discussed below, *infra* text accompanying notes 174, 363, courts have generally conveyed an attitude of restraint toward imposing liability under § 510(c). *See, e.g.*, Redmond v. Jenkins (*In re* Alt. Fuels, Inc.), 789 F.3d 1139, 1154 (10th Cir. 2015) (referring to equitable subordination as "an extraordinary remedy to be employed by courts sparingly"); Bank of N.Y. v. Epic Resorts-Palm Springs Marquee Villas, LLC (*In re* Epic Capital Corp.), 307 B.R. 767, 773 (D. Del. 2004) (same); Bird v. SKR Credit, Ltd. (*In re* DigitalBridge Holdings, Inc.), No. 12-2373, 2015 WL 5766761, at *11 (Bankr. D. Utah Sept. 30, 2015) (same).

60. *AutoStyle*, 269 F.3d at 735.

61. *Id.* at 735, 744, 747. The other two theories were priority based on the defendants' alleged failure to perfect their security interests and invalidity of the participation agreements. *Id.* at 735–36, 740–41.

62. *Id.* at 753; Bayer Corp. v. MascoTech, Inc. (*In re* AutoStyle Plastics, Inc.), No. 1:99-CV-800, SG 96-83767, 1999 WL 1566474, at *3 (W.D. Mich. Dec. 16, 1999).

63. *See, e.g.*, Schubert v. Lucent Techs., Inc. (*In re* Winstar Commc'ns, Inc.), 554 F.3d 382, 412 (3d Cir. 2009) (holding that "dealings between [the] debtor and an insider [are] to be rigorously scrutinized" (quoting Fabricators, Inc. v. Tech. Fabricators, Inc. (*In re* Fabricators, Inc.), 926 F.2d 1458, 1465 (5th Cir. 1991))); Wilson v. Huffman (*In re* Missionary Baptist Found., Inc.), 712 F.2d 206, 211–12 (5th Cir. 1983) (stating that an "insider connection with the debtor[-company] compels close examination of [the] claim"). The insider status, however, goes to establishing the standard to apply in reviewing the insider's conduct. That is to say, in order to equitably subordinate a creditor-insider's claim, the creditor-insider must have actually used its power to control to its own advantage and to the other creditors' detriment. *See* Comstock v. Grp. of Institutional Inv'rs, 335 U.S. 211, 228–29 (1948). For additional discussion of the distinction between insiders and noninsiders under the doctrine of equitable subordination, see *infra* notes 172–174, 349.

64. *AutoStyle*, 269 F.3d at 745 (quoting *Fabricators*, 926 F.2d at 1464).

extension of an insider loan when the debtor is undercapitalized raises suspicion but that it is well settled that undercapitalization *alone* is insufficient to justify the subordination of insider claims.[65] Instead, the court admonished that § 510(c) requires a showing by the moving party of inequitable conduct on the part of the party against whom subordination is sought.[66] Because the plaintiff in this case was unable to present evidence creating a genuine issue of material fact that the defendants had engaged in any inequitable conduct, the court affirmed the lower courts' entry of summary judgment in favor of the defendants on the equitable subordination claim.[67] Turning next to the dismissal of the plaintiff's claim that the defendants' alleged debt should be recharacterized as equity, the court observed, initially, a split in the decisional law as to whether bankruptcy courts possess the authority to recharacterize claims at all.[68] Siding, however, with the view adopted by the district court in this case, the court affirmed that a bankruptcy court may consider whether to recharacterize a debt claim as an equity interest separate and apart from the issue of subordination under § 510(c).[69] Specifically, the court held that bankruptcy courts may use

65. *Id.* at 746–47; *see, e.g.*, *In re* Lifschultz Fast Freight, 132 F.3d 339, 345, 349 (7th Cir. 1997) (observing that, while the term "undercapitalization sounds bad," and is often used as a word "of opprobrium, . . . undercapitalization alone, without evidence of deception about the debtor's financial condition or other misconduct, cannot justify equitable subordination of an insider's debt claim"); Summit Coffee Co. v. Herby's Foods, Inc. (*In re* Herby's Foods, Inc.), 2 F.3d 128, 132 (5th Cir. 1993); Braas Sys., Inc. v. WMR Partners (*In re* Octagon Roofing), 157 B.R. 852, 858 (N.D. Ill. 1993) (noting that courts have been consistent in holding that undercapitalization alone is an insufficient reason to apply equitable subordination); *see also infra* note 91.

66. *AutoStyle*, 269 F.3d at 747 (citing Blasbalg v. Tarro (*In re* Hyperion Enters., Inc.), 158 B.R. 555, 563 (D.R.I. 1993)); *see also infra* notes 179–191 and accompanying text (concerning the essentiality of the requirement of inequitable conduct in most cases); *cf. infra* Part IV.A (examining the concept of no-fault subordination).

67. *AutoStyle*, 269 F.3d at 747.

68. *Id.* at 748 (citing Unsecured Creditors' Comms. of Pac. Express, Inc. v. Pioneer Commercial Funding Corp. (*In re* Pac. Express, Inc.), 69 B.R. 112, 115 (B.A.P. 9th Cir. 1986); Pinetree Partners, Ltd. v. OTR *ex rel.* State Teachers Ret. Sys. (*In re* Pinetree Partners, Ltd.), 87 B.R. 481, 491 (Bankr. N.D. Ohio 1988)). Based on circuit court decisions rendered after *AutoStyle*, it is fair to say that there is no longer such a disagreement. *See infra* Part I.C. Compare to *Official Committee of Unsecured Creditors of SGK Ventures, LLC v. NewKey Group, LLC (In re SGK Ventures, LLC)*, which expresses doubt that the Seventh Circuit would find that the bankruptcy courts possess the equitable power to reclassify a creditor's claim in a manner not stated in the Code. 521 B.R. 842, 860–61 (Bankr. N.D. Ill. 2014). *Accord In re* Fesco Plastics Corp., 996 F.2d 152, 157 (7th Cir. 1993) (holding that "a bankruptcy court is . . . not authorized to do whatever is necessary to reach an equitable result; it may only do whatever is necessary to enforce the Code").

69. *AutoStyle*, 269 F.3d at 748.

their equitable powers to test the validity of purported debts and, when necessary, recharacterize a transaction facially structured as a loan as an equity investment.[70]

As for the source of this equitable authority, the court turned to § 105 of the Code, rather than "principles of equitable subordination" under § 510(c).[71] In what would quickly become the orthodox explanation for a stand-alone cause of action for recharacterization, the court pointed out that "there are important differences between . . . recharacterization and equitable subordination [remedies]."[72] Recharacterization, the court expounded, "turn[s] on whether a debt actually exists"; the purpose of the inquiry is to ascertain the true nature of the interest as debt or equity and treat it accordingly.[73] By contrast, in an equitable subordination analysis, the court is reviewing whether the holder of what is concededly a legitimate debt claim engaged in inequitable conduct.[74] If found to have occurred, then "the *remedy* is subordination of the [offending] creditor's claim to that of another creditor [but] *only to the extent necessary* to offset injury or damage suffered by the creditor in whose favor the equitable doctrine may be effective."[75] Thus, according to the court, not only do recharacterization and equitable subordination serve different *functions*, but the extent to which a claim is subordinated under each process could be different.[76] Put another way, the distinction proffered

70. *Id.* The reasoning of the court in *AutoStyle* has been influential with lower courts in those circuits where the circuit court of appeals has yet to address the issue. *See, e.g.*, Aquino v. Black (*In re* AtlanticRancher, Inc.), 279 B.R. 411, 431–32 (Bankr. D. Mass. 2002) (citing *AutoStyle* in support of the conclusion that a bankruptcy court has the power to recharacterize a claim from debt to equity); *see also infra* note 110.

71. *AutoStyle*, 269 F.3d at 748.

72. *Id.*

73. *Id.* at 748–49 (quoting Matthew Nozemack, Note, *Making Sense out of Bankruptcy Courts' Recharacterization of Claims: Why Not Use § 510(c) Equitable Subordination?*, 56 WASH. & LEE L. REV. 689, 716 (1999)).

74. *Id.* at 749. This would seem to suggest that the characterization analysis precedes the determination of whether the creditor engaged in inequitable conduct. *See* FCC v. Airadigm Commc'ns, Inc. (*In re* Airadigm Commc'ns, Inc.), 616 F.3d 642, 658 (7th Cir. 2010) (suggesting, in dicta, that the determination of "whether a claim should be recharacterized . . . comes logically prior to determining whether a claim should be subordinated"). However, not all courts approach the two questions in that order. *See infra* text accompanying notes 233–34.

75. *AutoStyle*, 269 F.3d at 749 (citing *In re* W. T. Grant Co., 4 B.R. 53, 74 (Bankr. S.D.N.Y. 1980)). *But see In re* Zenith Elecs. Corp., 241 B.R. 92, 107 (Bankr. D. Del. 1999) (holding that, in order for the court to be able to recharacterize a claim from debt to equity, the creditor must be found to have done something inequitable). *Zenith* is aberrational in this respect, but it does provide a good illustration of the confusion that exists between the two doctrines.

76. *AutoStyle*, 269 F.3d at 748–49. In fact, despite this and seemingly other

by the court in *AutoStyle* was that equitable subordination involves the adjustment of the legal priority of a *real* claim, while recharacterization entails a determination of the legality of that priority in the first instance.[77]

The court in *AutoStyle* did concede, however, that some confusion exists between the two remedies due to the fact that undercapitalization can be a factor in the equitable subordination analysis, just as it often is a factor in the recharacterization analysis.[78] This has caused "some courts to equitably subordinate claims that other courts would recharacterize as equity contributions."[79] In fact, as discussed below,[80] the sharp line of demarcation between recharacterization and equitable subordination is of relatively recent origin. Which is to say that, historically, the question of recharacterization was subsumed under the umbrella of equitable subordination. Hence, the two doctrines are not nearly as distinct from one another as *AutoStyle* and subsequent decisions make it appear.[81]

conceptual differences between the two analyses, the real practical differences between recharacterization and equitable subordination may not run nearly as deep as explanations like those offered by the court in *AutoStyle* (and many other opinions) would lead one to believe. *See infra* Part IV.C.3.

77. This distinction has been repeated in multiple reported decisions. *See, e.g.*, Gernsbacher v. Campbell (*In re* Equip. Equity Holdings, Inc.), 491 B.R. 792, 841 (Bankr. N.D. Tex. 2013) (conceding that both doctrines entail the altering of priority of payment for a creditor's claim in the Bankruptcy Code's distribution scheme, but, based on their differences in focus, describing the two doctrines as distinct). As put forward below, whether these differences warrant the separation of recharacterization and equitable subordination as conceptually distinct remedies has yet to receive critical analysis and is open to question. *See infra* Part IV.C.3.

78. *AutoStyle*, 269 F.3d at 749 (quoting Nozemack, *supra* note 73, at 717). Interestingly, Nozemack's note makes a very different argument than the one advanced in this Article. He eschews § 510(c) as the basis for debt recharacterization and, instead, maintains that the bankruptcy courts are authorized to recharacterize a debt claim as an equity interest independent of the doctrine of equitable subordination. Nozemack, *supra* note 73, at 690. While I do not necessarily disagree with this point, I advance the opposite argument that recharacterization can occur under the auspices of § 510(c) for the purpose of preserving the courts' authority. *See infra* Part IV.B. Ironically, Nozemack was making his argument for the purpose of preserving the ability of the bankruptcy courts to undertake debt recharacterization in the face of a Ninth Circuit Bankruptcy Appellate Panel decision that had determined that the power exceeded the bankruptcy courts' authority under § 510(c) and thus was not available. *See infra* note 126 and accompanying text. That decision was later overturned by the Ninth Circuit. *See infra* notes 130–35 and accompanying text. Now, in reaction to *Law*, I am suggesting in the present treatment that, with the same objective in mind, authority for recharacterization can properly be found under the doctrine of equitable subordination.

79. *AutoStyle*, 269 F.3d at 749 (quoting Nozemack, *supra* note 73, at 717).

80. *See infra* notes 177, 313, 378 and accompanying text.

81. See *infra* Part IV.C.3 for further discussion.

Nonetheless, having articulated the distinction between recharacterization pursuant to the courts' general authority under § 105(a) and subordination under § 510(c), the court turned to the standards that should control whether recharacterization was warranted on the facts of the case. Rather than employ the categorical approach employed by the court in *N & D Properties*,[82] the *AutoStyle* court endorsed a multifactor approach, utilizing an eleven-factor test articulated in the court's earlier decision in *Roth Steel Tube Co. v. Commissioner*.[83] *Roth Steel* was not a subordination case in any sense of the term. Rather, it was an appeal from a tax court case in which the Internal Revenue Service ("IRS") challenged the taxpayer's deduction for bad debt losses on the basis that the advances in question were really capital contributions rather than loans.[84] In *AutoStyle*, given that eight of the eleven *Roth Steel* factors tilted toward "debt," to one extent or another, while only two leaned slightly toward "equity," and the evidence concerning the final factor was disputed, the court affirmed the decisions of the lower courts granting the defendants' summary judgment motion as to the recharacterization cause of action.[85] While no actual recharacterization thus took place in *AutoStyle*, the decision

82. For an example, see *Estes v. N & D Properties, Inc.* (*In re N & D Properties, Inc.*), as presenting a standard grounded more or less on the principle of *modus ponendo ponens*. 799 F.2d 726, 733 (11th Cir. 1986); *see also supra* text accompanying note 54. Another shortcoming of the approach in *N & D Properties*—the presence of either one of two factors produces the result—is its implicit assumption that debt and equity are two kinds of financials securities in the way in which chocolate and vanilla are two flavors of ice cream. However, in an era of increasing diversification in the types of instruments used in financial transactions, including hybrid types of instruments that possess some of the characteristics of both debt and equity, an ipso facto approach is far too blunt of a tool. By contrast, the multifactor approach, with no single factor or mix of factors necessarily dispositive in any given case one way or the other, is far more suited to the current, more nuanced financing environment. *See* United States v. State St. Bank & Tr. Co., 520 B.R. 29, 72–75 (Bankr. D. Del. 2014) (discussing the fact-intensive, case-specific nature of the multifactor approach). *But see* Wilton & Moeller-Sally, *supra* note 30, at 1262–63 (identifying the same phenomenon as one of the weaknesses of the multifactor approach).

83. 800 F.2d 625, 630 (6th Cir. 1986). These factors include the two *N & D Properties* conditions for recharacterizing, but not in the sense that the presence of either one necessarily produces the results. Rather, under the multifactor approach, none of the factors is itself dispositive and their significance will vary depending upon circumstances. *AutoStyle*, 269 F.3d at 750. However, the court went on to indicate that "[t]hin or inadequate capitalization is strong evidence that the advances are capital contributions rather than loans." *Id.* at 751 (citing *Roth Steel*, 800 F.2d at 630); *see also* Autobacs Strauss, Inc. v. Autobacs Seven Co. (*In re* Autobacs Strauss, Inc.), 473 B.R. 525, 576 (Bankr. D. Del. 2012) (discussing the relevance of undercapitalization in connection with both equitable subordination and debt recharacterization).

84. *Roth Steel*, 800 F.2d at 626.

85. *AutoStyle*, 269 F.3d at 750–53.

nevertheless established the availability of relief based on such a cause of action and offered a comprehensive apology for its existence.

C. Other Circuit Decisions Prior to Lothian Oil

1. The Tenth Circuit

The next circuit court to grapple with the issue of whether the bankruptcy courts are endowed with the power to recharacterize debt claims as equity interests was the Tenth Circuit Court of Appeals in *In re Hedged-Investments Associates*.[86] The appellants in the case were investors (and affiliated entities) in the debtor-entities that had operated a stock investment Ponzi scheme.[87] The appellants sought, in what has become a common pattern,[88] alternatively, to have the defendant-lender's claim against the debtor subordinated under § 510(c) or to have the claim recharacterized as an equity advance.[89] In either case, the result would be that the defendant would lose its priority over the investors and, instead, take *pari passu* with the limited partner interests of the investors. Contrary to the result reached in *N & D Properties*,[90] the court in *Hedged-Investments* agreed with the district court that the absence of "inequitable conduct" barred application of the equitable subordination remedy.[91] Following the Sixth Circuit's lead in *AutoStyle*, however, the court distinguished between "the remedies of recharacterization and equitable subordination," noting that the absence of inequitable conduct was not dispositive as to the former.[92] More specifically, the court described equitable subordination as

86. Sender v. Bronze Grp., Ltd., (*In re* Hedged-Invs. Assocs., Inc.), 380 F.3d 1292 (10th Cir. 2004).

87. *Id.* at 1295.

88. Initially, virtually every recharacterization case also included a claim based on § 510(c). More recently, as separation of the two doctrines has become more established, one occasionally finds a claim for relief only for recharacterization without an alternative cause of action based on equitable subordination. *See, e.g.*, Devices Liquidation Tr. v. Pinebridge Vantage Partners, L.P., 528 B.R. 229, 232–33 (Bankr. E.D.N.Y. 2015).

89. *Hedged-Invs.*, 380 F.3d at 1295.

90. *See supra* notes 49–50 and accompanying text.

91. *Hedged-Invs.*, 380 F.3d at 1302 (noting that to qualify for relief under § 510(c), the plaintiff must make a prima facie showing of culpable conduct, and undercapitalization alone is insufficient in this regard). While unquestionably the dominant view, as will be discussed below, inequitable conduct is not always a prerequisite for equitable subordination. *See infra* Part IV.A. The bankruptcy court had ordered that the defendant's loan be subordinated to equal priority with the investment interests of the limited partners but refused to recharacterize the loan as equity. *Hedged-Invs.*, 380 F.3d at 1296–97. It was the latter decision that the limited partner interests appealed. *Id.*

92. *Hedged-Invs.*, 380 F.3d at 1297.

focused on the behavior of the parties, while recharacterization, emanating from the courts' § 105(a) power, scrutinizes the substance of the transaction.[93] Turning to the legal standard governing recharacterization, as in *AutoStyle*, the court borrowed from tax law cases to identify a nonexclusive list of thirteen factors bearing on the determination of whether a purported debt is actually disguised equity.[94] Of these factors, which, for all intents and purposes, mirrored the eleven *Roth Steel* factors,[95] the court found only three pointed in favor of an equity characterization of the investment in question and, thus, affirmed the lower courts' opinions that recharacterization of the defendant's advances was not in order.[96] Thus, while, once more, not actually ordering that the remedy be imposed, the decision stood for the proposition that, under the right facts, the bankruptcy courts possess the equitable authority to recharacterize a claim even when the traditional grounds for subordination under § 510(c) do not exist.

2. The Third and Fourth Circuits

In 2006, both the Third and Fourth Circuits rendered recharacterization opinions within the space of five months of one another.[97] Both courts concurred with the holding in *AutoStyle* and *Hedged-Investments* that the bankruptcy courts' general equitable authority under § 105(a) was broad enough to encompass the recharacterization of debt in the proper circumstances.[98] In addition, in *In re Dornier Aviation*, the Fourth Circuit, after ruling that the recharacterization power is integral to a consistent application of the

93. *Id.* The court treated the issue as a mixed question of fact and law, thus deferring to the bankruptcy court's factual findings. *Id.*

94. *Id.* at 1298. The court derived these factors from the opinion in *Stinnett's Pontiac Serv., Inc. v. Comm'r*, 730 F.2d 634, 638 (11th Cir. 1984) (citing Estate of Mixon v. United States, 464 F.2d 394, 402 (5th Cir. 1972)). In explaining the test's application, the court observed that none of the factors on the list is itself dispositive. *Hedged-Invs.*, 380 F.3d at 1298–99. The court also noted its earlier rejection, in *Sinclair v. Barr* (*In re Mid-Town Produce Terminal, Inc.*), 599 F.2d 389 (10th Cir. 1979), of the automatic subordination of insider loans on the ground that such an approach would have the undesirable effect of discouraging owners from attempting to salvage troubled businesses. *Hedged-Invs.*, 380 F.3d at 1297. As was not unusual at the time it arose, *Mid-Town* did not include an independent claim for recharacterization, but rather proceeded simply as a subordination case under applicable 1898 Act precedent. 599 F.2d at 390.

95. *See supra* note 83.

96. *Hedged-Invs.*, 380 F.3d at 1299.

97. Cohen v. KB Mezzanine Fund II, LP (*In re* SubMicron Sys. Corp.), 432 F.3d 448 (3d Cir. 2006); Fairchild Dornier GMBH v. Official Comm. of Unsecured Creditors (*In re* Dornier Aviation (N. Am.), Inc.), 453 F.3d 225 (4th Cir. 2006).

98. *SubMicron*, 432 F.3d 448; *Dornier Aviation*, 453 F.3d 225.

Bankruptcy Code, approved of the bankruptcy court's use of the factors applied by the Sixth and Tenth Circuits in those cases in deciding when recharacterization is warranted.[99] By contrast, while not by any means outright rejecting the multifactor approach,[100] the Third Circuit in *In re SubMicron Systems Corp.* held that the determinative inquiry in classifying an advance as a loan or an equity contribution should focus on the intent of the parties at the time the transaction occurred.[101] Ultimately, however, the court did concede that "[n]o mechanistic scorecard suffices. And none should, for Kabuki outcomes elude difficult fact patterns."[102]

In *SubMicron*, the issue arose in connection with the defendant-lenders' attempt to credit bid their notes under § 363(k).[103] *Dornier Aviation* involved the unsecured creditors committee's challenge to a parent corporation's $146 million claim arising out of prepetition inventory sales to its wholly-owned subsidiary that had filed for relief under Chapter 11.[104] The Third Circuit, regarding the district court's

99. *Dornier Aviation*, 453 F.3d at 234 ("We think it important to note that a claimant's insider status and a debtor's undercapitalization alone will normally be insufficient to support the recharacterization of a claim. . . . However, when other factors indicate that the transaction is not a loan at all, recharacterization is appropriate to ensure the consistent application of the Bankruptcy Code.").

100. Indeed, the court approved of the seven-factor test that the district court had applied. *SubMicron*, 432 F.3d at 456 n.8. The district court borrowed the test from an earlier Delaware case, *Official Committee of the Unsecured Creditors of Color Tile, Inc. v. Blackstone Family Investment Partnership, L.P.* (*In re Color Tile, Inc.*). Nos. 96-76 (HSB), 96-80 (HSB), Civ.A. 98-358-SLR, A-98-90, 96-77 (HSB), 96-78 (HSB), 96-79 (HSB), 2000 WL 152129 (D. Del. Feb. 9, 2000).

101. Because intent typically can only be divined from circumstantial evidence, a court must look closely at the economic reality in finding intent. Thus, the difference in approach from that of the Fourth and Sixth Circuits is probably negligible, although the emphasis on *intent* does imply an element of deliberation to mask the true character of the investment in a fashion that is less prevalent in the other approaches. If the point of the inquiry is to discern the intrinsic character of an instrument, arguably proof of intent should not be essential. *See* Friedman's Liquidating Tr. v. Goldman Sachs Credit Partners, L.P. (*In re* Friedman's Inc.), 452 B.R. 512, 519 (Bankr. D. Del. 2011) (reading *SubMicron* to require a recharacterization analysis to focus on the overarching inquiry of the parties' intent, rather than a multifactor test).

102. *SubMicron*, 432 F.3d at 456; *see also* Va. Broadband, LLC v. Manuel, 538 B.R. 253, 266 (W.D. Va. 2015) (stating that no single factor is dispositive).

103. Unlike some of the earlier cases, the defendants in *SubMicron*, comprised of several financial institutions, were not traditional insiders.

104. 453 F.3d at 230. In response to the defendant's argument that the Bankruptcy Code does not permit recharacterization of an allowed claim other than under § 510(c), the court noted:

> [D]enying a bankruptcy court the ability to recharacterize a claim would have the effect of subverting the Code's critical priority system by allowing equity investors to jump the line and reduce the recovery of true creditors. In light of the

recharacterization conclusion as a question of fact reviewed under a traditional clearly erroneous standard,[105] affirmed the decision below, refusing to recharacterize the challenged loans.[106] In *Dornier Aviation*, the court affirmed the bankruptcy court's finding that, on the whole, the transactions in question were more consistent with a capital contribution than a loan, thus making it the first of these cases to sustain a decision to recharacterize a putative loan as a contribution of risk capital.[107] Of the eleven *Roth Steel* factors, the bankruptcy court in *Dornier Aviation* found that five in particular pointing to a capital contribution were most significant: (1) the defendant's insider status, (2) lack of a fixed maturity date, (3) lack of a fixed payment schedule, (4) the debtor's long history of nonprofitability, and (5) the defendant's assumption of the debtor's losses.[108] The Fourth Circuit agreed that these facts were sufficient to support the decision to recharacterize the claim as a capital contribution.[109]

Thus, through 2006, and even arguably through 2010,[110] the courts

> broad language of § 105(a) and the larger purpose of the Bankruptcy Code, we believe that a bankruptcy court's power to recharacterize is essential to the proper and consistent application of the Code.

Id. at 231. The fact that the claim was *allowed* would also become significant in light of later decisions, *see infra* Part I.D, as the court also rejected the defendant's position that recharacterization serves the same purposes, or calls for the same analysis, as disallowance under § 502(b) and equitable subordination. *Dornier Aviation*, 453 F.3d at 232 (noting that disallowance entails the complete rejection of a claim, while recharacterization leaves the claimant with *some* interest).

105. *SubMicron*, 432 F.3d at 456–57. The district court had withdrawn the reference to the bankruptcy court in this case, so appeal was made pursuant to the court's conventional appellate jurisdiction under 28 U.S.C. § 1291, rather than its jurisdiction under 28 U.S.C. § 158(d) applicable in cases originating in the bankruptcy court. *Id.* at 453–54. The court in *Dornier Aviation* similarly deferred to the factual findings below—in that case of the bankruptcy court—in addressing the defendant's argument that the court erred in applying the multifactor approach to its claim. 453 F.3d at 235.

106. *SubMicron*, 432 F.3d at 457.

107. Obviously, some lower courts had already exercised the power. *See, e.g.*, Blasbalg v. Tarro (*In re* Hyperion Enters., Inc.), 158 B.R. 555, 561 (D.R.I. 1993) (holding that "where shareholders have substituted debt for adequate risk capital, their claims are appropriately recast as equity regardless of satisfaction of the other requirements of equitable subordination" (citing Diasonics, Inc. v. Ingalls, 121 B.R. 626, 630 (Bankr. N.D. Fla. 1990))).

108. *Dornier Aviation*, 453 F.3d at 234–36. This was quite consistent with the view at the time that debt recharacterization ultimately hinges on questions of fact, not law, thus requiring deference to the bankruptcy courts' findings under a clearly erroneous standard. *See supra* notes 93, 105 and accompanying text.

109. *Dornier Aviation*, 453 F.3d at 234.

110. In a 2010 decision, the Seventh Circuit affirmed lower courts' refusal to recharacterize a cash infusion, but did not do so on the ground offered by those courts—which was that the cause of action was likely not recognized by the circuit—but rather on

of appeals were in lockstep. They were in accord, first, about the bankruptcy courts' prerogative by means of their equitable powers to undertake debt recharacterization to preserve classification of advances based on their underlying economic substance rather than the form in which they had been cast. Second, they agreed that federal authority controlled when debt recharacterization should apply, even if they expressed somewhat different views on which federal law approach should control.[111] As we see next, however, that was all about to change.

D. Enter Lothian Oil *and the Minority Approach*

1. The Fifth and Ninth Circuits

In 2011, in *In re Lothian Oil*, an appeal was taken to the Fifth Circuit on the issue of the bankruptcy courts' ability to recharacterize

the basis that the remedy was foreclosed by a stipulation that had been entered into by parties in the case. FCC v. Airadigm Commc'ns, Inc. (*In re* Airadigm Commc'ns, Inc.), 616 F.3d 642, 653 (7th Cir. 2010). In the course of its opinion, the court did observe that the overwhelming weight of authority supports the proposition that bankruptcy courts act within their equitable powers when they recharacterize loans as infusions of equity. *Id.* Subsequent lower court decisions have disagreed over whether this signaled an openness of the circuit to recharacterization. *Compare* Gecker v. Flynn (*In re* Emerald Casino, Inc.), No. 11 C 4714, 2015 WL 1843271, at *8–9 (N.D. Ill. Apr. 21, 2015) (suggesting the circuit court would likely follow the majority view on recharacterization), *with* Official Comm. of Unsecured Creditors of SGK Ventures, LLC v. NewKey Grp., LLC (*In re* SGK Ventures, LLC), 521 B.R. 842, 861 (Bankr. N.D. Ill. 2014) (predicting that the Seventh Circuit would reject the notion that the bankruptcy courts possess the equitable authority to recharacterize claims separate from their statutory authority under § 510(c)).

While the Second Circuit has not issued a characterization opinion, the lower courts in that circuit have agreed on the view that the authority to recharacterize debt as equity springs from the equitable power of the bankruptcy courts. *See, e.g.*, *In re* Sabine Oil & Gas Corp., 574 B.R. 503, 567–68 (Bankr. S.D.N.Y. 2016) (following the Sixth Circuit's approach in *AutoStyle*); Weisfelner v. Blavatnik (*In re* Lyondell Chem. Co.), 544 B.R. 75, 92–93 (Bankr. S.D.N.Y. 2016).

111. One commentator has identified three different approaches to when recharacterization will be ordered employed by the circuit courts that regard the authority as derived from § 105(a). Bryan C. Curran, Comment, *The "State" of Federal Bankruptcy Law: The Ninth Circuit's Debt Recharacterization Analysis in* In re Fitness Holdings International, 55 B.C. L. REV. E-SUPPLEMENT 47, 53 (2014). These approaches are (1) a per se rule (*N & D Properties*), (2) a multifactor test (*AutoStyle*, *Hedged-Investments*, and *Dornier Aviation*), and (3) intent of the parties (*SubMicron*). *Id.* These classifications are reasonable. However, as explained *infra* note 248, the multifactor and the intent of the parties approaches actually have much more in common than might be suspected, and the per se approach has been relegated to the Eleventh Circuit. Thus, there was actually less disagreement on the question than might, at first blush, have appeared to be the case.

an investment denominated as a loan as an equity interest.[112] Consistent with the other circuits to address the question, the court, in an opinion authored by Judge Jones, answered the question in the affirmative.[113] However, in a significant departure from those earlier decisions, rather than locate the source of the bankruptcy courts' authority in § 105(a), as all of the other circuits to speak to the issue to date had done, the Fifth Circuit held that resort to § 105(a) was unnecessary (and perhaps unwise).[114] Instead, the court concluded that the power to recharacterize resided in the bankruptcy courts' authority to allow and disallow claims under § 502,[115] an approach that the Fourth Circuit in *Dornier Aviation* had specifically rejected as inadequate.[116] The issue of from where the bankruptcy courts' authority derives is of far more than academic interest. If the intrinsic nature of the advance is to be resolved as part of the claims allowance process under § 502, then the determination will hinge under subsection (b)(1) on whether the purported debt "is unenforceable as against the debtor . . . under any agreement or *applicable law*."[117] Invoking the Supreme Court's decision in *Butner v. United States*,[118] Judge Jones stated that "applicable law" for this purpose meant state law.[119] In the case itself, this seemed to make little difference, inasmuch as, according

112. Grossman v. Lothian Oil Inc. (*In re* Lothian Oil Inc.), 650 F.3d 539, 542 (5th Cir. 2011).

113. *Id.* at 543–44.

114. *Id.* at 543 (referring to the circuit's general bias for taking a "cautious" approach to § 105(a)).

115. *Id.* (stating that "recharacterizing the claim as an equity interest is the logical outcome of the reason for disallowing it as debt").

116. *See infra* notes 229–36 and accompanying text. Curiously, in a post-*AutoStyle* decision, a panel of the Sixth Circuit had also indicated that "a claim seeking to recharacterize debt as equity is the same as objecting to the claim's 'allowance.'" Official Comm. of Unsecured Creditors of Russell Cave Co. v. Gen. Elec. Capital Corp. (*In re* Russell Cave Co.), 107 F. App'x 449, 451 (6th Cir. 2004) (citing *In re* Micro-Precision Techs., Inc., 303 B.R. 238, 243 (Bankr. D.N.H. 2003)). However, it is clear that the court in *Russell Cave* had no intention of altering circuit precedent; the opinion also stated that a recharacterization claim and a claims objection are "one-in-the same" because the bankruptcy court may take equitable considerations into account as a basis for disallowance of a claim, and cited *AutoStyle* approvingly. *Id.*; *see* Bayer Corp. v. MascoTech, Inc. (*In re* AutoStyle Plastics, Inc.), 269 F.3d 726, 748–49 (6th Cir. 2001). See *infra* note 231 for additional discussion.

117. 11 U.S.C. § 502(b)(1) (2012) (emphasis added).

118. 440 U.S. 48 (1979).

119. *Lothian Oil*, 650 F.3d at 543 (quoting *Butner*, 440 U.S. at 54). Interestingly, in *Patterson v. Shumate*, the Supreme Court rejected the argument that the same phrase—applicable law—should be limited to state law. 504 U.S. 753, 758 (1992). Of course, in that case, there was a specific federal statute on point rather than a federal standard derived from earlier precedent in tax cases. *Id.* at 755.

to the court, Texas courts have imported the multifactor approach from federal tax court cases to decide when a putative loan should be regarded as an equity interest.[120] However, other states (including perhaps even Texas in the future) may use different tests, thus creating the potential for disuniformity that always exists when deference is accorded to substantive state law in defining a bankruptcy outcome.[121] Additionally, by treating the issue on appeal as the appropriateness of the bankruptcy court's determination to allow or disallow the claim, the *Lothian Oil* court concluded that the lower courts' ruling should be reviewed as a matter of law,[122] thus implicating de novo review. This, of course, was in sharp contrast with the approach taken in other circuits regarding the degree of deference to be shown to the bankruptcy courts' factual findings in relation to this issue.[123] As detailed further below,[124] there are additional troublesome consequences to limiting recharacterization to circumstances where state law would authorize such action. In 2013, the split among the circuits was widened further by the Ninth Circuit's decision in *In re Fitness Holdings International*.[125] Prior to that decision, precedent in the circuit had held that the bankruptcy courts did not possess authority to recharacterize claims as debt or equity other than in connection with application of the statutory remedy provided in § 510(c).[126] The issue came up in *Fitness Holdings* in the context of the trustee's action to recover a prepetition transfer from the debtor to its sole shareholder as a constructively fraudulent conveyance.[127] The defendants countered that the shareholder had provided reasonably equivalent return value since the payment was on account of a preexisting debt and, under § 548(d)(2)(A),

120. *Lothian Oil*, 650 F.3d at 544.

121. *See infra* notes 244, 250. *See generally* Wilton & Moeller-Sally, *supra* note 30, at 1268–74 (reviewing authority from Massachusetts and Wisconsin).

122. 650 F.3d at 542.

123. *See supra* notes 93, 105, 108 and accompanying text. In *SubMicron*, of course, the district court served as the trial court and, as such, finder of fact. *See supra* note 105.

124. *See infra* Part III.A.

125. Official Comm. of Unsecured Creditors v. Hancock Park Capital II, L.P. (*In re* Fitness Holdings Int'l, Inc.), 714 F.3d 1141 (9th Cir.), *amended by* 529 F. App'x 871 (9th Cir. 2013).

126. Unsecured Creditors' Comms. of Pac. Express, Inc. v. Pioneer Commercial Funding Corp. (*In re* Pac. Express, Inc.), 69 B.R. 112, 116 (B.A.P. 9th Cir. 1986) (concluding that equitable subordination under § 510(c) is the sole authority under the Code for all actions involving the subordination of claims), *superseded by Fitness Holdings*, 714 F.3d 1141. Because the court concluded that the objectors had failed to meet their burden of proving the claimants had engaged in inequitable conduct, so as to warrant subordination under § 510(c), the court vacated the judgment of the bankruptcy court ordering subordination. *Id.* at 116–18.

127. 714 F.3d at 1144.

"the satisfaction or securing of a present or antecedent debt" constitutes value.[128] Thus, the transfer could not be fraudulent under § 548(a)(1)(B) if the original advances from the defendant were true loans.[129] At the outset, the Ninth Circuit rejected the earlier precedent from the circuit's Bankruptcy Appellate Panel that had held that the bankruptcy courts lacked authority, separate and apart from the statutory remedy of equitable subordination, to recharacterize an obligation that did not constitute a debt.[130] However, in determining the source of the alternative authority, the court declined to follow the approach adopted in the majority of circuits of looking to the general equitable powers of the bankruptcy courts under § 105(a)[131]—an approach that, in turn, leads to application of federal rules and standards in determining when the power will be exercised.[132] Instead, the *Fitness Holdings* court chose to follow the Fifth Circuit's lead in *Lothian Oil* by electing to treat a cause of action based on recharacterization as a plea to disallow the claim in question under § 502(b)(1).[133] To do so, the court reasoned, would be "more consistent with Supreme Court precedent than that of the circuits that have fashioned a federal test for recharacterizing an alleged debt in reliance on their general equitable authority under § 105(a)."[134]

And so, the complete severance of recharacterization from equitable subordination, and a full-blown split in the circuits over the basis on which the bankruptcy courts derived their power to accomplish the former, were simultaneously established. Whether, in light of the uncertain state of the equitable authority of the bankruptcy courts under § 105(a), that unlinking of the historical connection between debt recharacterization and equitable subordination was judicious is open to doubt. Before, however, turning to a brief exegesis of the evolution of

128. *Id.* at 1145 (quoting 11 U.S.C. § 548(d)(2)(A) (2012)).

129. *Id.* at 1149.

130. *Id.* at 1147 ("*Pacific Express* erred in holding that the 'characterization of claims as equity or debt' is governed by § 510(c)." (quoting *Pac. Express*, 69 B.R. at 115)).

131. *See supra* Part I.B–C.

132. This is true even if the decisions that find the authority to recharacterize claims stems from the equitable powers of the bankruptcy court, conferred through § 105(a), are not fully in accord with what the federal rule should control. *See supra* note 111.

133. *Fitness Holdings*, 714 F.3d at 1148.

134. *Id.* Those Supreme Court precedents were, of course, *Travelers* and *Butner*, *see infra* notes 214, 226, 259, and it should perhaps come as no surprise that the court was influenced by the *Travelers* decision, since it overturned a Ninth Circuit decision that had held that an attorneys' fees clause in a contract, enforceable under state law, could not form the basis for recovery of fees incurred in litigating bankruptcy issues. Travelers Cas. & Sur. Co. v. Pac. Gas & Elec. Co., 167 F. App'x 593, 594 (9th Cir. 2006), *vacated*, 549 U.S. 443 (2007).

equitable subordination under the Code, it warrants pause to consider whether analogizing debt recharacterization as a request for disallowance under § 502(b), rather than subordination under § 105(a), requires the kind of submissive deference to state law engaged in by the Fifth and Ninth Circuits.

2. Equitable Disallowance

In their staunch adherence to a one-dimensional interpretation of the holding in *Butner*,[135] both the *Lothian Oil* and the *Fitness Holdings* courts presumed that "applicable law" for purposes of § 502(b)(1) meant exclusively state law. And yet, even if one accepts that dubious construction,[136] it does not necessarily rule out the possibility of recharacterizing a claim as an equity interest in an appropriate case without resort to controlling state law precedent. Although controversial,[137] in *Adelphia Recovery Trust v. Bank of America, N.A.*,[138] the district court upheld the bankruptcy court's decision not to dismiss the plaintiff's objection to the defendants' claim in the case.[139] Specifically, the plaintiff alleged that the defendant-banks had aided and abetted the breach of fiduciary duty by the debtor's former managers and that, therefore, their claim should be disallowed on equitable grounds.[140]

Disallowance, of course, in not available under § 510(c), only subordination.[141] However, if equitable disallowance were to be

135. Butner v. United States, 440 U.S. 48 (1979) (stating that state law governs property interest in bankruptcy).

136. *See* Ponoroff, *supra* note 3 (manuscript at 57–58) (arguing that *Butner* is frequently applied more broadly than originally intended).

137. *See generally* Alan M. Ahart, *Why the Equitable Disallowance of Claims in Bankruptcy Must Be Disallowed*, 20 AM. BANKR. INST. L. REV. 445 (2012) (arguing that disallowance may only be ordered based on applicability of the statutory grounds for disallowance detailed in § 502).

138. 390 B.R. 64 (S.D.N.Y. 2008), *adhered to on reconsideration*, Nos. 05 Civ. 9050 (LMM), 03 MDL 1529, 2008 WL 1959542 (S.D.N.Y. May 5, 2008).

139. *Id.* at 80.

140. Adelphia Commc'ns Corp. v. Bank of America, N.A. (*In re* Adelphia Commc'ns Corp.), 365 B.R. 24, 31–32 (Bankr. S.D.N.Y. 2007). The bankruptcy court had denied the defendants' Federal Rule of Civil Procedure 12(b)(6) motion to dismiss the bulk of the plaintiff's claims for wrongdoing on the defendants' part in their prefiling dealings with the debtor and the debtor's management.. *Id.* Procedurally, the district court had withdrawn the reference to the bankruptcy court over the adversary proceeding in the case, but the parties agreed to allow determination as to pending motions for dismissal with the bankruptcy court. *Adelphia*, 390 B.R. at 67.

141. *See infra* notes 170, 247. In addition, as Judge Ahart points out in his article, equitable subordination is remedial in nature, while equitable disallowance is penal.

recognized and then invoked in the context where the proper characterization of a financial advance to the debtor is at issue, the practical effect of disallowing the claim would be to subordinate the investment to the claims of general creditors. That is to say, whether the purported claim is subordinated or disallowed, the economic impact on the claimant (and other creditors) is identical.[142] In *Adelphia*, the unsecured creditors committee filed suit against multiple banks that were advising investment banks, participants on loan syndications, or subsequent acquirers of bank debt involved in the extension of credit to the debtor companies, which, according to the complaint, was then promptly looted by the debtors' then-management and affiliated persons and entities.[143] The complaint contained multiple causes of action, including relief based on equitable subordination, recharacterization, and equitable disallowance.[144] The defendants moved to dismiss on the ground of failure to state a claim upon which relief might be granted.[145] In its lengthy opinion, the bankruptcy court concluded that the facts, if proven, could sustain a cause of action on two of the abovementioned three theories.[146]

With regard to the § 510(c) claim, the bankruptcy court ruled that factual issues concerning the defendants' conduct and harm to unsecured creditors precluded dismissal on preliminary motion.[147] As for the recharacterization cause of action, the bankruptcy court followed the prevailing wisdom at the time that it possessed the equitable

Ahart, *supra* note 137, at 450–51. *But see infra* notes 237–42 and accompanying text.

142. There is an important exception to this statement that pertains when subordination is to less than all of the debtor's creditors or there is a surplus remaining after senior claims are paid, since, unlike with disallowance, subordination does not eliminate the claim in toto. For an insightful discussion and analysis of this point, see David Gray Carlson, *The Logical Structure of Fraudulent Transfers and Equitable Subordination*, 45 WM. & MARY L. REV. 157 (2003), which points out that while the practical consequence of characterizing a remedy as recession, demotion, or avoidance will make little difference in most cases, it can make a big difference at the margin, and, thus, proposes that the metaphoric concepts that currently drive the remedial responses in the case of fraudulent transfers and equitable subordination be unified under the alternative concept of transfer. This is why it matters whether recharacterization is conceptually regarded as subordination or disallowance. For further discussion of which of the two is the more appropriate analogical construct, and the entailments that follow therefrom, see *infra* text accompanying notes 234–38.

143. *Adelphia*, 365 B.R. at 31–33.

144. *Id.* at 32.

145. *Id.* at 71.

146. *Id.*

147. *Id.* at 69–70. The court applied a standard for applying equitable subordination established by the Fifth Circuit in *Benjamin v. Diamond* (*In re Mobile Steel Co.*), 563 F.2d 692 (5th Cir. 1977). *See* discussion *infra* text accompanying note 170.

authority under § 105(a) to undertake the exercise based on the multifactor approach derived, in part, from tax court cases.[148] Nonetheless, dismissal as to this claim was granted based on the plaintiff's failure to address, by either allegations or argument, any of the showings required to be made in order for a debt to be recharacterized as equity; instead the plaintiff relied entirely on the argument that the funds received when the debt was incurred were actually used (by the former managers) as an equity contribution.[149] Turning to the cause of action seeking equitable disallowance, distinct from subordination under § 510(c) or recharacterization, the bankruptcy court held that this power, first established by the Supreme Court in *Pepper v. Litton*,[150] survived the enactment of the 1978 Act, even though it is not provided for expressly in the Code.[151] The court justified its conclusion based on two considerations: the legislative history accompanying § 510[152] and the well-recognized principle that Congress intended for the courts to continue to look to pre-Code law where the Code itself is silent.[153] On appeal, the district court agreed that equitable disallowance is permissible under *Pepper*,[154] but it corrected

148. *Adelphia*, 365 B.R. at 73–75.

149. *Id.* at 75. Unlike the usual recharacterization case, the individuals and entities extending the advance were not the owners of the debtor. Moreover, insofar as the factors bearing on recharacterization were concerned, the court noted that the plaintiff-creditors committee "put[] all of its eggs in a single basket," asserting that funds received from the putative loan were actually used as equity contributions by the debtors' management. *Id.* As the court noted, this "is in too many respects a play on words—melding an equity contribution by the Rigases [(the former managers of the company)] and an argued equity contribution by the bank lenders—and fails to address, by either allegations or argument, the showings that need to be made under the caselaw for recharacterizing debt as equity." *Id.*

150. 308 U.S. 295 (1939).

151. *Adelphia*, 365 B.R. at 72 (suggesting that *Pepper* was *both* an equitable subordination case *and* an equitable disallowance case). Once the court recognized the existence of the claim under the Code, unresolved factual questions bearing on its applicability in the case resulted in denial of the motion to dismiss. *Id.* at 72–73.

152. The court specifically relied on the following statement in the legislative history:

> This section is intended to codify case law, such as *Pepper v. Litton*, 308 U.S. 295, 60 S. Ct. 238, 84 L.Ed. 281 (1939), and *Taylor v. Standard Gas and Electric Co.*, 306 U.S. 307, 59 S. Ct. 543, 83 L.Ed. 669 (1938), *and is not intended to limit the court's power in any way. . . . Nor does this subsection preclude a bankruptcy court from completely disallowing a claim in appropriate circumstances.*

Id. at 71 (quoting H.R. REP. NO. 95-595, at 359 (1977), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6315).

153. *Id.* (quoting Midlantic Nat'l Bank v. N.J. Dep't of Envtl. Prot., 474 U.S. 494, 501 (1976)).

154. Adelphia Recovery Trust v. Bank of America, N.A., 390 B.R. 64, 74 (S.D.N.Y. 2008) (finding that *Pepper* endorsed equitable disallowance and nothing in the legislative history has been shown to indicate that Congress intended to eliminate that pre-Code

the bankruptcy court's recitation of the legislative history with a fuller account that negated the conclusion that Congress *intended* to provide for equitable disallowance when it enacted the Code.[155] Although it offers an avenue for what effectively amounts to debt recharacterization as part of the claims allowance process that is not tied to state law, equitable disallowance has received, at best, a mixed reception in the courts, both before and after the *Adelphia* decision.[156] In a 2012 article, Judge Ahart not only asserted that the doctrine was unauthorized under the language of the Code and the legislative history, but also that the Supreme Court itself erred in *Pepper* when it concluded that the bankruptcy court could equitably disallow a claim in the first place.[157] Although that bold assertion may be dubious, as discussed below, disallowance does not represent the most notionally precise concept to which to associate debt recharacterization.[158]

practice), *adhered to on reconsideration*, Nos. 05 Civ. 9050 (LMM), 03 MDL 1529, 2008 WL 1959542 (S.D.N.Y. May 5, 2008). In a related decision in the *Adelphia* bankruptcy case, the district court cited with approval the bankruptcy judge's statement that equitable disallowance is available only in "extreme instances—perhaps very rare—where it is necessary as a remedy." 365 B.R. at 73.

155. *Adelphia*, 390 B.R. at 74–76 (explaining that the House Report on which the bankruptcy court had based its determination was based on a version of a bill (H.R. 8200) that did not reflect the final text of the 1978 Act, including the final language of § 510(c)). The court also pointed out that the version of the bill that the Senate Judiciary Committee reported out favorably (S. 2266) contained a subsection (c)(3) which specifically provided for disallowance based on the equities of the case. *Id.* at 75. Without explanation, that provision did not make it into the final version of the bill. Thus, the court concluded that, at the end of the day, "Section 510 [as enacted] . . . contains no provision for equitable disallowance," and the legislative history insofar as the intent of Congress is concerned is ambiguous at best. *Id.* at 75–76.

156. *Compare In re* LightSquared Inc., 504 B.R. 321, 338–39 (Bankr. S.D.N.Y. 2013) (disagreeing with the decisions in *Adelphia* and holding that the Code does not permit equitable disallowance of claims that are otherwise allowable under § 502(d)), *and* Ahart, *supra* note 137, at 459 n.146 (citing relevant authorities), *with In re* Wash. Mut., Inc., 461 B.R. 200, 256–59 (Bankr. D. Del. 2011) (permitting assertion of equitable disallowance claim to go forward in the face of a motion to dismiss on standing grounds), *vacated in part*, No. 08-12229 (MFW), 2012 WL 1563880 (Bankr. D. Del. Feb. 24, 2016). In a subsequent opinion in that case, however, the court, in referring to its earlier opinion and order, noted that its determination

> that the Equity Committee has standing to pursue certain equitable disallowance claims was merely a preliminary ruling. In contrast to a ruling on the merits based upon a fully developed factual record after a full trial and discovery, the precedential value of the portions of the September Opinion and September Order that are related to the Standing Motion therefore is not high.

Wash. Mut., 2012 WL 1563880, at *19.

157. Ahart, *supra* note 137, at 450–51 (explaining that the 1898 Act did authorize the bankruptcy courts to disallow a claim based on the equities of the case).

158. *See infra* notes 234–38 and accompanying text.

In addition, the Supreme Court's decision in *Law*[159] now places the vitality of the doctrine in even further peril. *Law*, of course, involved the equitable disallowance of an exemption, and in the context of a provision of the Code that specifically prohibited payment of administrative expenses from exempt property.[160] Thus, *Adelphia* is factually distinguishable from *Law*. Nonetheless, the equitable disallowance of an exemption and the equitable disallowance of a claim are undeniably analogous. Combined with the Court's other admonitions in the case and more generally about the limited scope of the bankruptcy courts' equitable powers under § 105(a),[161] one can only conclude that the future prospects for equitable disallowance are not promising. Therefore, if the recharacterization question is to continue to be analyzed as a matter of federal law, prudence cautions that specific Code authority needs to be found. This then brings us foursquare to the doctrine of equitable subordination.

II. EQUITABLE SUBORDINATION

The 1978 Act, for the first time, incorporated into the substantive law governing bankruptcy cases an express provision recognizing the power of the bankruptcy courts to subordinate particular claims on equitable as well as contractual grounds.[162] Specifically, § 510(c) of the

159. Law v. Siegel, 134 S. Ct. 1188 (2014).

160. *See supra* notes 20, 21 and accompanying text. Unquestionably, *Law* is distinguishable from cases like *Adelphia* in the sense that the Code does prohibit equitable disallowance in the manner that § 522(k) insulates exempt property from liability for administrative expenses.

161. *Law*, 134 S. Ct. at 1194–95 ("We have long held that 'whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of' the Bankruptcy Code." (quoting Norwest Bank Worthington v. Ahlers, 495 U.S. 197, 206 (1988))). *See generally* Taylor v. Caillaud, No. 315-CV-00206-GCM, 2015 WL 7738391, at *3 (W.D.N.C. Dec. 1, 2015) (noting that, beyond the specific holding in *Law*, the Court also rejected the argument that bankruptcy courts have an inherent equitable power to deny exemptions, and that nearly every court to consider *Law* had construed that dicta as precluding courts from denying an exemption on the basis of the debtor's bad faith); Haines, *supra* note 17.

162. The recognition of consensual subordination under inter-creditor agreements is recognized in bankruptcy under § 510(a). In addition to contractual and equitable subordination, § 510(b) provides for a form of statutory subordination in the case of a claim (i) arising from recession, (ii) for damages arising from the purchase or sale of a security of the debtor (or its affiliate), or (iii) for reimbursement or contribution on account of such a claim to all claims or interests that are senior or equal to the claim represented by such security. 11 U.S.C. § 510(b) (2012). The purpose for this provision is to prevent disgruntled investors from recouping their losses at the same level as general unsecured creditors. *See, e.g.*, Rombro v. Dufrayne (*In re* Med Diversified, Inc.), 461 F.3d 251, 256 (2d Cir. 2006) (citing Baroda Hill Invs., Ltd. v. Telegroup, Inc. (*In re* Telegroup,

Code provides:

> Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may—
>
> (1) 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;[163] or
>
> (2) order that any lien securing such a subordinated claim be transferred to the estate.[164]

The roots of court-ordered subordination, however, are found much earlier in bankruptcy jurisprudence. The doctrine was first articulated and developed in a series of Supreme Court cases decided under the former Act.[165] According to the legislative history of § 510(c), these

Inc.), 281 F.3d 133, 141–42 (3d Cir. 2002)).

163. It will be recalled that the term "claim" is defined in § 101(5)(A) as a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." 11 U.S.C. § 101(5)(A). The definition is, in a word, comprehensive. "Interest" refers to the ownership rights of "equity security holders," including corporate shareholders and owners of limited partnership interests. *Id.* Under § 502(a), claims and interests are deemed *allowed* on filing a proof of claim or interest, and, of course, under § 726(a)(2), only the holders of allowed claims share in any bankruptcy distribution.

164. *Id.* § 510(c). In the case of the subordination of a secured claim, this is necessary to preserve the interest for the estate in the event the transfer was not also voidable so as to trigger § 551. *See, e.g.*, Ford v. Feldman (*In re* Fla. Bay Trading Co.), 177 B.R. 374, 382–83 (Bankr. D. Fla. 1994).

165. In *Pepper v. Litton*, 308 U.S. 295 (1939), the Court elaborated on its "Deep Rock" decision of a few months earlier in *Taylor v. Standard Gas & Electric Co.*, wherein the Court acknowledged the equity powers of the bankruptcy courts by affirming the subordination of the open account claims of the debtor's parent company to the rank of common shareholder based on the parent's mismanagement of the bankrupt. 306 U.S. 307, 315, 323–24 (1939). These two cases, together with *Comstock v. Group of Institutional Investors*, 335 U.S. 211 (1948), comprise a trilogy, which establish the doctrinal foundation of equitable subordination. *See* Carlson, *supra* note 142, at 198 (asserting that the Supreme Court "invented" equitable subordination in *Pepper*). Both *Pepper* and *Comstock* subordinated the claims of fiduciaries of the bankrupt. In *Pepper*, the Court held that subordination under equitable principles of the bankrupt party's dominant shareholder's claim was warranted where the shareholder used his insider position to gain a personal advantage at the expense of the plaintiff. 308 U.S. at 311. *Comstock*, however, which involved an alter ego and undercapitalization scenario, narrowed the potential scope of the bankruptcy courts' equitable authority as enunciated in *Pepper* by observing that a court cannot reclassify a valid claim that an innocent party

cases, along with other relevant authorities decided under the 1898 Act, continue to be influential in interpreting the meaning and scope of the doctrine under the Code.[166] That same legislative history makes equally clear that, in codifying the bankruptcy courts' authority to subordinate claims under principles of equitable subordination, Congress did not intend to limit the power and ability of the bankruptcy courts to further define and develop the perimeters of the doctrine.[167] To the contrary, Congress deliberately left it to the courts, in the context of actual cases, to fashion the standards and guidelines governing the future application of the judicially-created doctrine, now newly exalted to statutory rank under the Code.[168] However, as was observed earlier in

asserted in good faith just because the court perceives the result to be inequitable. *Comstock*, 335 U.S at 229–30.

For an extended treatment of subordination under the 1898 Act, see Asa S. Herzog & Joel B. Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 15 VAND. L. REV. 83 (1961). For summary treatments of those cases in connection with the development of the common law doctrine of equitable subordination, see Scott M. Brown, Note, *No Fault Equitable Subordination: Reassuring Investors that Only Government Penalty Claims Are at Risk*, 34 WM. & MARY L. REV. 487, 490–96 (1993); Nozemack, *supra* note 73, at 692 (ultimately advancing a position very much at odds with the approach taken herein, as the author's aim is to supply an answer to the question posed by his title).

166. "It is intended that the term 'principles of equitable subordination' follow existing case law and leave to the courts development of this principle." 124 CONG. REC. 32,398 (1978) (statement of Rep. Edwards); *id.* at 33,998 (statement of Sen. DeConcini); *accord* H.R. REP. NO. 95-595, at 359 (1977), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6315 (noting, in relation to an earlier version of the bill, that the new provision was intended to codify existing case law, such as *Pepper* and *Taylor*). Representative Edwards and Senator DeConcini served as floor managers of the bill in their respective chambers of Congress and, contrary to the normal conference process, essentially hammered out the final terms of the bill. They issued identical statements that, because of the unusual circumstances, are considered important components of the legislative history. Their floor statements are together hereinafter referred to as the "Floor Managers' Statement."

167. *See* 124 CONG. REC. 32,398 (1978) (statement of Rep. Edwards); *id.* at 33,998 (statement of Sen. DeConcini); *see also infra* notes 296–97 and accompanying text (discussing the statement in toto). House Report 95 contained even more expansive language suggesting that "[t]he 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. However, as discussed, *supra* note 155, House Report 95 was issued in response to an earlier version of the bill that did not reflect the final text of § 510(c), and, thus, must be read with that admonition in mind. On the other hand, it hardly renders House Report 95 irrelevant in the interpretation of the Code. For general discussion of the unusual circumstances surrounding the passage of the Code, see Kenneth N. Klee, *Legislative History of the New Bankruptcy Law*, 28 DEPAUL L. REV. 941 (1979). As to how this unusual legislative process impacted what finally became § 510(c) of the 1978 Act, see Rafael Ignacio Pardo, Note, *Beyond the Limits of Equity Jurisprudence: No-Fault Equitable Subordination*, 75 N.Y.U. L. REV. 1489 (2000).

168. *See* Burden v. United States, 917 F.2d 115, 117–18 (3d Cir. 1990) (citing *In re*

connection with the discussion of *N & D Properties*,[169] because equitable subordination is considered to be "remedial" and not penal,[170] it was understood that a claim would be subordinated only to the extent necessary to remediate the harm caused to the debtor and other creditors as a consequence of the offending conduct.[171]

For a brief time after enactment of the 1978 Act, bankruptcy courts made relatively liberal, but appropriate, use of the doctrine of equitable subordination "to the end that fraud will not prevail, that substance will not give way to form, [and] that technical considerations will not prevent substantial justice from being done."[172] Gradually, however, the

Virtual Network Servs. Corp., 902 F.2d 1246, 1248–50 (7th Cir. 1990)) (reaching the conclusion that Congress intended for the courts to develop "principles of equitable subordination" based on a review of the applicable legislative history). The court in *Virtual Network* observed that "principles of equitable subordination" are broader than the doctrine that developed prior to § 510(c)(1)'s enactment. 902 F.2d at 1250; *see also infra* note 297 and accompanying text.

169. *See supra* text accompanying note 44.

170. *See, e.g.*, Mishkin v. Siclari (*In re* Adler, Coleman Clearing Corp.), 277 B.R. 520, 563 (Bankr. S.D.N.Y. 2002) ("The equitable subordination doctrine, codified in part in Section 510(c) of the Bankruptcy Code, is limited to reordering priorities; it does not permit disallowance of claims." (footnote omitted) (citing 80 Nassau Assocs. v. Crossland Fed. Sav. Bank, 169 B.R. 832, 836–37 (Bankr. S.D.N.Y. 1994))); *see also supra* note 141.

171. *See, e.g.*, *80 Nassau Assocs.*, 169 B.R. at 840 ("The principle of equitable subordination . . . empowers and requires the Bankruptcy Court to tailor the remedy to fit the harm. If the injury or unfair advantage affects only a specific creditor or segment of creditors, the court should subordinate the offending claimant only to the more limited class of claims rather than the claims of all creditors." (citing Miller v. Borton (*In re* Bowman Hardware & Elec. Co.), 67 F.2d 792 (7th Cir. 1933); Bank of New Richmond v. Prud. Credit Assoc. of River Falls (*In re* Osborne), 42 B.R. 988, 1000 (W.D. Wis. 1984))). The misconduct, however, need not necessarily arise out of the creation of the claim for which subordination is sought. *See, e.g.*, Enron Corp. v. Ave. Special Situations Fund II, LP (*In re* Enron Corp.), 333 B.R. 205, 219 n.4 (Bankr. S.D.N.Y. 2005) ("Fundamentally, the analysis focuses on the alleged inequitable conduct, and any associated harm therefrom, not on any particular claim or group of claims.").

172. Pepper v. Litton, 308 U.S. 295, 305 (1939). Spurred by the decision of the court in *Bergquist v. First National Bank of St. Paul* (*In re American Lumber*), 7 B.R. 519 (Bankr. D. Minn. 1979), *aff'd*, 5 B.R. 470 (D. Minn. 1980), there was a brief period of time when equitable subordination was seen as a potentially powerful weapon in the emerging field of lender liability. *See* Andrew DeNatale & Prudence B. Abram, *The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors*, 40 BUS. LAW. 417, 424–25 (1985) ("Once a creditor assumes control over a debtor's operations, it assumes a duty to deal fairly with the debtor and its creditors, and its conduct is subjected to the scrutiny of the court."); Jeremy W. Dickens, Note, *Equitable Subordination and Analogous Theories of Lender Liability: Toward a New Model of "Control,"* 65 TEX. L. REV. 801, 802 (1987) ("[T]he use of equitable subordination against nonmanagement creditors has the financial community searching for standards by which to measure the boundaries of legitimate conduct."). However, while a lender that exerts too much control over the borrower could still be vulnerable even today, courts have generally been reluctant to find that a lending institution's conduct rises to the level of the kind of gross misconduct that might warrant

courts, and particularly the courts that sit in appellate review of bankruptcy decisions, began to cut back, if not necessarily on the authority of the bankruptcy courts under § 510(c), then on the circumstances under which the bankruptcy courts might invoke that authority.[173] The contraction in the scope of the remedy, coupled with the courts' chariness in bringing it to bear,[174] was most keenly felt, of course, in the case of claims held by noninsiders.[175] Not coincidently by

subordination of it claim. *See supra* note 163. Therefore, the traditional "easy" targets for subordination have been and remain claims held by insiders: a corporate debtor's officers, directors, and controlling stockholders. Such claimholders stand in a fiduciary relationship with the community of players—the debtor, equity owners, and creditors—imposing heightened standards for their conduct. *See* Fabricators, Inc. v. Tech. Fabricators, Inc. (*In re* Fabricators, Inc.), 926 F.2d 1458, 1465 (9th Cir. 1991) (noting that the level of inequitable conduct required in the case of insiders is different); CapMark Fin. Grp. Inc. v. Goldman Sachs Credit Partners L.P., 491 B.R. 335, 345 (S.D.N.Y. 2013) (noting that, in the case of insiders, once the plaintiff makes a prima facie showing of inequitable conduct, the burden shifts to the claimant to prove good faith and the inherent fairness of the transaction); Litzler v. Cooper (*In re* Margaux Tex. Ventures, Inc.), 545 B.R. 506, 514 (Bankr. N.D. Tex. 2014) (noting that "[a] claim arising from the dealings between a debtor and an insider is to be rigorously scrutinized by the courts" (alteration in original) (quoting Bayer Corp. v. MascoTech, Inc. (*In re* AutoStyle Plastics, Inc.), 269 F.3d 726, 744 (6th Cir. 2001))). *But see* Va. Broadband, LLC v. Manuel, 538 B.R. 253, 264 (W.D. Va. 2015) (pointing out that the standard for inequitable conduct is not as high when the creditor is an insider).

173. *See* Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351, 1356–57 (7th Cir. 1990) (finding that, in the case of noninsiders, a creditor whose conduct does not exceed the powers reserved to it under its contract does not engage in inequitable conduct). The Fifth Circuit went even further in *Smith v. Associate*s *Commercial Corp.* (*In re Clark Pipe and Supply Co.*) with its observation that, even if the loan documents give the lender the right to exert control, it is the exercise of that power, and not simply its reservation, that is inequitable. 893 F.2d 693, 701 (5th Cir. 1990); *see also* Friesen v. Seacoast Capital Partners II, L.P. (*In re* QuVIS, Inc.), 469 B.R. 353, 368 (D. Kan. 2012) (holding that a lender that exercised its rights under a loan agreement, including having its managing director placed on the debtor's board of directors, did not qualify as a nonstatutory insider for purposes of § 510(c)); *supra* note 27; *infra* text accompanying note 285.

174. *See, e.g.*, Nat'l Emergency Servs. v. Williams, 371 B.R. 166, 170 (W.D. Va. 2007) (describing equitable subordination as an extraordinary remedy to be invoked sparingly); Aetna Bank v. Dvorak, 176 B.R. 160, 166 (N.D. Ill. 1994) (providing that equitable subordination should only be invoked in extreme circumstances); *Margaux Tex. Ventures*, 545 B.R. at 514–15 (observing that less egregious conduct may support equitable subordination when the claimant is an insider); *see also supra* note 59. In an article written around the heyday of lender liability, DeNatale and Abram suggested that the application of equitable subordination to nonmanagement creditors was due not to changes in the doctrine itself, but rather evolving commercial developments, including the use of more aggressive financial transactions. DeNatale & Abram, *supra* note 172, at 447–48.

175. *See, e.g.*, *In re* Mid-Am. Waste Sys., Inc., 284 B.R. 53, 70 (Bankr. D. Del. 2002) ("[T]he standard for finding inequitable conduct is much lower [for insiders versus

any means, this trend to rein in the bankruptcy courts' application of its statutory subordination powers under § 510(c) paralleled, and I would suggest may have instigated, the emergence of recharacterization as an autonomous, standalone basis for challenging equity interests allegedly disguised or mislabeled as debt. Prior to that time, despite whatever conceptual differences might have been perceived to exist between the two doctrines,[176] recharacterization challenges tended to be treated as part, and within the boundaries, of an equitable subordination analysis.[177]

noninsiders]."). However, while courts are reluctant to subordinate noninsider claims, the lack of insider status does not confer blanket immunity in the face of egregious conduct. *See, e.g.*, Miller v. Greenwich Capital Fin. Prods., Inc. (*In re* Am. Bus. Fin. Servs., Inc.), 362 B.R. 149, 157 (Bankr. D. Del. 2007) (finding that defendant intentionally suppressed the value of debtor's assets); *Adler, Coleman Clearing Corp.*, 277 B.R. at 566 (finding the creditor "willingly" and "knowingly" engaged in conduct that amounted to "fraud, illegality, [and] breach of fiduciary duty"); *see also infra* text accompanying notes 207–11. For a couple of early examples of subordination being invoked against noninsiders, see *Osborne*, 42 B.R. at 999 (finding that creditor misrepresented debtor's financial situation to another creditor so that the other creditor would continue to extend the debtor credit); First Nat'l Bank of Gatlinburg v. Charles Blalock & Sons, Inc. (*In re* Just for the Fun of It of Tenn., Inc.), 7 B.R. 166, 180 (Bankr. E.D. Tenn. 1980) (finding that contractor filed false notice of completion, on which other creditors relied when granting additional credit to bankrupt).

176. Among other differences, it has been pointed out that insider status is not technically a factor in the recharacterization analysis. *See* Erica Litovitz, *Debt Recharacterization and Its Place in the Bankruptcy Code*, 10 SETON HALL CIR. REV. 307, 326 (2014). On the one hand, for the most part, disinterested third parties deal with the debtor at arm's length and do not infuse new equity into the corporation. *See* United States v. Colo. Invesco, Inc., 902 F. Supp. 1339, 1345 (D. Colo. 1995). Thus, recharacterization is primarily suggested when the contributors are insiders, bearing in mind that "control" may be a sufficient basis to confer insider status, even in the absence of a formal relationship with the debtor such as an officer or director position. *See Fabricators*, 926 F.2d at 1466. See *infra* Part IV.C for further discussion of this point. In addition, while a recharacterization scenario may well entail inequitable conduct, it is not a prerequisite. This probably represents, more so than the status of a claimant as an insider or noninsider, the most substantive contemporary difference between the two remedies. *See infra* text accompanying notes 333, 344.

177. *See, e.g.*, Aquino v. Black (*In re* AtlanticRancher, Inc.), 279 B.R. 411, 433 (Bankr. D. Mass. 2002) (noting that recharacterization was once considered solely in conjunction with equitable subordination, but now is recognized as a separate cause of action). In an 1898 Act case, the Supreme Court observed that "[t]he power of the bankruptcy court to subordinate claims or to adjudicate equities arising out of the relationship between the several creditors is complete." Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215, 219 (1941) (citing Taylor v. Standard Gas & Elec. Co., 306 U.S. 307 (1939); *Pepper*, 308 U.S. 295; Bird & Sons Sales Corp. v. Tobin, 78 F.3d 371 (8th Cir. 1935)). In their classic treatment of equitable subordination under the 1898 Act, Herzog and Zweibel devote an entire section to the "Capital Contribution Cases," which they describe as "a sub-classification within the general sphere of equitable subordination." Herzog & Zweibel, *supra* note 165, at 93. They go on to state:

Doubtless, the most influential decision affecting the scope of the doctrine under the Code was handed down by the Fifth Circuit in a case decided, ironically enough, under the 1898 Act: *In re Mobile Steel Co.*[178] The Fifth Circuit's opinion in *Mobile Steel* is most notable for its articulation of a three-pronged test for ascertaining when equitable subordination of a claim (or interest) should be ordered. Specifically, the conditions that have to be satisfied in order to invoke the courts' authority under § 510(c) were stated as being that: (1) the claimant engaged in *inequitable conduct*, (2) the misconduct caused injury to other creditors or conferred an unfair advantage on the claimant, and (3) the subordination would not be inconsistent with the provisions of the Code.[179] With regard to the critical first prong, inequitable conduct has, in turn, generally come to be understood as comprising behavior falling into one of three categories: (1) fraud, illegality, and breach of fiduciary duty; (2) undercapitalization; and (3) use of the debtor as a mere instrumentality or alter ego.[180] Although recognition of undercapitalization as bearing on inequitable conduct unquestionably

> Once the judicial investigation has determined that the claim is not *in fact* a debt but is a proprietary interest, subordination follows as a matter of course for the essential nature of a capital interest is a fund contributed to meet the obligations of a business and which is to be repaid only after all other obligations have been satisfied. Inasmuch as the focal issue is the true nature of the transaction, in order to effect subordination, it is not necessary to prove the existence of fraud or other inequitable conduct.

Id. at 94. In ascertaining the true nature of a monetary advance, the authors proceed to discuss a list of factors that, in many respects, mirror the multifactor approach favored in a majority of circuits for determining when recharacterization is appropriate. *Id.* at 95–97; *see supra* Part I.C. Never do the authors state or imply that the matter is distinct from or should be examined other than under the doctrine of equitable subordination. *See infra* note 337.

178. Benjamin v. Diamond (*In re* Mobile Steel Co.), 563 F.2d 692 (5th Cir. 1977).

179. *Id.* at 700. The third condition or guiding principle is something of a formality. *See, e.g.,* 80 Nassau Assocs. v. Crossland Fed. Sav. Bank (*In re* 80 Nassau Assocs.), 169 B.R. 832, 841 (Bankr. S.D.N.Y. 1994) (observing that it would be difficult to imagine a circumstance where subordination was not warranted once the first two prongs had been satisfied). However, the third prong has been described as "a reminder to the bankruptcy court that although it is a court of equity, it is not free to adjust the legally valid claim of an innocent party who asserts the claim in good faith merely because the court perceives that the result is inequitable." Enron Corp. v. Ave. Special Situations Fund II, LP (*In re* Enron Corp.), 333 B.R. 205, 231 (Bankr. S.D.N.Y. 2005) (citing United States v. Noland, 517 U.S. 535, 539 (1996)).

180. *See* Wilson v. Huffman (*In re* Missionary Baptist Found.), 712 F.2d 206, 212 (5th Cir. 1983); SEC. v. Spongetech Delivery Sys., Inc., 98 F. Supp. 3d 530, 553 (E.D.N.Y. 2015) (identifying three "paradigms" in which courts have found inequitable conduct); Bank of N.Y. v. USA Capital Diversified Tr. Deed Fund, LLC (*In re* Epic Capital Corp.), 290 B.R. 514, 524 (Bankr. D. Del. 2003), *aff'd*, 307 B.R. 767 (D. Del. 2004).

suggests a nexus with debt recharacterization,[181] as noted earlier,[182] the courts have overwhelmingly held that undercapitalization *alone* is insufficient to meet the standard.[183] Thus, with its emphasis on inequitable conduct, *Mobile Steel* and its progeny have made debt recharacterization an awkward, albeit not entirely impossible,[184] fit under § 510(c), thereby likely hastening the relatively recent evolution of recharacterization into an independent claim for relief and remedy. The Supreme Court entered into the discussion of equitable subordination under the Code in *United States v. Noland*,[185] a case that even further narrowed the scope of § 510(c), but at the same time also cracked open the door to a potentially more expansive interpretation.[186] At issue in the case was the lower courts' subordination of the government's postpetition, nonpecuniary tax loss penalty claim upon conversion of a case from Chapter 11 to Chapter 7.[187] The Supreme Court reversed, stating emphatically that a reordering of Code priorities under § 510(c) based solely on the intrinsic nature of the claim exceeded the scope of the courts' authority under "principles of equitable subordination."[188] The Court reaffirmed this position in a case decided during the same term, *United States v. Reorganized CF & I Fabricators of Utah*, holding that even when the claim in question is not entitled to a statutory priority, as was true in *Noland*, subordination cannot be wholly based on the nature of the claim itself.[189]

181. This was a consistent theme in the trilogy of Supreme Court cases, *see supra* note 165, that gave rise to equitable subordination, and that also have been cited as forming the basis for the bankruptcy courts' authority to recharacterize claims. *See, e.g.*, FCC v. Airadigm Commc'ns (*In re* Airadigm Commc'ns, Inc.), 616 F.3d 642, 657–58 (7th Cir. 2010) (noting the connection made in the case law between the remedy of recharacterization and the sentiments expressed by the Supreme Court in *Pepper*).

182. *See infra* Part IV.A.

183. *See, e.g.*, Fabricators, Inc. v. Tech. Fabricators, Inc. (*In re* Fabricators, Inc.), 926 F.2d 1458, 1469 (9th Cir. 1991); *In re* Va. Broadband, LLC, 521 B.R. 539, 564 n.170 (Bankr. W.D. Va. 2014) (citing *In re* Lifschultz Fast Freight, 132 F.3d 339, 349 (7th Cir. 1997)), *aff'd*, 538 B.R. 253 (W.D. Va. 2015).

184. *See infra* Part IV.A–B.

185. 517 U.S. 535 (1996).

186. *See infra* Part IV.B.

187. In affirming the bankruptcy court's decision to subordinate the government's administrative expense claim, the Sixth Circuit stated: "Because of the nature of postpetition, nonpecuniary loss tax penalty claims in a Chapter 7 case, we believe such claims are susceptible to subordination." United States v. Noland (*In re* First Truck Lines, Inc.), 48 F.3d 210, 218 (6th Cir. 1995), *rev'd*, 517 U.S. 535.

188. *Noland*, 517 U.S. at 542–43 (stating that § 510(c) permits a court to make exceptions to a general rule only when justified by particular facts).

189. 518 U.S. 213, 228 (1996) (describing *Noland* as having nothing to do with the fact that the claim in that case was entitled to statutory priority, but rather with the reordering of priority on a categorical basis).

Of critical importance for present purposes, while the Court's decision in *Noland* referred to the *Mobile Steel* factors as "influential,"[190] it did not affirmatively adopt or endorse those standards.[191] That is to say, the holdings in *Noland* and *Reorganized CF & I* were based entirely on the "if this, then that" nature of the reasoning in the lower courts' decisions, and not on their conclusion that equitable subordination might be invoked despite the absence of misconduct on the defendant's part. This omission spawned a discussion in the case law and commentary about the possibility of so-called no-fault equitable subordination,[192] the phrase used to refer to application of the remedy without proof of the first *Mobile Steel* factor, namely, inequitable conduct. Although the concept of no-fault subordination has gained some support in certain types of cases,[193] for the most part, proof of inequitable conduct largely remains the order of the day.[194] However, as will be discussed below,[195] it may be timely to reexamine the sagacity of that view. Two additional equitable subordination cases deserve mention before moving on. In the first, John and Jeffrey Wooley, officers, directors, and the largest shareholders of Schlotzsky's, Inc., made two secured loans, totaling $3.5 million, to the company in order

190. *Noland*, 517 U.S. at 543 (noting that it is not necessary to "decide today whether a bankruptcy court must always find creditor misconduct before a claim may be equitably subordinated").

191. It should be observed that some courts have determined this statement to be a sufficient indication of the Court's approval of the *Mobile Steel* test so as to warrant adoption of the test. *See, e.g.*, Schubert v. Lucent Techs. Inc. (*In re* Winstar Commc'ns, Inc.), 554 F.3d 382, 411–12 (3d Cir. 2009). It should also be noted that while the circuit court in *Reorganized CF & I* had specifically ruled that equitable subordination might be invoked despite the absence of inequitable conduct, United States v. Reorganized CF & I Fabricators of Utah, Inc. (*In* re CF & I Fabricators of Utah, Inc.), 53 F.3d 1155, 1158–59 (10th Cir. 1995), *vacated*, 518 U.S. 213, the Supreme Court's opinion only rejected categorical subordination of tax penalties and did not question the possibility of no-fault subordination if done after an individualized analysis of the facts of the case. *Reorganized CF & I*, 518 U.S. at 229. Even the Tenth Circuit, however, has declined to apply the exception to claimant misconduct beyond the tax penalty context. Sender v. Bronze Grp., Ltd. (*In re* Hedged-Invs. Assocs., Inc.), 380 F.3d 1292, 1301 (10th Cir. 2004).

192. *See infra* Part IV.A. *See generally* Jonathan A. Carson, *Pre-Petition Capital Contributions: The Road to Equitable Treatment in Bankruptcy*, 1999 COLUM. BUS. L. REV. 403, 416; Pardo, *supra* note 167, at 1492; Richard C. Solow, *The Very Limited No-Fault Equitable Subordination Theory: Why Section 510(c) Requires Misconduct in Nearly All Cases*, 22 J. BANKR. L. & PRAC. 1 (2013)

193. *See infra* Part IV.A.

194. *See, e.g.*, Citicorp Venture Capital, Ltd. v. Comm. of Creditors Holding Unsecured Claims, 160 F.3d 982, 986–87 (3d Cir. 1998); *In re* LifSchultz Fast Freight, 132 F.3d 339, 347–49 (7th Cir. 1997); *see also supra* note 171 and accompanying text.

195. *See infra* Part IV.B.

to alleviate severe cash flow shortages.[196] In addition, the second loan agreement pledged the company's assets as additional security for $4.3 million in guaranties previously made by the Wooleys on the company's outstanding bank debt.[197] Despite the further cash infusion, the company's financial fortunes continued to decline, and the Wooleys were removed as officers (and resigned as directors) of the company.[198] Not long after, the company commenced a case under Chapter 11, whereupon the unsecured creditors committee filed an adversary proceeding seeking to strip the Wooleys of their security interests and subordinate their purported debt claims under § 510(c).[199] The bankruptcy court ruled in favor of the committee, finding that the Wooleys had breached their fiduciary duties by the manner in which they obtained approval for their loans and, in so doing, had secured "an unfair advantage" for themselves vis-à-vis other creditors.[200] The district court affirmed, and the case was appealed to the Fifth Circuit, which reversed the lower courts in no uncertain terms.[201] While the court surmised that the record could probably support a finding of inequitable conduct and unfair advantage, it concluded that the absence of a showing of any harm to the debtor or its creditors was fatal to the claim for relief under § 510(c).[202] In insisting upon a showing of "harm,"

196. Wooley v. Faulkner (*In re* SI Restructuring, Inc.), 532 F.3d 355, 357–58 (5th Cir. 2008).

197. *Id.* at 358.

198. *Id.*

199. *Id.*

200. *Id.* at 359.

201. *Id.* at 360–61.

202. *Id.* at 361. The court rejected the committee's argument that unsecured creditors were harmed because the debtor's assets were reduced when the Wooleys were granted a security interest in the company's assets. *Id.* at 362–63. Specifically, the court observed that the loan proceeds had been used to pay some unsecured creditors, and, thus, unsecured creditors as a class were not harmed. *Id.* The court also pointed out that the unsecured creditors that had *not* been paid were unable to show that they had any entitlement to payment senior to that of the creditors who were paid. *Id.* This may well be true, but it does not overcome the fact that they were still harmed by the net reduction in the company's assets available for distribution to unsecured creditors. In any case, the court also rejected the committee's theory of harm in the form of "deepening insolvency." *Id.* at 363. This represents a theory of damages under which a plaintiff might recover the entire difference in value between the company as of the date that it became insolvent and as of the date it ultimately files for bankruptcy depending on how the loaned proceeds are used. *See generally* Hugh M. McDonald, Todd S. Fishman & Laura Martin, *Lafferty's Orphan: The Abandonment of Deepening Insolvency*, AM. BANKR. INST. J., Dec.–Jan. 2008, at 1. In rejecting the deepening insolvency theory of damages, the court indicated its intent to align itself with the Third Circuit's decision in *Seitz v. Detweiler, Hershey & Assocs., P.C.* (*In re CitX Corp.*), 448 F.3d 672, 678 (3d Cir. 2006), wherein the court qualified its earlier opinion in *Official Committee of Unsecured Creditors v. R.F. Lafferty*

the Fifth Circuit seemed to be ignoring its own formulation of the conditions that must be satisfied in order to invoke the doctrine, which included that the misconduct must cause injury to other creditors *or confer an unfair advantage on the claimant*.[203] That formulation might logically be read to suggest that these are alternative ways to satisfy the second element for equitable subordination, one of which *was* satisfied in *SI Restructuring*.

In any case, the result in *SI Restructuring* was hailed in some quarters for not creating an additional barrier that might tend to deter insiders from making loans to their beleaguered companies.[204] The decision might also be perceived as further distancing debt recharacterization from equitable subordination, inasmuch as the former, not being directly remedial in nature, would not appear to hinge on a showing of harm to the debtor or other creditors. As will be seen,[205] however, there were factors at play in *SI Restructuring* that do not make its holding, properly delineated, inconsistent with the recharacterization of debt by means of § 510(c). Furthermore, mischaracterization of an investment in the debtor entity that artificially elevates its priority is, by its very nature, prejudicial to the holders of true debt claims.[206] The second case, *In re Yellowstone Mountain Club*,[207] is notable as a rare contemporary example of subordination being (1) ordered against a *noninsider*, though its facts were unusually egregious, and (2) ordered without a specific showing of

& Co., 267 F.3d 340, 351 (3d Cir. 2001), which had recognized deepening insolvency as a valid cause of action under Pennsylvania law. *SI Restructuring*, 532 F.3d at 363; *see also infra* notes 327–328 and accompanying text (discussing subsequent developments regarding the deepening insolvency theory). In any case, the court in *SI Restructuring* went on to muse that even if it were inclined to accept deepening insolvency as a valid theory of damages, the facts did not support its application in this case. 532 F.3d at 364.

203. *See supra* note 179 and accompanying text. Instead, the court seemed to assume that unfair advantage was part of the first, rather than the second, prong of the *Mobile Steel* test. *SI Restructuring*, 532 F.3d at 361–62.

204. *See, e.g.*, Patricia A. Redmond & Jessica D. Gabel, *Not All Loans Are Created Equal: Equitable Subordination and Prepetition Lending After* SI Restructuring, AM. BANKR. INST. J., Nov. 2008, at 22.

205. *See infra* text accompanying notes 324–25.

206. *See infra* note 329 and accompanying text. The only exception would be where the debtor remains solvent in a balance-sheet sense despite the additional liability created by the mischaracterized investment.

207. Credit Suisse v. Official Comm. of Unsecured Creditors (*In re* Yellowstone Mountain Club, LLC), No. 08-61570-11, 2009 WL 3094930 (Bankr. D. Mont. May 12, 2009) (granting preliminary injunction), *vacated*, No. 08-61570-11-RBK, 2009 WL 10624435 (Bankr. D. Mont. June 29, 2009). The opinion was thereafter vacated following settlement. *Yellowstone Mountain*, 2009 WL 10624435.

affirmative misconduct in the *Mobile Steel* sense of that phrase.[208] Giving rise to the case, Credit Suisse acted as the lead arranger for a $375 million loan to the debtor companies.[209] The transaction involved what the court referred to as a "new financial product" that, among other things, allowed the shareholders of the debtor companies to receive significant distributions from the loan proceeds.[210] Finding, in addition to the unusual character of the credit facility, a wholesale lack of due diligence and negligent lending practices on the part of the defendant, the court ordered that $209 million of the total loan amount be subordinated to the claims of the debtor-in-possession lender, as well as to unsecured creditors.[211] The decision not only marks a sharp reversal in the trend to narrow the scope of the doctrine of equitable subordination, but, as discussed in Part IV below, also points the way toward assuring that the courts' ability to recharacterize equity contributions disguised as debt is not undermined either by the uncertainty surrounding the reach of the equitable authority of the bankruptcy courts under § 105(a) or unnecessary obeisance to nonuniform state law.

III. RECHARACTERIZATION REDUX

A. The Flaw in the Minority Approach

Timorous about construing § 105(a) more broadly, both *Lothian Oil*[212] and *Fitness Holdings*[213] looked to § 502(b) as the statutory basis on which a bankruptcy court might recharacterize a transaction

208. Some questioned just how outrageous the lender's conduct was in light of current standards governing a lender's responsibilities in arms-length transactions. *See, e.g.*, Jo Ann J. Brighton & Felton E. Parrish, Yellowstone*: New Standards for Lender Liability in Today's Economic Climate*, AM. BANKR. INST. J., Sept. 2009, at 28. For a more critical view of the Credit Suisse's conduct in the loan transaction, see J. Thomas Beckett, *A Rogue Loan, Not a Rogue Decision: A Response to a Recent Analysis of* Yellowstone, AM. BANKR. INST. J., Nov. 2009, at 22. In terms of how the phrase "inequitable conduct" has come to be understood, see *supra* note 180 and accompanying text.

209. *Yellowstone Mountain*, 2009 WL 3094930, at *5.

210. *Id.* at *8. In this particular case, there are some eerie similarities to the transaction at issue in *Adelphia Recovery Trust v. Bank of America, N.A.*, 390 B.R. 64 (S.D.N.Y. 2008), *adhered to on reconsideration*, Nos. 05 Civ. 9050 (LMM), 03 MDL 1529, 2008 WL 1959542 (S.D.N.Y. May 5, 2008), discussed *supra* notes 138–55 and accompanying text.

211. *Yellowstone Mountain*, 2009 WL 3094930, at *10. The $209 million represented the portion of the loan proceeds transferred to the companies' shareholders. *Id.*

212. Grossman v. Lothian Oil Inc. (*In re* Lothian Oil Inc.), 650 F.3d 539 (5th Cir. 2011).

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

denominated as a loan by classifying it as equity. Proceeding from what they perceived to be the sentiments of the Supreme Court expressed in *Butner v. United States*,[214] that step led both courts to the subsidiary conclusion regarding the primacy of state law in determining if and when the circumstances dictate recharacterization.[215] As I have opined elsewhere,[216] however, the Supreme Court's 1979 decision in *Butner* has been given a far more sweeping construction and application than is merited by its actual holding.[217] Nevertheless, even conceding for present purposes the broad interpretation of the case adopted by the Fifth and Ninth Circuits, *Butner* (and its progeny) still cannot possibly stand for the proposition for which both decisions cite it, nor can it support the rule applied in those cases.

To begin with, in *Fitness Holdings*, the court looked to *Travelers Casualty & Surety Co. v. Pacific Gas & Electric Co.*, which, citing *Butner*, held that courts should not use a federal rule to determine whether a prepetition contract represents a "right to payment" giving rise to a "claim" for purposes of the federal bankruptcy law.[218] *Butner*, in turn, held that "[p]roperty interests are created and defined by state law," and that, "[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."[219] The import of these statements is that, although the question of what constitutes property of the estate is

214. 440 U.S. 48 (1979).

215. *See supra* Part I.D.1.

216. *See, e.g.*, Lawrence Ponoroff, *Reclaim This! Getting Credit Seller Claims in Bankruptcy Right*, 48 U. RICH. L. REV. 733, 789 (2014) ("[W]e all bow to *Butner*, but, in truth, the principle articulated in *Butner* represents no more than a bias. By definition, then, it applies more often than not, but it is not an absolute that substitutes for reasoned analysis in each instance where federal and state law intersect." (footnote omitted)); *see also infra* notes 221–25 for other expositions questioning the appropriateness of the expansive interpretation *Butner* has received in the lower courts.

217. *Butner* actually does no more than express in the negative the basic truism that when a state law property definition interferes with federal bankruptcy policy, the state law rule is preempted under the Supremacy Clause of the Federal Constitution. For example, in *Kanter v. Moneymaker* (*In re Kanter*), the court invalidated a state statute that purported to defease the bankruptcy trustee of any interest in a prepetition personal injury lawsuit. 505 F.2d 228, 230–31 (9th Cir. 1974). The court found that enforcement of that provision directly conflicted with the provisions of the former Bankruptcy Act's definition of property of the estate as well as with the overall distributional priority scheme established by the Act. *Id.*; *see also In re* Pruitt, 401 B.R. 546, 564 (Bankr. D. Conn. 2009) (suggesting that many courts read *Butner* too broadly).

218. 549 U.S. 443, 450–51 (2007).

219. *Butner*, 440 U.S. at 55.

determined as a matter of federal law,[220] the nature and attributes of a debtor's interest in property will ordinarily be ascertained by reference to nonbankruptcy law, and, most frequently, state law.[221] This only makes sense in that, for the most part, Congress has chosen (and wisely so) not to create an entirely new regime of property rights, entitlements, limitations, and priorities that would attain upon the filing of a federal bankruptcy case.[222]

On its facts, however, *Butner* involved an issue of whether a mortgage interest extended to rents from the encumbered property;[223] the opinion had nothing at all to say about whether the substance of the transaction coincided with the manner in which it had been labelled. It had nothing to say because the transaction was assumed by all concerned to be precisely what it purported to be, such that its true character was never an issue in the case. Thus, *Butner* is largely superfluous insofar as the issue that the courts faced in *Lothian Oil* and *Fitness Holdings* is concerned. Even more to the point, however, simply because state law determines whether a claim exists—whether there is a right to payment—that determination says absolutely nothing about how the claim will or should be treated in bankruptcy, i.e., whether it will be allowed or disallowed in a bankruptcy case, and, if allowed, the priority it will enjoy. The questions are controlled exclusively by federal law,[224] and therefore must be resolved based on the policies implicated

220. Bd. of Trade v. Johnson, 264 U.S. 1, 10 (1924); McCarthy, Johnson & Miller v. N. Bay Plumbing, Inc. (*In re* Pettit), 217 F.3d 1072, 1078 (9th Cir. 2000) (stating that "whether an interest claimed by the debtor is 'property of the estate' is a federal question to be decided by federal law" and it is irrelevant that state law might not call the same interest *property* (citing *Butner*, 440 U.S. at 54–55)).

221. This is basically the teaching of *Butner*; federal law establishes the scope of property of the estate—regardless of how the interest might be characterized by state law—and state law then defines the nature of the debtor's property interest. *See* Flores v. Yarnall (*In re* Flores), Nos. NV-09-1263-DJuP, 08-21047-MKN, 2010 WL 6259989, at *7 (B.A.P. 9th Cir. Apr. 6, 2010) (interpreting the Ninth Circuit's holding in *Sierra Switchboard Co. v. Westinghouse Electric Corp.*, 789 F.2d 705 (9th Cir. 1986)).

222. Although Congress has the constitutional authority to create and determine property interests in bankruptcy, by and large commercial law has remained primarily the province of the states. *See generally* A. Brooke Overby, *Our New Commercial Law Federalism*, 76 TEMP. L. REV. 297 (2003) (examining the historical and present allocation of lawmaking power in commercial areas between the federal and state governments and proposing a new cooperative framework between the two).

223. 440 U.S. at 52–53.

224. *See* James N. Duca & Cori Ann C. Yokota*, The Role of* Res Judicata *in Bankruptcy Claim Allowance Proceedings*, 17 U. HAW. L. REV. 1, 10 (1995) (observing that both before and after enactment of the 1978 Act, the Supreme Court's decision in *Vanston Bondholders Protective Committee v. Green*, 329 U.S. 156 (1946) has been understood as establishing "the principle that the allowance of a claim is strictly a matter of federal law"); *see also* CHARLES JORDAN TABB, LAW OF BANKRUPTCY 762 (3d ed. 2014) (making the

upon the filing of a bankruptcy case, policies that simply do not attain under state law.[225] In no way does *Butner* alter that axiomatic truth. Thus, to conclude that state law would regard a particular investment as a loan (or as an equity contribution) in a given situation is, if not entirely meaningless, certainly not decisive, and by no means does it signal the end of the inquiry. In short, that state law conclusion does not answer the question of *how* this claim should be characterized *in bankruptcy*,[226] save for the fortuitous circumstance when the state law rule for making that determination just happens to coincide with the federal test.[227] But to leave the matter to be decided based on the purely serendipitous rubrics of state law is hardly prudent; it is not mandated by the Supreme Court's opinion in *Butner* and it is certainly no way to run the railroad.[228]

The court in *Dornier Aviation* recognized this need to go beyond § 502(b), noting that "even if a claimant is able to meet § 502's minimal threshold for allowance of the claim, the bankruptcy court still must look beyond the form of the transaction to determine the claim's proper [provenance]."[229] In doing so, the *Dornier Aviation* court understood

same point in the context of the consequences of surrender of property subject to § 1325(a)(5), the so-called "hanging paragraph" at the end of § 1325(a)).

225. As stated in *In re American Reserve Corp.*:

> The principal function of bankruptcy law is to determine and implement in a single collective proceeding the entitlements of all concerned. . . . When there is not enough to go around, the bankruptcy judge must establish priorities and apportion assets among creditors with the same priority, but the starting point is legal entitlements that exist outside of bankruptcy.

840 F.2d 487, 489 (7th Cir. 1988) (citing *Butner*, 440 U.S. 48; Bos. & Me. Corp. v. Chi. Pac. Corp., 785 F.2d 562, 565 (7th Cir. 1986)). As just one of many examples, § 502(b)(6) places a cap on an allowable claim for future rents because of the risk that otherwise such a claim might overwhelm the case, thereby treating other creditors unfairly and inhibiting the prospects of a successful reorganization. *See In re* Kmart Corp., 362 B.R. 361, 384 (Bankr. N.D. Ill. 2007), *aff'd*, Philip Morris Capital Corp. v. Kmart Corp., No. 07 C 1926, 2007 WL 3171316 (N.D. Ill. Oct. 24, 2007).

226. *See* Litovitz, *supra* note 176, at 315–16 (noting that the *Lothian Oil* court's reliance on *Butner* was inapposite and introduced several unnecessary problems into the analysis). *See generally* Juliet M. Moringiello, *(Mis)use of State Law in Bankruptcy: The Hanging Paragraph Story*, 2012 WIS. L. REV. 963, 987–88 (pointing out as well that, implicitly, the Court held that state law generally controlled property rights upon entry into bankruptcy, but not necessarily what happened to them in bankruptcy or how they looked upon exit). Professor Moringiello expands on the overly-broad interpretation that *Butner* has received in the case law. *See generally* Juliet M. Moringiello, *When Does Some Federal Interest Require a Different Result?: An Essay on the Use and Misuse of* Butner v. United States, 2015 U. ILL. L. REV. 657.

227. *See supra* note 120 and accompanying text.

228. *See infra* text accompanying note 250 (concerning why reliance on state law to resolve the characterization question in bankruptcy is capricious).

229. Fairchild Dornier GMBH v. Official Comm. of Unsecured Creditors (*In re* Dornier

what the *Lothian Oil* and *Fitness Holdings* courts overlooked, namely, that when the issue involves the underlying character of the investment, § 502(b) alone is inadequate to do the job.[230] That is, without the aid of § 105(a) (or other authority) to permit the court to ascertain the true nature of the investment, a putative claim might survive the allowance process despite its inherent equity character.[231] The *Dornier Aviation* opinion went on to explain that "[d]isallowance of a claim under § 502(b) is only appropriate when the claimant has *no* rights vis-à-vis the bankrupt, *i.e.*, when there is 'no basis in fact or law' for *any* recovery from the debtor."[232] Recharacterization, by contrast, occurs only "when the claimant has *some* rights vis-à-vis the bankrupt."[233] With this, the court seemed to be implying that allowance or disallowance is relegated to real claims, while the question in the recharacterization context is unearthing the intrinsic substance of the investment, once established, to be valid on its face. Thus, the court

Aviation (N. Am.), Inc.), 453 F.3d 225, 232 (4th Cir. 2006). Concededly, the court in *Dornier Aviation* also distinguished § 510(c) from recharacterization, *id.*, a differentiation that I try to harmonize. *See infra* Part IV.B.

230. Litovitz, *supra* note 176, at 320–21 (pointing out that several circuits are in agreement that the requirements for allowability and the degree of scrutiny under § 502(b) are low).

231. *Dornier Aviation*, 453 F.3d at 231–32 (providing that the allowance inquiry only directs the bankruptcy court to ascertain whether there is a basis for payment *of any kind* from the estate to the claimant). Earlier, a panel of the Sixth Circuit, in an unpublished opinion, appeared to take a contrary view. *See* Official Comm. of Unsecured Creditors of Russell Cave Co. v. Gen. Elec. Capital Corp. (*In re* Russell Cave Co.), 107 F. App'x 449 (6th Cir. 2004). In that decision, the court cryptically stated that "[a] recharacterization claim and objecting to a claim's allowance are one-in-the[-]same." *Id.* at 451. However, the decision was unusual as the reorganization plan, which had been proposed by the debtor and the plaintiff, called for all "claims objections" to be filed within 120 days of the confirmation date. *Id.* at 450. The plaintiff's complaint seeking recharacterization was filed after the claims objections deadline. *Id.* The bankruptcy court determined that it fell under the broad definition of "claim objections" in the plan and, thus, dismissed it as time-barred. *Id.* It was this decision that was on appeal. *Id.* It also bears noting that the circuit court's decision cited *AutoStyle*. *Id.* at 450–51 (citing Bayer Corp. v. MascoTech, Inc. (*In re* AutoStyle Plastics, Inc.), 269 F.3d 726, 748–49 (6th Cir. 2001)). For these reasons, it appears that the decision can be treated as *sui generis* and not really relevant to the general question of whether recharacterization more closely aligns with disallowance or subordination.

232. 453 F.3d at 232 (quoting Diasonics, Inc. v. Ingalls, 121 B.R. 626, 631 (Bankr. N.D. Fla. 1990)).

233. *Id.*; *see also* Cohen v. KB Mezzanine Fund II, LP (*In re* SubMicron Sys. Corp.), 432 F.3d 448, 454 (3d Cir. 2006) (providing that the bankruptcy courts' ability to recharacterize purported debt as equity, just like its ability to equitably subordinate debt, is "grounded in [its] equitable authority to ensure 'that substance will not give way to form, [and] that technical considerations will not prevent substantial justice from being done'" (footnote omitted) (quoting Pepper v. Litton, 308 U.S. 295, 305 (1939))).

correctly concluded that the recharacterization analysis is separate from the allowance process and takes place only after the claim is deemed allowed.[234] The point being that if the essential character of the investment is verified during the claims allowance process under state law, there is simply no next step, as the issues of "allowance" and "character" are conflated into a single inquiry, and one that likely eclipses the factors most relevant to uncovering the inherent nature of the claimant's interest in the case. This largely defeats the purpose for testing the character of a claim in the first place, which is to ascertain its true nature in light of the goals of a federal debt collection procedure.

To expand on the last point, the consequence of concluding that there is a defense to payment of a claim under § 502(d) is that the claim is *disallowed*, meaning it will not participate in the bankruptcy case. But that is the wrong conceptual analogy for capturing recharacterization situations since the focus in the claims allowance process is on validity or invalidity, and not priority. A determination that a purported debt is really an equity contribution may eliminate the "claim" in the § 101(5) "right to payment" sense of the word, but it does not result in the claim being eliminated as a cognizable interest in the case. To the contrary, it remains a valid and enforceable economic right in the debtor entity, even if its value has been diminished through recharacterization.[235] In other words, what has transpired is that the investment, though not invalid, has been *subordinated*, but not *disallowed*. This is why, if § 105(a) cannot provide the authority to permit debt recharacterization, § 510(c) is a much more compatible new home.[236] And it is more than a matter of semantics, as the metaphoric entailments of referring to the reclassification of a claim as subordination rather than disallowance are different. Put another way, because of the prowess of metaphor, and its impact on our cognitive

234. *Dornier Aviation*, 453 F.3d at 232–33.

235. The Supreme Court made something of the same point in relation to the distinction between a nonprovable claim under the 1898 Act and disallowance. Lesser v. Gray, 236 U.S. 70, 74 (1915) ("A bankruptcy court in which an estate is being administered has full power to inquire into the validity of any alleged debt or obligation of the bankrupt upon which a demand or claim against the estate is based. This is essential to the performance of the duties imposed upon it. When an alleged debt or obligation is ascertained to be invalid—without lawful existence—the claim based thereon is necessarily disallowed. A disallowed claim and a nonprovable debt are not identical things; and a failure accurately to observe the distinction has led to confusion in argument.").

236. *See infra* Parts IV.B–C.

reasoning processes,[237] using the most accurate metaphoric concept to describe a phenomenon is much more likely to produce coherence in the law and avoid undesirable and untoward results.[238]

From a policy perspective, some commentators have heralded the decisions in *Lothian Oil* and *Fitness Holdings* for resolving the characterization question under state law principles rather than under a federal framework. One such commentator urged that reliance on state law will yield more "consistent, predictable results" and minimize the risk that a bankruptcy court will infringe on substantive state policy.[239] Similarly, in another apologia for use of state law, the authors contend that "[t]he 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."[240] These views implicitly endorse and are congruent with the purely proceduralist view of bankruptcy law,[241] which would place the bankruptcy courts in much the same position insofar as any readjustment of rights is concerned as a federal district court deciding a case under its diversity jurisdiction.[242]

237. This point has most compellingly been made in the pioneering work of Lakoff and Johnson on experiential realism. *See generally* GEORGE LAKOFF & MARK JOHNSON, METAPHORS WE LIVE BY (1980); Mark L. Johnson, *Mind, Metaphor, Law*, 58 MERCER L. REV. 845 (2007).

238. *See* Carlson, *supra* note 142, at 162 (commenting that injustice is sometimes the result when courts "enslave" themselves to the wrong metaphor). For present purposes, the point is to protect the distributional hierarchy in § 726 of the Code, which, in subsection (a)(6), places equity in the "last" position in the sense that all unsecured debt must be satisfied before equity interest holders receive anything. While the last position will often be left taking nothing, it is not because the interest lacks validity, but rather simply because of insufficient wherewithal to satisfy prior claims. That scenario is the nature of *subordination*, not *disallowance*.

239. *See* Curran, *supra* note 111, at 53 (arguing that, "[u]nlike federal rule approaches that are not rooted in precedent, the state law approach ensures that bankruptcy courts do not overreach the extent of their equitable power by supplementing the Code with other substantive areas of the law").

240. Wilton & Moeller-Sally, *supra* note 30, at 1278. The authors also lament that application of a set of factors developed in tax court cases may be inconsequential or immaterial in a bankruptcy setting. *Id.* at 1263. Of course, just because the list of factors arose in the context of IRS challenges to the tax treatment accorded to an advance does not mean that those factors must be weighted and applied in the same fashion as they might be in a tax case.

241. *See* sources cited *supra* note 8.

242. Slavish adherence to state law enfeebles the policies of fresh start and rehabilitation of the debtor, each of which require that, when necessary, the bankruptcy forum alter state law rights and entitlements in service of adjusting the competing interests and values implicated by the unique considerations accompanying a collectivized debt collection procedure. *See* Vern Countryman, *The Use of State Law in Bankruptcy Cases (Part 1)*, 47 N.Y.U. L. REV. 407, 409 (1972) ("Also in the category of judicial errors,

In addition to a general distaste for that limited outlook on the role of the bankruptcy regime in our commercial economy,[243] I would submit that, in fact, the results derived from application of state law to decide the innate character of an interest will have just the opposite effect that these commentators assert.

In the first place, it is state law that, almost by definition, will produce inconsistent and nonuniform results, as the several states' jurisprudence in relation to the methodology for discriminating between debt claims and equity interests will obviously never be congruent.[244] Second, that law will be much more fulsome and well-developed in some jurisdictions than others, creating uncertainty in the latter cases as to what the applicable standard actually provides and, therefore, increasing the risk of an improper outcome.[245] Third, wholesale deference to state law ignores the often overlooked qualification in *Butner* for circumstances where an important federal interest may warrant a deviation from the state law rule.[246] Under *Lothian Oil* and

in my judgment, are those decisions which treat *Erie Railroad Co. v. Tompkins* as requiring the application of state law in bankruptcy cases." (footnote omitted)).

243. *See* Ponoroff, *supra* note 3 (manuscript at 59) ("A healthy and utile system of bankruptcy embodies a set of distributional norms and outcomes that differ from state law, and that have aggregate social and economic aspirations, such as allowing for survival of a business through reorganization and the discharge of debt, that are alien or forbidden to state law.").

244. Wilton and Moeller-Sally, in their criticism of a federal approach to the determination, point out that the law in Wisconsin, like the law in Massachusetts, is inconsistent with federal debt recharacterization cases. Wilton & Moeller-Sally, *supra* note 30, at 1274. However, it is equally true that the law of Wisconsin is not consistent with the law of Massachusetts. *Id.* As the authors note, Wisconsin law requires initial undercapitalization or inequitable conduct by an insider before insider debt may be recharacterized as an equity contribution. *Id.* Texas, on the other hand, appears to follow the multifactor approach derived from tax cases. *See* Grossman v. Lothian Oil Inc. (*In re* Lothian Oil Inc.), 650 F.3d 539, 544 (5th Cir. 2011). Moreover, some states apply federal debt recharacterization precedent in applying state law. *See, e.g.*, Dealer Servs. Corp. v. Am. Auto Auction, Inc., No. NNHCV095028282S, 2013 WL 2451250, at *12–13 (Conn. Super. Ct. May, 14 2013); *cf.* Curtis Wheaton, Comment, *Clearing a Minefield of Insolvency Law: Toward Debt Recharacterization as a Supplement to the Bankruptcy Code*, 55 SANTA CLARA L. REV. 769, 779 (2015) (opining that whether approaches that ground the question in state law "are viable depends on state law application to bankruptcy, and whether debt recharacterization fits within these areas"). The attenuated connection between state law cases and the bankruptcy issue is also discussed *infra*. *See infra* text accompanying notes 250–56.

245. *See, e.g.*, Stapleton v. Newkey Grp. (*In re* SGK Ventures, LLC), No. 13 B 37603, 2015 WL 7755525, at *20 (Bankr. N.D. Ill. Nov. 30, 2015) (noting that the guidance on this question provided under Illinois law is "sparse"). It has also been pointed out that deference to state law would pose a major issue in some cases in determining which state law to apply. *See* Litovitz, *supra* note 176, at 320.

246. *See supra* note 217.

Fitness Holdings, even a state law rule that, for example, called for complete immunity from reclassification for claims held by noninsiders would have to be respected. Yet, it is precisely that possibility—definition of a property interest in a manner that undermines bankruptcy equality policy—that illustrates why recharacterization is permitted in the first place and why it must be exercised under the bankruptcy courts' equitable authority separate and apart from the determination of the claim's validity under § 502.

The suggestion that application of a federal rule will have a chilling effect on the capital markets and, particularly, on the willingness of insiders to extend credit to keep their troubled firms afloat, also misses the mark.[247] Surely, the development, albeit over a period of time,[248] of a coherent federal standard to be applied in determining when debt is to be recharacterized would be infinitely more preferable to virtually any type of lender than leaving the matter to the vagaries, inconsistencies, and idiosyncrasies of state law. This is particularly true in an environment that, over the past couple of decades, has witnessed an enormous national consolidation in the banking and allied financial

247. *See, e.g.*, Redmond & Gabel, *supra* note 204, at 22 ("Essentially, equitable subordination and recharacterization disincentivize eleventh-hour restoration financing."); Michael R. Tucker, Note, *Debt Recharacterization During an Economic Trough: Trashing Historical Tests to Avoid Discouraging Insider Lending*, 71 OHIO ST. L.J. 187, 213–14 (2010) (urging the scraping of indeterminate tests in connection with insider transactions); *see also* Braas Sys., Inc. v. WMR Partners (*In re* Octagon Roofing), 157 B.R. 852, 858 (N.D. Ill. 1993) (making a similar point about discouraging insider loans when needed the most). What is likely to have an even greater chilling effect, however, and provide even less guidance to lenders, is leaving the resolution of the question to the vagaries and whim of the laws of fifty separate jurisdictions. Moreover, knowing the criteria (under a multifactor approach) that a court will later use to evaluate the character of the advance, a lender can likely acquire some measure of comfort simply by avoiding overreaching.

248. Currently, even among the courts taking a federal approach to the issue, there are two, perhaps three, different standards being employed. *See supra* notes 53, 83, 101–02 and accompanying text. Two as opposed to three because the "intent of the parties' approach" in *SubMicron* is not inconsistent with the multifactor standard. *See, e.g.*, Anderson v. Commonwealth Renewable Energy, Inc. (*In re* Commonwealth Renewable Energy, Inc.), 540 B.R. 173 (Bankr. W.D. Pa. 2015) (representing a decision of a bankruptcy court in the Third Circuit approaching the analysis in much the same way as courts applying the multifactor approach); *see also supra* notes 100, 111. Moreover, the categorical approach of *N & D Properties* has really not gotten much, if any, traction outside of the Eleventh Circuit.

The proposal advanced in this Article for relocating the source of the bankruptcy courts' authority to engage in debt recharacterization ought to hasten the development of a single standard. *See infra* text accompanying notes 341–42. Indeed, it is entirely plausible to imagine that, over time, a more uniform and predictable federal test would emerge.

services industries.[249] Furthermore, tolerating incursions on bankruptcy distribution and priority norms because of fear over disincentivizing corporate insiders from trying to help their financially flagging companies is not only predicated on an unproven and perhaps questionable assumption about insider behavior, but it also has an unpleasant "peace in our time" feel to it.

Even more fundamentally, however, than the above three factors, state law jurisprudence in relation to the issue was not and never will be developed with a view toward the allocational norms that should govern in a collectivized debt collection proceeding.[250] The establishment of those norms is an exercise consigned exclusively to Congress. That is to say, while the question may be framed identically in and out of bankruptcy, i.e., is this investment truly a debt obligation or is it really risk capital, the context in which the question is being asked matters mightily. To divorce that consideration from the process is to invite results that can only serve their intended objectives fortuitously, if at all.

By its very nature, a bankruptcy proceeding involves the adjustment and reconciliation of multiple, and often conflicting, claims in and to a limited pool of assets.[251] The process is a dynamic one that

249. The differences in jurisprudence among the states is less likely to be an issue for inside lenders, but even in those situations, there may still be uncertainty over which state's law applies and, of course, a lack of uniformity from district to district.

250. The distinction between state law and the federal tests was highlighted in *Kaye v. Nath Cos., Inc.* (*In re Duke & King Acquisition Corp.*), wherein the court described Minnesota jurisprudence relating to recharacterization of corporate debt as

> allow[ing] a court, "in the exercise of its equitable powers, [to] set aside a transaction or ignore the form of that transaction, particularly where the parties are in a confidential or fiduciary relationship." The nomenclature used by parties in the original transaction is not controlling; the question is the end-resultant substance [of the transaction] . . . .

508 B.R. 107, 157 (Bankr. D. Minn. 2014) (alteration in original) (citations omitted) (first quoting Schaub v. Kortgard, 372 N.W.2d 427, 430 (Minn. Ct. App. 1985); and then quoting Booth v. Union Fibre Co., 162 N.W. 677, 677 (Minn. 1917)). As might well be expected, Delaware has adopted a test for recharacterization that is much more deferential to the business judgment of the board than the bankruptcy standards. *See, e.g.*, Nelson v. Emerson, C.A., No. 2937-VCS, 2008 WL 1961150, at *9 (Del. Chan. Ct. May 6, 2008).

251. This is the so-called c*ommon pool* problem, a state of affairs that arises when there are simply not enough assets to go around, such that creditors will behave in a manner not in the best interest of the creditor collective. *See* JACKSON, *supra* note 3, at 10–13. There is no disagreement regarding this core function of bankruptcy law. However, Jackson, and his frequent collaborator, Doug Baird, would have it that bankruptcy is nothing more than a federal debt collection system, the *sole object* of which is, or should be, to ameliorate the common pool problem. *See* Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815, 827 (1987); Lawrence Ponoroff & F. Stephen Knippenberg, *The Implied Good Faith Filing*

begins with, but cannot completely nor satisfactorily be controlled by, the ordering of priorities and entitlements established under state law.[252] Unlike the adjudicatory model that defines state debt collection law, there are no defined "winners" and "losers" in a bankruptcy case. Rather, the object of the bankruptcy process is to maximize estate value and apportion that value in a manner consonant with the goals of the system, which are themselves the subject of considerable debate.[253] Inevitably, then, as the agency charged with responsibility to preside over the administration of the estate, the bankruptcy court must retain reasonable discretion to alter the technical, legal priority of claims when necessary to effectuate the purposive objectives of the order, as they may exist from time to time.[254] The Supreme Court recognized this by its approbation of the judicially created doctrine of equitable

Requirement: Sentinel of an Evolving Bankruptcy Policy, 85 NW. U. L. REV. 919, 949–50 (1991) (outlining and critiquing the "Collectivist" position, as Baird and Jackson's view of bankruptcy law has come to be termed, that bankruptcy exists only to respond to the common pool problem); *see also supra* note 8.

252. Ponoroff & Knippenberg, *supra* note 251, at 966–67 ("The pace and complexity of modern commercial life have created enormous pressure for a system in which a broad range of competing concerns and interests can be factored into specific solutions which are unattainable (or attainable only at the cost of unacceptable delay) under applicable non-bankruptcy law and procedure."); *see also* David Gray Carlson, *Philosophy in Bankruptcy*, 85 MICH. L. REV. 1341, 1389 (1987) (declaring that a search for any "deep structure" in the Bankruptcy Code is generally a forlorn endeavor).

253. The disagreement among scholars over the scope of bankruptcy policy was originally framed in the debate between Professors Warren and Baird, in which conflicting policy views were stated as polarities. *See generally* Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775 (1987); Baird, *supra* note 251. A manageable summation and explication of the positions of the debaters can be found in Baird. Baird, *supra* note 8 (identifying, solely for purposes of convenience, the two "camps" as that of "Proceduralist" (Baird) and "Traditionalist" (Warren)). For more contemporary descriptions of the distinction between the positions, see Levitin, *supra* note 9, at 4–5 and Jonathan C. Lipson, *Debt and Democracy: Towards a Constitutional Theory of Bankruptcy*, 83 NOTRE DAME L. REV. 605, 617–21 (2008) (labeling the parties at the antipodal ends of the spectrum as the "proceduralists" and the "statists").

254. "[E]quality is equity, and this is the spirit of the bankrupt law." Cunningham v. Brown, 265 U.S. 1, 13. (1924). A "beguiling slogan," perhaps, 2 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 45.2, at 1287 (1965), but a slogan consistently reflected in bankruptcy law in the form of a central tenet, namely, substantially equal treatment of substantially similar claims, that is to say, equal distribution. *See* DeNatale & Abram, *supra* note 172, at 418–19 ("Although the orchestral functions are marshalling and distribution, the contrapuntal theme is intended to be equality of distribution. [The equity powers of the bankruptcy court should function to ensure] fair . . . results for all . . . interested parties [to the proceeding] where . . . narrow judicial interpretation [of the substantive rules] would yield an inequitable result."); *see also supra* note 2. *See generally* 1 JOHN NORTON POMEROY, A TREATISE ON EQUITY JURISPRUDENCE AS ADMINISTERED IN THE UNITED STATES OF AMERICA §§ 405–08 (4th ed. 1918).

subordination under the 1898 Act,[255] and Congress followed suit when it codified the doctrine in the 1978 Act.[256] *Lothian Oil* and *Fitness Holdings* deprive the courts in those circuits of that discretion in situations where § 510(c) is deemed inapplicable.

B. The Potential Flaw in the Majority Approach

As noted at the onset, the first attempt to use the Supreme Court's decision in *Law*[257] to invalidate the decisions relying on § 105(a) as authority for debt recharacterization failed.[258] The defendant in *In re Alternative Fuels* argued that, as a consequence of the Supreme Court's decision in *Law*, combined with its earlier opinion in *Travelers*,[259] the bankruptcy courts' ability to call upon its § 105(a) powers in support of its competence to recharacterize debt as equity had been abrogated.[260] The line of reasoning continued that, because reclassification of a putative debt as an equity contribution could only occur as part of the claims allowance process under § 502(b), the circuit court's earlier decision in *Hedged-Investments*, along with its application of a federal thirteen-factor test,[261] was no longer valid.[262]

The Tenth Circuit disagreed.[263] As for *Travelers*, the court observed that the holding in the case extended only to the point that claims valid under state law will be allowed in bankruptcy, except where expressly disallowed by the Code.[264] In other words, the holding did not go so far as to preclude a court from taking a "second step" in its analysis to determine whether an otherwise allowed claim fails in bankruptcy

255. *See* sources cited *supra* note 165 and accompanying text.
256. *See supra* note 166 and accompanying text.
257. Law v. Siegel, 134 S. Ct. 1188 (2014).
258. *See supra* text accompanying note 23.
259. Travelers Cas. & Sur. Co. v. Pac. Gas & Elec. Co., 549 U.S. 443 (2007). As discussed earlier, *Travelers* overruled a Ninth Circuit decision that the allowability of post-petition attorneys' fees pursuant to a prepetition contract are not recoverable regardless of whether they would be enforceable under applicable state law. *See supra* Part I.C.1.
260. Redmond v. Jenkins (*In re* Alt. Fuels, Inc.), 789 F.3d 1139, 1146–47 (10th Cir. 2015).
261. Sender v. Bronze Grp., Ltd. (*In re* Hedged-Invs. Assocs., Inc.), 380 F.3d 1292, 1298 (10th Cir. 2004); *see also supra* text accompanying notes 94–96.
262. *Alt. Fuels*, 789 F.3d at 1147–49.
263. *Id.* at 1146.
264. *Id.* at 1149. It is also worth reiterating that the Court qualified its references to the allowability in bankruptcy of claims enforceable under state law with qualifier terms such as "generally" and "usually." *Travelers*, 549 U.S. at 450–51. Thus, while the Court certainly suggested a narrow scope of operation, it did not make the presumption as to the allowability of claims enforceable under state law absolute. *Alt. Fuels*, 789 F.3d at 1149.

because it involves transactions properly characterized as equity.[265] As explained earlier,[266] the fact that local law concludes that a claim exists has nothing to do with whether or not that claim should or will be allowed in a bankruptcy proceeding nor, for that matter, how it will be treated in that case. Those questions are decided under federal law.[267]

In relation to *Law,* the court noted that, unlike the surcharge of a debtor's exemption, an order to recharacterize a claim as an equity contribution does not transgress any specific provision of the Code.[268] Therefore, the court declined the invitation to join the Fifth and Ninth Circuits by conflating debt recharacterization with claim disallowance. Having distinguished both decisions, the court then reaffirmed that its decision in *Hedged-Investments* remained good authority, noting—of some importance for present purposes—that "recharacterization" under § 105(a) is essential to a court's ability to properly implement the priority scheme of the Bankruptcy Code, including priority for true creditors as against equity investors.[269]

While the rationale in *Alternative Fuels* seems sound enough, it takes a somewhat narrow view of the precedential reach of the Supreme Court's respective holdings in *Travelers* and *Law*. As ever, hope beats eternal, but there is of course no assurance that other circuits will follow suit. This is particularly of concern in light of the legislative and judicial trend in recent years to reduce the discretion of bankruptcy judges,[270] an ambition that naturally demands curbing the equitable

265. *See* Fairchild Dornier GMBH v. Official Comm. of Unsecured Creditors (*In re* Dornier Aviation (N. Am.), Inc.), 453 F.3d 225, 232 (4th Cir. 2006); *see also supra* text accompanying notes 97–108.

266. Allowability and characterization are separate questions, but become conflated if the latter exercise can only occur under § 502 rather than pursuant to the equitable authority of the bankruptcy courts. *See supra* notes 226, 233–38 and accompanying text.

267. *See supra* note 224.

268. *Alt. Fuels*, 789 F.3d at 1148.

269. *Id.* at 1146. The court went on to deny relief under both recharacterization and equitable subordination. *Id.* at 1156. In his dissenting opinion, Judge Phillips, also applying *Hedged-Investments* factors, would have affirmed the bankruptcy court's decision to recharacterize the loan at issue as an equity contribution. *Id.* (Phillips, J., dissenting).

270. While the restraints on bankruptcy judges' discretion in personal bankruptcy cases have received considerable attention, the BAPCPA also imposed limitations on bankruptcy judges in business cases. *See supra* note 25. In addition to its ruling in *Law*, the Supreme Court's earlier bombshell decision in *Stern v. Marshall*, 564 U.S. 462, 487 (2011), limiting the courts' jurisdiction to enter final judgments on state law counterclaims that are not resolved entirely through the claims allowance or disallowance process, is further evidence of a decided trend in the body politic to reign in the autonomy of bankruptcy judges as tightly as possible to those powers enumerated in the Code and not beyond. *See* Stapleton v. Newkey Grp. (*In re* SGK Ventures, LLC), No. 13 B 37603,

authority of the bankruptcy courts under § 105(a). Furthermore, although the narrow issue before the Court in *Law* was whether equitable disallowance is prohibited without regard to how perfidious the debtor or how execrable her actions, *Law* may have significant ramifications for other areas of bankruptcy law[271] and, at a minimum, has narrowed considerably the wiggle room that the Court, in *Marrama v. Citizens Bank of Massachusetts*,[272] seemed for a time to have restored to § 105(a).

At the time it was decided, *Marrama* was applauded as restoring some punch to the bankruptcy courts' ability to invoke § 105(a) even in the face of a contrary Code provision.[273] The issue in *Marrama* was whether the debtor had an "absolute" right to convert his Chapter 7 case to a case under Chapter 13, despite his patently fraudulent conduct.[274] The text of § 706(a) seems to confer that right unconditionally. According to the *Marrama* Court, however, the "broad" authority conferred on bankruptcy judges by § 105(a) includes the authority to sanction a debtor's bad-faith litigation abuse by ordering forfeiture of the relief that would otherwise have been available.[275] While the Court in *Law* did not outright reject *Marrama*, and made a feeble effort to distinguish it,[276] it can hardly be gainsaid that it represented a rousing endorsement of the earlier holding. Indeed, it is hard not to see *Law* as a retreat from *Marrama*, and under the principal holding in *Law*—that § 105(a) has no role to play when an express provision of the Code speaks to a matter—it is highly likely

2015 WL 7755525, at *20 (Bankr. N.D. Ill. Nov. 30, 2015) (citing *Law* as evincing the correctness of its earlier prediction that the Seventh Circuit would be unlikely to find that the bankruptcy courts possessed the equitable authority to treat a claim in a manner not stated in the Code); *see also supra* note 68 and accompanying text.

271. *See supra* note 20.

272. 549 U.S. 365 (2007).

273. *See, e.g.*, Jeffrey W. Warren & Shane G. Ramsey, *Revisiting the Inherent Equitable Powers of the Bankruptcy Court: Does* Marrama v. Citizens Bank of Massachusetts *Signal a Return to Equity?*, AM. BANKR. INST. J., Apr. 2007, at 22, 62–63 (hailing the decision as cause for celebration by those concerned about the trend limiting the exercise of discretion by bankruptcy judges). Of course, the celebration turned out to be a short-lived one. *See infra* note 276.

274. *Marrama*, 549 U.S. at 367.

275. *Id.* at 374–75.

276. The opinion in *Law* attempted to reconcile its holding in *Marrama* by drawing a line between substantive rights granted by the Code (which bankruptcy courts may not abridge) and mere "futile procedural niceties" imposed by a literal reading of the Code (which bankruptcy courts have equitable authority to disregard). Law v. Siegel, 134 S. Ct. 1188, 1197 (2014). Thus, the Court was able to opine: "*Marrama* most certainly did not endorse, even in dictum, the view that equitable considerations permit a bankruptcy court to contravene express provisions of the Code." *Id.*

Marrama would come out differently if decided today.

IV. REALIGNING EQUITABLE SUBORDINATION AND RECHARACTERIZATION

The ultimate fate of the bankruptcy courts' prerogatives under § 105(a) are shrouded in doubt in light of *Law*.[277] That fact strengthens the appeal to fold debt recharacterization into the claims allowance process, representing a far less unsettled source of authority, a fact that certainly influenced the Ninth Circuit.[278] However, doing so largely denudes the process of the considerations most relevant to the determination of how a particular investment should be characterized in order to remain faithful to the statutory scheme of priority and distribution in a bankruptcy case.[279] Thus, a better solution is needed to assure that the classification of an allowed claim as debt or equity continues to be governed by a developing uniform federal approach, and, ideally, under the equitable authority of the bankruptcy courts.[280] That solution, I would urge, is to eliminate what is largely an artificial distinction to begin with between equitable subordination and

277. After *Law* it is unclear where courts will draw that line in connection with various non-Code practices in which the bankruptcy courts frequently engage other contexts, such as, on a finding that the action is essential to the success of the reorganization, approving Chapter 11 plans providing for nonconsensual releases of affiliates or insiders of the debtor, or extension of the stay to nondebtor parties. *See supra* note 20. In the former situation, § 524(e) states that the "discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt." 11 U.S.C. § 524(e) (2012). Likewise, § 362 of the Code, by its terms, limits the stay to actions against the debtor or the estate, except in circumstances specifically contemplated by the Code, such as the co-debtor stay in § 1301. *See id.* §§ 362, 1301. With its limited view regarding bankruptcy courts' equitable powers, *Law* calls these decisions (and other analogous exercises of equitable powers in apparent conflict with the Code in other contexts) into question.

278. *See supra* note 134; *see also* Stapleton v. Newkey Grp. (*In re* SGK Ventures, LLC), No. 13 B 37603, 2015 WL 7755525, at *20 (Bankr. N.D. Ill. Nov. 30, 2015) (citing *Law* as casting into serious doubt the authority of the bankruptcy courts to recharacterize a claim under their general equitable authority).

279. *See supra* text accompanying note 234.

280. Although Professor Levitin makes a compelling case for the common law of bankruptcy as involving a uniquely federal interest, Levitin, *supra* note 9, at 71□77, the received wisdom remains that when Congress enacts a "comprehensive legislative scheme," the omission of a remedy is deemed to be intentional. *See* Walker v. Cadle Co. (*In re* Walker), 51 F.3d 562, 567 (5th Cir. 1995) (quoting Nw. Airlines, Inc. v. Transp. Workers Union, 451 U.S. 77, 97 (1981)); *see also* Plank, *supra* note 8, at 639 (rejecting the concept of a federal common law in bankruptcy and suggesting that, when confronted with an issue beyond the scope of the Code, the bankruptcy courts must apply state law). Thus, regardless of one's personal views on the question, it would be imprudent to attempt to locate the authority to recharacterize debt to the inherent power of the courts.

recharacterization[281] by expanding the interpretation of § 510(c) broadly enough to serve as the enabling authority in recharacterization cases. This approach would not only provide a textual justification for exercise of the power, but would also preserve a federal framework over the entirety of the subject.[282] Is it, however, a tenable interpretation and application of the doctrine of equitable subordination?[283]

I would submit that it is, notwithstanding that the bias, at least until recently,[284] has been to limit application of the doctrine of equitable subordination generally, and particularly so in the case of noninsiders.[285] That bias, however, is not only inconsistent with the broad grant of discretion that Congress saw fit to confer on the bankruptcy courts in 1978 when it codified the doctrine,[286] but has been harmful as well to the overall integrity of a utile system of bankruptcy.[287] In effect, the doctrine of equitable subordination has in a sense itself been "subordinated" in the service of, among other vague ideologically-oriented philosophies, federalism and judicial restraint. Therefore, it is time to take a fresh perspective on the issue, and, in particular, appreciate the very different contextual circumstances in which equitable subordination has been employed in the past,[288] and may appropriately be applied under the Code.

Because equity contributions can be dressed up in loan clothing both innocently as well as with improper intent, and the harm to other creditors is identical in both situations, employing equitable subordination to afford relief when the true nature of an advance to the debtor is mischaracterized as a loan requires that we recognize an additional exception to the first prong of the *Mobile Steel*

281. *See supra* note 177.

282. For a useful, but ahistorical discussion of why § 510(c) cannot be used as the basis for debt recharacterization, see generally Nozemack, *supra* note 73. An alternative approach to the one proposed here is a legislative solution. *See generally* Wheaton, *supra* note 244. This would certainly do the job, but is probably highly unrealistic in the recent and prevailing political climate surrounding bankruptcy. *See supra* notes 15, 273; *infra* note 363.

283. *See, e.g.*, Fairchild Dornier GMBH v. Official Comm. of Unsecured Creditors (*In re* Dornier Aviation (N. Am.), Inc.), 453 F.3d 225, 232–33 (4th Cir. 2006) (articulating the contemporary view that recharacterization requires a different inquiry and serves a different function than equitable subordination).

284. *See supra* note 177; *infra* note 313 and accompanying text.

285. *See supra* note 63; *infra* note 349.

286. *See supra* note 167.

287. This is so, bearing in mind that a utile bankruptcy system harbors policy objectives distinct from state law. *See supra* note 225 and accompanying text.

288. *See supra* note 172.

formulation[289]—that is, expand modestly the circumstances under which the requirement of insisting upon a finding of inequitable conduct will be relaxed. In addition, while insider status certainly can and does factor into a recharacterization analysis,[290] it is neither a necessary factor nor necessarily a dominant one. Therefore, bringing the analysis under § 510(c) would also mean, when the question involves the intrinsic character of a claim, softening the distinction in the quantum of proof courts often employ in reviewing insider versus noninsider transactions.

A. No-Fault Subordination

The concept of equitable subordination in the absence of inequitable conduct (so-called no-fault equitable subordination) is not without precedent, although it has yet to be universally embraced.[291] Having not been expressly condoned or rejected by either Congress or the Supreme Court, it thus represents an unsettled area of law. The argument that Congress did not intend for § 510(c) to be applied to a claim unless the facts demonstrate some form of misconduct is based on the legislative history of the 1978 Act.[292] It stems from language in the Floor Managers' Statement to the effect that "it is intended that . . . 'principles of equitable subordination' follow existing case law"[293] and a belief that all of the 1898 Act cases involving equitable subordination included a finding of creditor misconduct.[294] Even to the extent, however, that this description of case law under the former Act is accurate,[295] it ignores the remainder of the Floor Managers' Statement,

289. *See supra* text accompanying note 179 (explaining the *Mobile Steel* formulation). The reference here is to an *additional* exception because certain exceptions are already recognized in at least some jurisdictions. *See infra* Part IV.A.

290. *See infra* text accompanying notes 353–61.

291. *See generally* Solow, *supra* note 192. But see *In re Lifschultz Fast Freight*, 132 F.3d 339, 348 (7th Cir. 1997) and *Montgomery Ward Holding Corp. v. Schoeberl* (*In re Montgomery Ward Holding Corp.*), 272 B.R. 836, 845 (Bankr. D. Del. 2001), both of which suggest that, despite the general rule requiring inequitable conduct in most cases, equitable subordination may exist even in the absence of misconduct by the creditor whose claim is under scrutiny.

292. *See supra* notes 167–68 and accompanying text.

293. 124 CONG. REC. 32,398 (1978) (statement of Rep. Edwards).

294. *See* Pardo, *supra* note 167, at 1507 (arguing that at the time the Code was adopted, a claim for equitable subordination required proof of inequitable conduct, and, "[o]n this evidence alone, it seems that the intent of Congress was to allow equitable subordination only in cases involving creditor misconduct").

295. It is the case that misconduct was present in each of the trilogy of Supreme Court cases, *see supra* note 165, generally regarding the establishing (or approving of) the doctrine of equitable subordination under the 1898 Act. However, several months prior to

providing that—as part of the compromise between the House and Senate versions of the bill—Congress resolved to leave the development of "principles of equitable subordination" to the courts, which can mean only to evolve in the usual common law fashion.[296] In other words, what Congress said in 1978 was that § 510(c) codifies the doctrine as it presently exists, and, as a judicially created doctrine to begin with, its ultimate contours and boundaries would unfold over time in the evolving decisional law. Moreover, the language in the Floor Managers' Statement indicating that, "a claim is generally subordinated if the holder of such claim is guilty of inequitable conduct" is prefaced by the phrase "[t]o date."[297] This, too, is a clear indication that Congress did not intend to forever freeze the scope of equitable subordination to its historical confines.

As far as the Supreme Court is concerned, as observed earlier,[298] its rejection in *Noland*[299] and *Reorganized CF & I*[300] of automatic or categorical subordination based purely on the intrinsic nature of the claim did *not* encompass a rejection of no-fault equitable

the passage of the 1978 Act, the Second Circuit rendered its decision in *Jezarian v. Raichle* (*In re Stirling Homex Corp.*), in which the court ordered subordination of claims by defrauded shareholders who had not been found to have engaged in any misconduct. 579 F.2d 206, 209–10 (2d Cir. 1978). In *In re Virtual Network Servs. Corp.*, the court expressed the view that the principal managers of the bill were likely aware of the decision and also expressed the belief that subordination would be warranted under the language of what would become § 510(c)(1) of the Code. 902 F.2d 1246, 1249 (7th Cir. 1990). *But see* Pardo, *supra* note 167, at 1501–02 (taking the position that reliance on *Stirling* as authority for a no-fault theory of equitable subordination is misplaced).

296. 124 CONG. REC. 32,398 (1978) (statement of Rep. Edwards); *see also* Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351, 1356 (7th Cir. 1990) ("Absence of statutory criteria commits the subject to the courts, to be worked out in the common law fashion." (citing *Virtual Network*, 902 F.2d at 1248–49)); Newman v. Tyberg (*In re* Steel Wheels Transp., LLC), Nos. 06-15377 DHS, 06-15378 DHS, 2011 WL 5900958, at *6 (Bankr. D.N.J. Oct. 28, 2011) ("Section 510(c) does not codify the elements of an equitable subordination claim. Rather, it directs the Court to apply judicially developed principles of equitable subordination to the equities at hand." (citing Citicorp Venture Capital, Ltd. v. Comm. of Creditors Holding Unsecured Claims, 323 F.3d 228, 234 (3d Cir. 2003))).

297. 124 CONG. REC. 32,398 (1978) (statement of Rep. Edwards).

298. *See supra* text accompanying notes 192–96.

299. United States v. Noland, 517 U.S. 535 (1996). In *Noland*, the postpetition tax claim was entitled to a statutory priority. *Id.* at 543.

300. United States v. Reorganized CF & I Fabricators of Utah, Inc., 518 U.S. 213 (1996). In *Reorganized CF & I*, the Court extended the holding of *Noland* in that the nonpecuniary tax claim arose prepetition and was nonpriority. *Id.* at 229. Specifically, the Court held that the principle of *Noland* had nothing to do with transfer between classes, as distinct from ranking within a single class. *Id.* Rather, the principle was that a categorical reordering of priorities was beyond the scope of judicial authority under § 510(c), making the subordination in this equally objectionable as in *Noland*. *Id.*

subordination,[301] which had formed part of the rationale in the lower courts.[302] The Supreme Court in those decisions made crystal clear that the bankruptcy courts may not adjust the priority of claims "merely because the court perceives that the result is inequitable,"[303] but it stopped short of holding that inequitable conduct is *required* for subordination under § 510(c). Hence, the Supreme Court's opinions cannot be read as rejecting the reasoning of the courts of appeals that have, without requiring proof of misconduct, permitted subordination of nonpecuniary tax loss (the type of claims involved in *Noland* and *Reorganized CF & I*) and certain other categories of claims based on a totality of the circumstances analysis.[304]

In *In re Virtual Network Services Corp.*, for example, the Seventh Circuit affirmed the subordination of the IRS's prepetition tax penalty claim since, the court observed, allowing the claim to share ratably with the debtor's other unsecured creditors would not punish the debtor, as intended, but rather would unfairly dilute the claims of unsecured creditors.[305] That is to say, while the government's claim technically enjoyed the same legal priority as other unsecured debt claims, it would

301. *See Noland*, 517 U.S. at 543 ("Given our conclusion that the Sixth Circuit's rationale was inappropriately categorical in nature, we need not decide today whether a bankruptcy court must always find creditor misconduct before a claim may be equitably subordinated.").

302. At the court of appeals level in both *Noland* and *Reorganized CF & I*, the courts, like other circuits to address the issue, *see infra* note 306, did state that, even in the situation involving tax penalties, the bankruptcy court must determine if subordination is appropriate based on the equities in the case. *See* United States v. Noland (*In re* First Truck Lines, Inc.), 48 F.3d 210, 218 (6th Cir. 1995), *rev'd*, 517 U.S. 535; United States v. Reorganized CF & I Fabricators of Utah, Inc. (*In re* CF & I Fabricators of Utah, Inc.), 53 F.3d 1155, 1159 (10th Cir. 1995), *vacated*, 518 U.S. 213. The Supreme Court's opinions reversing them nonetheless regarded the courts' rationales as inappropriately categorical in nature, given the lower courts' reliance on language in the Floor Managers' Statement, *see supra* note 166, to the effect that

> under existing law, a claim is generally subordinated only if [the] holder of such claim is guilty of inequitable conduct, or the claim itself is of a status susceptible to subordination, such as a penalty or a claim for damages arising from the purchase or sale of a security of the debtor.

124 CONG. REC. 32,398 (1978) (statement of Rep. Edwards). This, apparently, implied to the Court that it was more the source of the claim that accounted for subordination below rather than the overall fairness or equities of the situation.

303. *Noland*, 517 U.S. at 539 (quoting DeNatale & Abram, *supra* note 172, at 428); *accord Reorganized CF & I*, 518 U.S. 213.

304. *See infra* text accompanying notes 306, 308–311.

305. 902 F.2d 1246, 1250 (7th Cir. 1990). The court also pointed out the absence of conflict with the statutory scheme of priority and distribution set forth in § 726(a) since the perambulatory language in that provision states "[e]xcept as provided in section 510." *Id.* at 1249 (alteration in original) (quoting 11 U.S.C. § 726(a)).

have been inequitable to permit a nonpecuniary claim to share *pari passu* with creditors whose claims arose as a result of an actual parting with value. That argument in support of subordination is still compelling and, because the court in *Virtual Network* also stated that the bankruptcy courts must weigh the equities in each case before determining if subordination is warranted,[306] the decision has *not* been superseded by the Supreme Court's rulings in either *Noland* or *Reorganized CF & I*.[307]

In addition to tax penalty and other kinds of nonpecuniary claims,[308] the other category of cases where courts have applied § 510(c)

306. *Id.* at 1250; *see also* Schultz Broadway Inn v. United States, 912 F.2d 230, 232–34 (8th Cir. 1990) (holding that creditor misconduct is not a prerequisite to equitable subordination, but subordination must be considered on a case-by-case basis); Burden v. United States (*In re* Burden), 917 F.2d 115, 120 (3d Cir. 1990) (following *Virtual Network* in holding that "the district court must weigh the equities 'on a case-by-case basis without requiring in every instance inequitable conduct on the part of the creditor claiming parity among other unsecured general creditors.'" (quoting *Virtual Network*, 902 F.2d at 1250)). These decisions pointed as well to the reference in the Floor Managers' Statement, *see supra* note 166, about subordination being warranted in the case of misconduct or the status of the claim as a *penalty*. *See Schultz Broadway*, 912 F.2d at 232; *Burden*, 917 F.2d at 123. Similar to the opinion in *Virtual Network*, they also rejected the government's argument that the inclusion of a specific subordination provision for such claims in Chapter 7 (§ 726(a)(4)) implied an intention of Congress that subordination of such claims was impermissible in cases under other chapters of the Code. *Schultz Broadway*, 912 F.2d at 233; *Burden*, 917 F.2d at 118. *But see supra* note 291. In addition, in *In re Kreisler*, the Seventh Circuit cited *Mobile Steel*'s three-prong test approvingly, with no mention of *Virtual Network*. *In re Kreisler*, 546 F.3d 863, 866 (7th Cir. 2008) (quoting *Noland*, 517 U.S. at 538–39); *see also* Grede v. Bank of N.Y. Mellon Corp. (*In re* Sentinel Mgmt. Grp., Inc.), 809 F.3d 958, 965 (7th Cir. 2016) (mentioning the necessity for inequitable conduct without referring to *Virtual Network*); *In re* Lifschultz Fast Freight, 132 F.3d 339, 348 (7th Cir. 1997) (suggesting that *Virtual Network* represented an exception that should not be mistaken "for the death of [the] rule"); Pardo, *supra* note 167, at 1505–09 (debunking the courts' reliance on the Floor Managers' Statement).

307. *See supra* text accompanying notes 191–195, 298 and accompanying text. As in *Lifschultz*, 132 F.3d at 347–49, it has, however, been suggested that no-fault subordination has been and is limited to certain categories of cases. *See* NTP Marble, Inc. v. Papadopoulos (*In re* NTP Marble, Inc.), 491 B.R. 208, 214 (Bankr. E.D. Pa. 2013) (observing that most courts that have considered "no-fault" equitable subordination claims have waived the misconduct requirement in a limited set of cases, including those involving tax penalties, stock redemption claims, and punitive damages claims). This statement may not be entirely accurate in relation to the application of equitable subordination under the 1898 Act. *See supra* note 177. In addition, just because, empirically, the no-fault cases that have arisen thus far fall into one of those categories does not mean they are exclusive, unless one is able to posit a principled distinction between those three situations and every other situation.

308. *See, e.g.*, *In re* Friedman's, Inc., 356 B.R. 766, 776–79 (Bankr. S.D. Ga. 2006) (allowing subordination without a showing of misconduct but distinguishing between class claims seeking recovery of statutory penalties and claims seeking statutory minimum damages). *But see* Durango Ga. Paper Co. v. Pension Benefit Guar. Corp. (*In re*

without an explicit finding of misconduct is in connection with promissory notes given in connection with a stock redemption.[309] The reasoning of course is that the right to payment represented by the promissory note is simply a payout of the balance of the value of the payee's equity investment in the debtor and, as such, not a true debt, or at least different in kind from traditional third-party debt.

For instance, in *In re Merrimac Paper Co.*, the First Circuit initially held that claims arising out of stock redemption transactions could not be subordinated based solely on their intrinsic nature, as the bankruptcy court had done.[310] The court conceded, however, that such claims are suspect and might be subject to equitable subordination based on the *totality of the circumstances* in an individual case.[311] Of course, when a court subordinates a debt arising out of a stock repurchase transaction based on the totality of the circumstances, the operation comes remarkably close to the exercise in which the courts engage in the recharacterization cases, i.e., a putative debt claim is assigned the same priority as an equity interest. Indeed, the line between the two doctrines is blurred because, until *Noland* and *Reorganized CF & I*, the distinction between the two doctrines in the bankruptcy context was largely nonexistent and the remedies applied more or less interchangeably.[312] Moreover, this was true even when no misconduct was involved. It was only when, because of the uncertainty over the reach of the Supreme Court's holdings in those two cases, bankruptcy lawyers began to plead their allegations seeking subordination of an alleged misclassified investment based upon an

Durango Ga. Paper Co.), 539 B.R. 896, 902 (Bankr. S.D. Ga. 2015) (declining to extend *Friedman*'s to compensatory, actual loss claims).

309. See authorities cited in Pardo, *supra* note 167, at 1493 n.15 and also in Solow, *supra* note 192, at 12–13.

310. Merrimac Paper Co. v. Harrison (*In* re Merrimac Paper Co.), 420 F.3d 53, 60–62 (1st Cir. 2005) (rejecting lower court authorities that endorsed categorical subordination based on the Supreme Court's rulings in *Noland* and *Reorganized CF & I*).

311. *Id.* at 62–63 (qualifying earlier lower court precedent providing for automatic subordination of claims emanating from stock redemption agreements, but acknowledging that "the core principle of these decisions—that equity holders should not be able artificially to evade the debt-over-equity paradigm—is generally sound"). Because the lowers courts in *Merrimac* had followed that earlier precedent, summary judgment on the debtor's complaint for subordination of the appellant's claim was reversed and remanded to the bankruptcy court with instructions to reconsider the claim in light of the court's holding. *Id.* at 65; *see also* SPC Plastics Corp. v. Griffith (*In re* Structurlite Plastics Corp.), 224 B.R. 27, 35–36 (B.A.P. 6th Cir. 2007) (commenting that equitable subordination is not restricted to cases entailing creditor misconduct, and, in connection with a claim arising out of an agreement for former shareholders' equity interest, the court must give effect to the substance of the transaction as opposed to its form in the interest of fairness).

312. *See supra* note 177; *infra* text accompanying notes 339, 378.

independent theory that debt recharacterization emerged as a separate cause of action distinct from a claim for equitable subordination.[313] At the same time, a rationale developed in the case law that articulated a conceptual distinction between the two doctrines,[314] which, though real enough, is a distinction more of degree than kind.[315]

Finally, as discussed earlier,[316] utilizing the totality of the circumstances approach, the bankruptcy court in *In re Yellowstone Mountain Club* subordinated the claims of a noninsider without requiring an affirmative showing of intentional misconduct.[317] While *Yellowstone Mountain* might yet be reconciled with the view that insists upon "inequitable conduct" as an element of the cause of action,[318] its

313. This explains why recharacterization is primarily a twenty-first century phenomenon. *See supra* text accompanying note 33. This also is part of the explanation as to why, almost invariably, a proceeding in which recharacterization is sought by the plaintiff is accompanied by an alternative claim for equitable subordination. By way of illustration, of all of the circuit court cases discussed *supra* Part I, the only two that rejected § 105(a) as the source of the authority to recharacterize claims in bankruptcy proceedings did not also involve a claim for equitable subordination. *See* Official Comm. of Unsecured Creditors v. Hancock Park Capital II, L.P. (*In re* Fitness Holdings Int'l, Inc.), 714 F.3d 1141, 1147–48 (9th Cir. 2013); Grossman v. Lothian Oil Inc. (*In re* Lothian Oil Inc.), 650 F.3d 539, 543 (5th Cir. 2011). Moreover, the absence of the § 510(c) claim in *Fitness Holdings* can be attributed to the procedural posture in which recharacterization became an issue—namely, in order to resolve a complaint seeking to recover an alleged fraudulent transfer. *See supra* Part I.D.1. In *Lothian Oil*, the debtors challenged the claimants' "undetermined claims" under a liquidating Chapter 11 plan. 650 F.3d at 542. The appeal to the Fifth Circuit was due to the district court's holding that, as a matter of law, bankruptcy courts could only recharacterize the claims of corporate insiders. *Id.* However, the opinion indicated that the district court affirmed the bankruptcy court's dismissal of the defendants' claims on all but the recharacterization issue, without identifying what those other grounds were supporting the bankruptcy court's ruling in favor of the debtors. *Id.*

314. *See, e.g.*, Nozemack, *supra* note 73, at 705–12; *see supra* text accompanying notes 75–79, 95.

315. *See infra* Part IV.C.3.

316. *See supra* notes 207–211 and accompanying text.

317. Credit Suisse v. Official Comm. of Unsecured Creditors (*In re* Yellowstone Mountain Club, LLC), No. 08-61570-11, 2009 WL 3094930, at *1, *10 (Bankr. D. Mont. May 12, 2009), *vacated*, No. 08-61570-11-RBK, 2009 WL 10624435 (Bankr. D. Mont. June 29, 2009). Frankly, it is unclear whether *Yellowstone* should be read as sanctioning reckless lending practices as tantamount to inequitable conduct (i.e., expanding the definition beyond the traditional three categories), *see supra* note 179, or whether it is best seen as representing another exception to the requirement of inequitable conduct. *See* F. Stephen Knippenberg, *Re-Purposing Dram Shop Law to Subordinate the Claims of Reckless Bartenders of Credit Drunks: In Bankruptcy, This One Should Be on the House*, 52 U. LOUISVILLE L. REV. 39, 59 (2013) (suggesting that *Yellowstone* might be seen as describing the parameters of a new, fourth category of inequitable conduct).

318. 2009 WL 3094930, at *9 (describing the only plausible explanation for Credit Suisse's actions as driven by the fees it would extract from the loans, and referring to its

approach nonetheless strongly hints at the possibility of determining the existence of grounds for subordination without a finding of the presence, or absence, of any single element.[319] The point to be made is that no-fault equitable subordination remains a viable option under § 510(c), even if its reception in the decisional law to date has been uneven at best.[320]

B. Recharacterization as a Category of No-Fault Subordination

It is generally understood that equitable subordination is remedial in nature, not penal.[321] This has accounted for the general requirement that the "inequitable conduct" complained of be shown to have caused demonstrable harm to unsecured creditors.[322] An insistence of this

behavior as motivated by naked greed); *see also* Beckett, *supra* note 208, at 88 (observing that Credit Suisse's behavior was not consistent with the ordinary practices of any other arranger of a syndicated loan); *cf. In re* Aida's Paradise, LLC, 485 B.R. 806, 814 (Bankr. M.D. Fla. 2013) (holding that the debtor's allegations, if proven, would support a claim for equitable subordination against a noninsider since "even where all acts are technically or legally permissible, a lender must be careful not to become overly involved in a debtor's affairs").

319. This is consistent with a view that the three-pronged *Mobile Steel* test falls short of representing a statement of the essential elements of a claim for equitable subordination in all cases. *See* Anderson v. Bajaj (*In re* Med. Mgmt. Grp., LLC), 534 B.R. 646, 656 (Bankr. D.S.C. 2015) (showing that "[c]ourts have subordinated . . . [based on] a variety of transgressions" and do not require that the conduct be sufficient to support a standalone complaint). This, too, implies that any effort to reduce *equitable* subordination to a formulaic test, à la *Mobile Steel*, would necessarily be under-inclusive.

320. *See* NTP Marble, Inc. v. Papadopoulos (*In re* NTP Marble, Inc.), 491 B.R. 208, 213–14 (Bankr. E.D. Pa. 2013) (noting that no-fault equitable subordination is recognized in the Third Circuit); Newman v. Tyberg (*In re* Steel Wheels Transp., LLC), Nos. 06-15377 DHS, 06-15378 DHS, 2011 WL 5900958, at *6 (Bankr. D.N.J. Oct. 28, 2011) (same); *see also supra* notes 306–312.

321. *See, e.g.*, Walnut Creek Mining Co. v. Cascade Inv., LLC (*In re* Optim Energy, LLC), 527 B.R. 169, 175 (Bankr. D. Del. 2015); *see also supra* note 170.

322. Wooley v. Faulkner (*In re* SI Restructuring, Inc.), 532 F.3d 355, 362 (5th Cir. 2008). Of course, the *Mobile Steel* formulation, *supra* text accompanying note 179, also refers to the misconduct conferring an unfair advantage on the claimant *as well as* harm to other creditors. Further, in rejecting the argument that creditors who were *not* paid from the proceeds invested by the insiders, the court cited *Universal Farming Industries*. *SI Restructuring*, 532 F.3d at 362 (citing Spacek v. Thomen (*In re* Universal Farming Indus.), 873 F.2d 1334, 1335, 1337 (9th Cir. 1989)). Notably, however, the actual language in that decision stated that because the plaintiff was unable to show any legally cognizable harm to him or any other creditor, *or any unfair advantage* accruing to the defendant as a result of the conduct being challenged, the bankruptcy court did not abuse its discretion in determining that equitable subordination was not available. *Universal Farming*, 873 F.2d at 1337. In point of fact, the court in *SI Restructuring* referred to unfair advantage, but erroneously included it as part of the first rather than the second prong of *Mobile Steel*. *SI Restructuring*, 532 F.3d at 361 ("[W]e assume, without deciding,

requirement is of course what led the Fifth Circuit in *SI Restructuring* to overturn the lower courts' decisions to subordinate loans made by two officers of the debtor, who were also its largest shareholders.[323] At first blush this might seem to negate § 510(c) as a candidate to supplant § 105(a) as the statutory imprimatur for debt recharacterization. However, it is important to bear in mind that the panel in *SI Restructuring* rejected the unsecured creditors committee's expert's testimony that the company had been harmed by its incurring of additional debt.[324] Also, the court's rejection of "deepening insolvency" as a theory of harm was followed by its observation that the bankruptcy court had made no finding that the company was insolvent or undercapitalized at the time of the transactions at issue.[325] Those considerations, in turn, are key components in the multifactor approach used by the majority of the courts to test the characterization of the disputed investment.[326] Their absence in *SI Restructuring* is telling. Finally, the rationale of deepening insolvency, if not as an independent cause of action,[327] has more recently received a friendlier reception as a type of injury for purposes of analyzing corporate insider behavior than

that the record supports the finding of inequitable conduct and unfair advantage."). "Unfair advantage" is also an important component of justification for no-fault subordination. *See In re* Virtual Network Servs. Corp., 902 F.2d 1246, 1250 (7th Cir. 1990) (describing the district court's finding that it would confer an unfair advantage on the IRS if the tax penalty claim were not subordinated).

323. 532 F.3d at 360–61; *see also supra* text accompanying notes 196–203.

324. 532 F.3d at 363.

325. *Id.*

326. *See supra* Part I.B–C.

327. *See* Trenwick Am. Litig. Tr. v. Ernst & Young, L.L.P., 906 A.2d 168, 205 (Del. Ch. 2006) (holding that a strategy employed by an insolvent company "results in continued insolvency and an even more insolvent entity does not in itself give rise to a cause of action. Rather, in such a scenario the directors are protected by the business judgment rule. To conclude otherwise would fundamentally transform Delaware law."). *Trenwick* was cited in *SI Restructuring*. *SI Restructuring*, 532 F.3d at 364 (citing *Trenwick*, 906 A.2d at 174). As noted above, *see supra* note 202, the *SI Restructuring* opinion also cited the Third Circuit's decision in *CitX Corp.* as rejecting the doctrine. *SI Restructing*, 532 F.3d at 363 (citing Seitz v. Detweiler, Hershey & Assocs., P.C. (*In re* CitX Corp.), 448 F.3d 672, 678 (3d Cir. 2006)). Later, however, the Third Circuit altered course again, concluding that deepening insolvency remains a viable claim in Pennsylvania. *See* Official Comm. of Unsecured Creditors v. Baldwin (*In re* Lemington Home for the Aged), 659 F.3d 282, 292 (3d Cir. 2011) (reversing and remanding the lower court's summary judgment dismissal of the plaintiff's deepening insolvency claim). Subsequently, the court sustained the jury's verdict on a theory of deepening insolvency. Official Comm. of Unsecured Creditors v. Baldwin (*In re* Lemington Home for the Aged), 777 F.3d 620, 630 (3d Cir. 2015); *see also* NCP Litig. Tr. v. KPMG, 945 A.2d 132, 141–42 (N.J. Super. Ct. Law Div. 2007) (suggesting that rejection of the theory is at least the subject of some debate outside of Delaware).

it was accorded in *SI Restructuring*.[328]

In addition to the foregoing, it is also true that when the holder of what is, in substance, an equity interest, casts that interest in the form of a loan, other creditors are financially injured simply by the dilutive impact that the elevation of that equity interest to the status of debt will have in all but the rare full-pay cases. Thus, when the factors that must align to support an order of debt recharacterization are present—at least under the multifactor approach—the harm to the debtor or other creditors is almost invariably going to be present.[329] For this reason, the holding in *SI Restructuring* does not, in fact, render § 510(c) an inhospitable home for recharacterization.[330]

Another hurdle, however, in the way of reuniting equitable subordination and debt recharacterization, is created by the fact that the harm caused by miscasting an equity interest as debt exists whether the putative lender whose interest is being challenged acted with calculated deliberation, wonton recklessness, or blitheful ignorance. Furthermore, the injury to other creditors caused by the mischaracterization is the same without regard to whether the claimant is an insider or noninsider.[331] Because the recharacterization decision does not, therefore, depend on either intent or status, if equitable subordination is to be employed (or, really, reemployed)[332] in this context, the recharacterization of a claim as an equity investment cannot be shoehorned into the *Mobile Steel* test by treating it as an

328. Deepening insolvency has also gained some currency as a theory of damages, assuming liability on a separate cause of action. *See, e.g.*, Official Comm. of Unsecured Creditors of Hydrogen, L.L.C. v. Blomen (*In re* Hydrogen, L.L.C.), 431 B.R. 337, 357 (Bankr. S.D.N.Y. 2010) (holding that, in New York, deepening insolvency is regarded as a theory of damages, rather than an independent cause of action, that may only result from the breach of a separate duty or the commission of a separate tort); *cf.* Hunter v. Citibank, N.A., No. C09-02079 JW, 2011 WL 7462143, at *5 (N.D. Cal. May 5, 2011) (refusing to dismiss an aiding and abetting claim as an improper circumvention of the "discredited" deepening insolvency theory). *See generally* John Tully, Note, *Plumbing the Depths of Corporate Litigation: Reforming the Deepening Insolvency Theory*, 2013 U. ILL. L. REV. 2087 (critiquing the various ways that the doctrine has been employed by courts).

329. Moreover, as noted, *Mobile Steel* seems to contemplate that an unfair advantage conferred on the claimant may substitute for injury to creditors. *See supra* notes 169, 203 and accompanying text.

330. In addition, as discussed above, *see supra* notes 179, 203, 322, the second prong of the *Mobile Steel* test may be satisfied by a showing of "unfair conduct," as well as injury to other creditors. Obtaining the benefits of an equity investment without assuming the corresponding risks associated with the same would seem to squarely meet this requirement.

331. Insider status does, however, factor into the analysis of whether the claim is more properly treated as debt or equity. *See infra* text accompanying notes 353–361.

332. *See supra* note 194.

additional form of inequitable conduct.[333] To do so would result in an under-inclusive rule—not dissimilar in effect to one of the potential consequences of using state law to test the true nature of the obligation.[334] Instead, faced with the prospect of losing § 105(a) as the basis for recharacterizing debt as equity, and thus having the determination turn on the whimsy and caprice of state law jurisprudence developed with nonbankruptcy considerations in mind,[335] it is necessary to expand recognition of no-fault equitable subordination beyond tax, other penalty, and stock redemption claims to include actions seeking an adjudication of the true character of a capital investment in the debtor. To do so is not incompatible with either the language of § 510(c) or irreconcilable with the legislative history that underlies its enactment.[336] Instead, it is a natural evolution of the doctrine of equitable subordination, as contemplated by Congress,[337] to ensure fairness in the bankruptcy context. For this purpose, "fairness" is measured in terms of congruence with the distributional priorities and objectives established by and under the Code.[338] Assuring that those norms are not impugned requires policing and, from time-to-time,

333. This rules out the approach taken by Professor Knippenberg in treating predatory lending as a fourth form of inequitable conduct because, while equitable considerations might call for subordination, specific inequitable conduct by the claimant may not be implicated. *See* Knippenberg, *supra* note 317, at 42–43. Similarly, an estoppel rationale is unavailing since it, too, must be based on some kind of false statement or misleading representation. *See supra* note 166.

334. While there is an argument that disallowance does not have to be based on state law, certainly that is how some courts have interpreted it recently. *See supra* Part I.D.2.

335. *See supra* text accompanying notes 250–251.

336. Actually, the character of a claim was originally dealt with as part of the equitable subordination analysis; it bears reiterating, however, that historically once a determination was made that a debt was not in fact a debt but rather an ownership interest, subordination followed as a matter of course. *See* Herzog & Zweibel, *supra* note 165, at 94 (stating that "where the advance of capital funds is deliberately cloaked as a formal debt, it is indeed a common bed-fellow with subordinating influences such as fraud, illegality or other variants of misconduct"); *see also* Aquino v. Black (*In re* AtlanticRancher, Inc.), 279 B.R. 411, 433 (Bankr. D. Mass. 2002) ("[W]hile once considered solely in conjunction with the doctrine of equitable subordination, bankruptcy courts now consider recharacterization a separate cause of action." (citing Herzog v. Leighton Holdings, Ltd., 212 B.R. 898, 931 (Bankr. N.D. Ill. 1997))); *supra* note 177 and accompanying text; *infra* note 378 and accompanying text. It was arguably only after the Supreme Court muddied the waters about the application of § 510(c) to the recharacterization situation that creditors, and their lawyers, began to seek relief for mischaracterization as an independent cause of action. *See supra* notes 32, 313 and accompanying text.

337. For a contrary view about the compatibility of equitable subordination as a basis for recharacterizing debt as equity, see Nozemack, *supra* note 73, at 733.

338. *See supra* notes 217, 238.

overturning the artificial boost gained from elevating what is intrinsically an ownership interest to the level of a debt obligation. It is, in a word, inequitable to allow the holder of such an interest to take *pari passu* with the claims of true creditors who were neither seeking nor receiving the heightened benefits of, nor assuming the increased perils associated with, risk capital.

Bringing the bankruptcy courts' authority to properly characterize claims under the umbrella of § 510(c) would initially change nothing. It would simply preserve the power as a critical component of the bankruptcy courts' ability to ensure that the Code's statutory scheme of priority and distribution are not subverted by the form in which an investment is designated. Over time, however, there invariably would be ancillary benefits. First, much of the confusion created by the overlapping presence of undercapitalization as a consideration factoring into the analysis under both areas of law would be abated.[339] In addition, while it is true that taking this step would not itself resolve which federal standard should apply in determining when to reclassify a putative debt as equity,[340] it surely should force the issue and accelerate the progress toward a uniform federal standard. Logically, the multifactor approach, followed in a majority of the circuits treating the issue under a federal framework, is most consistent with the Supreme Court's direction that subordination must be based on a case-by-case analysis.[341] It is also consistent with the direction supplied by the authorities applying no-fault subordination in other contexts, namely, that the determination be made based on the totality of the circumstances.[342] Finally, by determining that the bankruptcy courts'

339. *See supra* note 78 and accompanying text. The confusion dates back to the Supreme Court's holding in *Pepper*. *See* Autobacs Strauss, Inc. v. Autobacs Seven Co. (*In re* Autobacs Strauss, Inc.), 473 B.R. 525, 577 (Bankr. D. Del. 2012) (pointing out that previously thin capitalization had been the standard for both equitable subordination and recharacterization before they were divided into separate inquiries).

340. *See supra* note 111 and accompanying text.

341. *See supra* notes 188–189 and accompanying text. It also assures that the requirement of harm to other creditors is met, as required by the Fifth Circuit's decision in *Wooley v. Faulkner* (*In re SI Restructuring, Inc.*), 532 F.3d 355 (5th Cir. 2008). *See supra* notes 196–203 and accompanying text.

342. This is particularly important given development of hybrid securities partaking of characteristics of both debt and equity. *See* Wilton & Moeller-Sally, *supra* note 30, at 1262 (noting that modern financing transactions can fall along a spectrum between debt and equity, potentially including securities that are neither purely one nor the other); *see also supra* note 82. Moreover, it bears reemphasizing that use of the factors developed in tax court cases does not mean that those factors have to be weighted and/or applied in bankruptcy in the same fashion as a tax court case. Since the standard is essentially a "totality of the circumstances" approach, those factors can offer guidance but do not necessarily have to represent a closed or exclusive list of relevant considerations in any

ability to recharacterize a debt claim as *equitable* in nature, the need to rely on § 502(b), with all of the conceptual asymmetries and negative entailments associated with "disallowance," would be eliminated. In sum, the shift in the source of the bankruptcy courts' authority, when the facts warrant, to recharacterize debt as equity as proposed could provide beneficial clarity in multiple respects.[343]

Therefore, to ensure that the standard for making the assessment as to the true character of a claim is both uniform and focused on relevant considerations, I would propose that the three-part test in *Mobile Steel* be tweaked as follows, with the proposed new language italicized and omitted language struck-through:

- The claimant must have engaged in some type of inequitable conduct, *or the claim must either constitute a penalty or involve a transaction appropriately characterized as an equity interest*;[344]

- The misconduct must have resulted in injury to the creditors ~~or conferred an unfair advantage on the claimant~~ *or, under the circumstances of the case, other creditors would be harmed if the claim were not subordinated*;[345]

given case.

343. This would include resolving the standard of review in a manner that accords greater discretion to the determination made in the first instance by the bankruptcy court, since the application of a multifactor approach is largely a factual determination, whereas the applicability of a state law defense is, or has been construed to be, a question of law that the appellate courts review de novo. *See supra* notes 93, 105, 122 and accompanying text.

344. Of course, more than one of the three triggers could be present in a particular case, but this addition to the first prong would overcome the objections of the Fifth and Ninth Circuits to look to § 105(a) to find the bankruptcy courts' authority to recharacterize claims improperly labelled as debt. Deliberately, this modification takes no affirmative position on whether the definition of inequitable conduct should be expanded beyond its traditional perimeter, *see supra* note 317, to include reckless or predatory lending along the lines suggested by *Yellowstone Mountain*. Credit Suisse v. Official Comm. of Unsecured Creditors (*In re* Yellowstone Mountain Club, LLC), No. 08-61570-11, 2009 WL 3094930, at *9 (Bankr. D. Mont. May 12, 2009), *vacated*, No. 08-61570-11-RBK, 2009 WL 10624435 (Bankr. D. Mont. June 29, 2009); *see supra* notes 207–211 and accompanying text. Instead, I would propose to leave that question to subsequent judicial determination.

345. Notably, the reference in the *Mobile Steel* test to conferring an unfair advantage on the claimant is eliminated in favor of a standard that requires proof of harm to other creditors. This would clarify the confusion over the point created by the Fifth Circuit's decision in *SI Restructuring*. *See supra* note 203. Of course, the language could also be retained without doing any violence to the proposal herein being made.

- Equitable subordination must not be inconsistent with the provisions of the Bankruptcy ~~Act~~ *Code*.

This would "codify," in a sense, the currently recognized exceptions to the requirement of creditor misconduct,[346] and also allay concerns that no-fault equitable subordination might gradually expand to eliminate or overwhelm the requirement of a showing of inequitable conduct.[347]

C. Objections to Bringing Recharacterization Under the Auspices of Equitable Subordination

1. Treatment of Insiders

It is generally accepted that, although equitable subordination applies to arms-length or noninsider claims,[348] noninsiders are granted considerably more latitude in dealing with the debtor; put in the obverse, insider claims will trigger a higher level of scrutiny and require a lower level of misconduct than in cases where the claimant is not an insider.[349] This is appropriate because, simply by virtue of their

346. The "penalty" language would capture nonpecuniary tax claims and other penalties, while the language concerning "appropriately characterized as an equity interest" would capture the stock redemption exception, *see supra* notes 309–310, as well as mischaracterized investments.

347. *See, e.g.*, *In re* Lifschultz Fast Freight, 132 F.3d 339, 347–48 (7th Cir. 1997) (expressing wariness about any expansion of exceptions to the requirement of finding inequitable conduct as a predicate to subordinating a claim); NTP Marble, Inc. v. Papadopoulos (*In re* NTP Marble, Inc.), 491 B.R. 208, 214 (Bankr. E.D. Pa. 2013) (pointing out that the cases that have been receptive to "no fault" equitable subordination have been limited to just a few categories of situations: tax penalties, stock redemption claims, and punitive damages claims); *see also infra* Part IV.C.2.

348. *See* LightSquared LP v. SP Special Opportunities LLC (*In re* LightSquared Inc.), 511 B.R. 253, 348 (Bankr. S.D.N.Y. 2014) (noting that it is now well-settled that the doctrine applies to general creditors or noninsiders). Moreover, courts have uniformly held that the Code's definition of "insider" must be flexibly applied on a case-by-case basis. *See* Pan Am Corp. v. Delta Air Lines, Inc., 175 B.R. 438, 499 (S.D.N.Y. 1994).

349. *See supra* notes 63, 172–175. Generally speaking, status of the creditor will not so much alter the standard of review as it will reduce the severity of the behavior that might constitute inequitable conduct. *See* 80 Nassau Assocs. v. Crossland Fed. Sav. Bank (*In re* 80 Nassau Assocs.), 169 B.R. 832, 840 (Bankr. S.D.N.Y. 1994). Thus, noninsider status does not provide immunity from equitable subordination, but it may increase the plaintiff's burden of proof. *See* Bayer Corp. v. MascoTech, Inc. (*In re* AutoStyle Plastics, Inc.), 269 F.3d 726, 744 (6th Cir. 2001) (describing the distinction in insider versus noninsider cases as involving a higher standard of proof); *In re* Adia's Paradise, LLC, 485 B.R. 806, 813 (Bankr. M.D. Fla. 2013) (noting that when the defendant-creditor is an insider or a fiduciary, the plaintiff must present material evidence of unfair conduct, at

position with the company, insiders have a much greater opportunity to engage in the sorts of transactions and behavior that would warrant subordination based on inequitable conduct.[350] Insiders also stand in a fiduciary relationship with the firm, which, of course, is not true in the case of arms-length creditors.[351] It has been suggested that, because recharacterization does not require a showing of misconduct, the claimant's status as an insider or noninsider is inconsequential in the analysis.[352] If true, this makes inclusion of recharacterization into the doctrine of equitable subordination a rather more difficult and logically awkward task than would otherwise be the case.

The suggestion that insider status is irrelevant under a recharacterization analysis may, however, be overstated, at least under the multifactor approaches adopted by the Sixth and Tenth Circuits.[353] In both cases, an "identity of interest" between the so-called creditor and the shareholder,[354] and "the . . . ability to obtain financing from outside lending institutions" are among the factors to be considered and weighed in making the determination as to the nature of the claim.[355] Moreover, "the extent to which the advances were subordinated to the claims of *outside* creditors" is one of the other eleven factors in *Roth*

which point the burden shifts to the creditor to prove it acted fairly; whereas if the defendant-creditor is *not* an insider or fiduciary, the challenging party debtor has the higher burden to prove, with particularity, more egregious conduct such as fraud, spoliation, or overreaching).

350. *LightSquared*, 511 B.R. at 348 (citing Official Comm. of Unsecured Creditors v. Conseco Fin. Servicing Corp. (*In re* Lois/USA, Inc.), 264 B.R. 69, 134 (Bankr. S.D.N.Y. 2001)).

351. *See* Lehman Bros. Holdings Inc. v. JPMorgan Chase Bank, N.A. (*In re* Lehman Bros. Holdings Inc.), 541 B.R. 551, 583 (Bankr. S.D.N.Y. 2015); *supra* notes 172–175.

352. *See* Litovitz, *supra* note 176, at 326 (maintaining that, in reviewing a claim for recharacterization, a bankruptcy court should not necessarily take into account the claimant's status as an insider or a noninsider).

353. *See supra* Part I.B–C.

354. In application, the analysis in relation to this factor focuses on a comparison between a shareholder percentage equity interest and its debt claim. *See* Friedman's Liquidating Tr. v. Goldman Sachs Credit Partners, L.P. (*In re* Friedman's Inc.), 452 B.R. 512, 522 (Bankr. D. Del. 2011) ("If stockholders make advances in proportion to their respective stock ownership, an equity contribution is indicated. On the other hand, a sharply disproportionate ratio between a stockholder's percentage interest in stock and debt is indicative of bona fide debt. Where there is an exact correlation between the ownership interests of the equity holders and their proportionate share of the alleged loan this evidence standing alone is almost overwhelming." (quoting *AutoStyle*, 269 F.3d at 751)).

355. Roth Steel Tube Co. v. Comm'r, 800 F.2d 625, 630 (6th Cir. 1986); *accord* Sender v. Bronze Grp., Ltd. (*In re* Hedged-Invs. Assocs., Inc.), 380 F.3d 1292, 1298 (10th Cir. 2004). The latter, of course, is also one of the two circumstances warranting subordination under the categorical test. *See supra* text accompanying note 53.

Steel,[356] and the thirteen-point test adopted in *Hedged-Investments* includes "the status of the contribution in relation to regular corporate creditors."[357] The status of the claimant as an insider or a noninsider matters in the evaluation and weighting of all of these factors, and possibly others.[358]

The point to be made is that insider status does bear on the analysis of whether recharacterization is justified more often than not, just as is true in connection with equitable subordination.[359] Insider status will trigger closer scrutiny in the recharacterization inquiry and weigh more heavily against the claimant than in the case of noninsider status, just as in an equitable subordination analysis. The difference is that the standard for actually recharacterizing a claim should be the same regardless of whether the claimant is an insider of the company, unlike those equitable subordination cases that require a lesser showing of misconduct, or a lower burden of proof, in the case of an insider.[360] In this respect, the sharp distinction between insiders and noninsiders

356. 800 F.2d at 630 (emphasis added); *see also In re* Cold Harbor Assocs., L.P., 204 B.R. 904, 915 (Bankr. E.D. Va. 1997) (noting that the ultimate aim is to ascertain if the transaction "bears the earmarks of an arms length negotiation" (citing Pepper v. Litton, 308 U.S. 295 (1939))).

357. *Hedged-Invs.*, 380 F.3d at 1298 (citing Stinnett's Pontiac Serv., Inc. v. Comm'r, 730 F.2d 634, 638 (11th Cir. 1984)). Of course, this factor can also apply to an outside creditor, but it is most likely to apply to a "loan" made by a party who is already an insider and thus able to use that status to secure disproportionately favorable terms compared with arms-length creditors.

358. Although, as noted above, *see supra* note 240, these factors may originally have been derived in tax cases, they need not be applied with the same degree of emphasis as in the tax cases. *See, e.g.*, *AutoStyle*, 269 F.3d at 750 ("The factors must be considered within the particular circumstances of each case." (citing *Roth Steel*, 800 F.2d at 630)).

359. *See, e.g.*, *In re* Petersburg Regency LLC, 540 B.R. 508, 545 (Bankr. D.N.J. 2015) (making the point that insiders occupy a different status than other creditors in connection with both an equitable subordination and a recharacterization analysis).

360. *See* Va. Broadband, LLC v. Manuel, 538 B.R. 253, 264 (W.D. Va. 2015) (stating that the standard for subordination is lower when the creditor is an insider). Other courts focus on burden of proof. *See* SEC v. Spongetech Delivery Sys., Inc., 98 F. Supp. 3d 530, 553–54 (E.D.N.Y. 2015) (stating that, "[i]n the case of non-insider claims, the proponent [of subordination] always bears the burden of proof[, but that,] . . . when a party seeks to subordinate an insider's claim, the party must only show 'a substantial basis to support the charge of unfairness, [whereupon] the burden shifts to the insider to show the fairness of the claim'" (quoting 80 Nassau Assocs. v. Crossland Fed. Sav. Bank *(In re* 80 Nassau Assocs.), 169 B.R. 832, 839 n.5 (Bankr. S.D.N.Y. 1994))); Capmark Fin. Grp. Inc. v. Goldman Sachs Credit Partners L.P., 491 B.R. 335, 345 (S.D.N.Y. 2013) (holding that, in the case of insiders, once the plaintiff makes a prima facie showing of inequitable conduct, the burden shifts to the claimant to prove good faith and the inherent fairness of the transaction); *80 Nassau Assocs.*, 169 B.R. at 839 n.5 (noting that the distinction between insider and noninsider creditors is important for purposes of allocating the burden of proof); *see also supra* note 275.

that exists in conventional equitable subordination analysis is not appropriate when the question is subordination of a putative debt based on its true character, unrelated to any sort of inequitable conduct. Nonetheless, the point remains that the two doctrines are not, in fact, as completely distinct from one another on this basis as might have been thought and as has sometimes been suggested.[361]

2. The Slippery Slope

Another concern that might be voiced to bringing recharacterization under the fold of § 510(c) is the same bromide that has been leveled at § 105(a);[362] namely, that it should not be construed so as to provide bankruptcy judges with free-wheeling authority to alter the legal priority of claims based principally on their general sense of right and wrong or some abstract notion of fairness or justice.[363] The fear, however, of unleashing a can of worms (to mix my metaphors) is spurious. First, as suggested above,[364] the expanded standard for applying equitable subordination can be crafted in a fashion that cabins it only to situations where the true substance of an investment is at issue.[365] This is a power that every circuit agrees the bankruptcy courts already possess, even if they disagree over the source from which that authority derives.

In what might be described as a perhaps ironic way of putting it, the proposed extension of § 510(c) can be made "categorical" in the sense that it would apply only to currently-recognized categories of exceptions to the inequitable conduct requirement and to challenges based on the intrinsic character of a monetary advance or other form of

361. *See infra* Part IV.C.3.

362. *See supra* notes 15, 18.

363. This is particularly true in the political climate that has prevailed since the BAPCPA. *See supra* note 270; *see also* Jean Braucher, *The Challenge to the Bench and Bar Presented by the 2005 Bankruptcy Act: Resistance Need Not Be Futile*, 2007 U. ILL. L. REV. 93, 94 (observing that the subtext of the BAPCPA "was the view that bankruptcy judges and consumer debtors' lawyers needed to be reined in to keep them from facilitating abuse by consumer debtors"); Kara J. Bruce, *Rehabilitating Bankruptcy Reform*, 13 NEV. L.J. 174 (2012) (discussing the BAPCPA's emphasis on a rules-based framework to limit what was perceived as undesirable judicial interference in Chapter 11).

364. *See supra* text accompanying note 354.

365. The other categories of no-fault subordination contemplated by the proposed formulation are already recognized in some jurisdictions as exceptions to the requirement of inequitable conduct and, so long as the determination is made on a case-by-case analysis, are not barred by the Supreme Court's holdings in *Noland* and *Reorganized CF & I*. *See supra* Part IV.A.

investment in the debtor. It would also not contravene the rulings in *Noland* and *Reorganized CF & I*, since the modified standard contemplates that the determination would be the product of a fact-intensive analysis and performed on a case-by-case basis. Third, while also an issue relating to bankruptcy jurisdiction more generally, it makes good policy sense that the bankruptcy courts be permitted a certain measure of latitude to alter the treatment in bankruptcy of transactions that, if left undisturbed, would compromise Code values, whether speaking in connection with § 105(a) or § 510(c). To permit the exercise of such discretion in a measured way falls well short of the Fifth Circuit's admonition that the bankruptcy courts not become "roving commission[s]" of righteousness.[366]

In sum, the bankruptcy courts' power to subordinate a claim for an equitable reason based on proof other than of the claimant's inequitable conduct is consonant with the general doctrine of equitable subordination and can be ordered within the framework of that doctrine as established by the Supreme Court back at the inception of the remedy.[367] Furthermore, as pointed out by the court in *Dornier Aviation*, using the claims allowance process as the sole opportunity for the courts to deal with mischaracterized interests is inadequate since it entails only a "minimal threshold" determination focused on different considerations than those that animate recharacterization.[368] Even the Fifth Circuit in *Lothian Oil* agreed that resolution of a recharacterization challenge requires a step beyond the claims allowance process,[369] although its actual holding is incongruent with that acknowledgement. Finally, as evinced by *Lothian Oil* and *Fitness Holdings*, resolving the question of whether a putative claim should be regarded as equity as part of the claims allowance process leads, not inescapably, but more likely than not, to the conclusion that the determination must be made based upon application of state law

366. Wells Fargo Bank of Tex. N.A. v. Sommers (*In re* AMCO Ins.), 444 F.3d 690, 695 (5th Cir. 2006) (quoting Mirant Corp. v. Potomac Elec. Power Co. (*In re* Mirant Corp.), 378 F.3d 511, 523 (5th Cir. 2004)). Even the Supreme Court in *Law* recognized "that in some circumstances a bankruptcy court may be authorized to dispense with futile procedural niceties in order to reach more expeditiously an end result required by the Code." Law v. Siegel, 134 S. Ct. 1188, 1197 (2014).

367. *See supra* notes 165, 177.

368. Fairchild Dornier GMBH v. Official Comm. of Unsecured Creditors (*In re* Dornier Aviation (N. Am.), Inc.), 453 F.3d 225, 231 (4th Cir. 2006).

369. Grossman v. Lothian Oil Inc. (*In re* Lothian Oil Inc.), 650 F.3d 539, 543 (5th Cir. 2011) ("[W]here the reason for such disallowance is that state law classifies the interest as equity rather than debt, then implementing state law as envisioned in *Butner* requires different treatment than simply disallowing the claim.").

precedent.[370] This not only triggers all the undesirable consequences of doing so, as outlined above, but it also means that there is no separate inquiry beyond the threshold question of allowability, even when such an inquiry is necessary to faithfully fulfill the priority scheme contemplated by the Code.[371] For these reasons, anchoring the authority to recharacterize a putative debt in § 510(c) would in no way be a first step down a slippery slope. Rather, by grounding the inquiry in the more apt metaphorical category, it would actually be a step in the right direction.

3. Conceptual Differences and Different Purposes

A further roadblock to bringing recharacterization under the aegis of § 510(c) that one might expect to be advanced is based on the frequently-pronounced reasoning that recharacterization does not entail subordination of a debt, but rather proper characterization of an interest as *not* a debt.[372] Thus, the argument would be that equitable subordination and recharacterization address distinct concerns, serve different purposes, and are inherently at odds with one another.[373] It would be contended, under this view, that equitable subordination applies when circumstances dictate that the payment priority of an otherwise legitimate debt be altered to take only after those of other claimants, while the object of the analysis in connection with recharacterization is to determine if a debt actually exists in the first place so that, if not, there is nothing to subordinate.[374]

370. Although it led precisely to that conclusion in those two cases, it may not necessarily have to follow in the ipso facto manner implied. *See supra* Part I.D; *see also supra* text accompanying note 217 (arguing that *Butner* has been given too broad of an interpretation).

371. *See supra* Part III.A.

372. *See* Cohen v. KB Mezzanine Fund II, LP (*In re* SubMicron Sys. Corp.), 432 F.3d 448, 454 (3d Cir. 2006) (suggesting that the terms recharacterization and equitable subordination address different concerns and require different inquiries by the court); Nozemack, *supra* note 73, at 717–18 (same). On the other hand, the court in *SubMicron* admitted that the two remedies lead to the same result. 432 F.3d at 454. For further discussion of the point, see *supra* notes 235–238 and accompanying text and *infra* note 377.

373. *See, e.g.*, Blasbalg v. Tarro (*In re* Hyperion Enters., Inc.), 158 B.R. 555, 560–61 (D.R.I. 1993) (pointing out that the language of § 510(c) speaks to subordination and not to the recasting of a claim as an interest). Of course, what is that recasting if not, in almost all practical respects, the subordination of a claim? *See supra* note 238 and accompanying text; *see also infra* note 376.

374. *See* Diasonics, Inc. v. Ingalls, 121 B.R. 626, 630–32 (Bankr. N.D. Fla. 1990) (discussing the distinction between disallowance and subordination); *see also* Gernsbacher v. Campbell (*In re* Equip. Equity Holdings, Inc.), 491 B.R. 792, 841 (Bankr. N.D. Tex.

However, while the two remedies may superficially appear to involve conceptually different exercises, in fact to persist in advancing that distinction would itself be an elevation of form over substance. To begin with, when both doctrines are properly understood, it is clear that they both derive from the equitable jurisdiction of the bankruptcy courts.[375] But, even more telling is the fact that the economic consequences of subordination and recharacterization are identical.[376] Thus, while their journeys may entail taking somewhat different paths, they arrive at the same destination. Moreover, the paths are not in fact all that different when we recall that many of the factors involved in a recharacterization analysis are also relevant in the determination of when equitable circumstances require that a claim be subordinated.[377] This is why, until more recently, the question of recharacterization was addressed by the courts in the context of equitable subordination rather than as an independent cause of action.[378] The concept of recharacterization is much more akin to subordination than it is to disallowance, as recharacterization does not result in elimination of the claimant's interest in the debtor or its right to participate in the case—only priority is affected.[379] Therefore, the instant proposal does nothing more than return the recharacterization analysis to the environs from where it originated in order to ensure that the issue continues to be resolved under federal standards and with a focus on the unique

2013) (noting that "while both doctrines entail the altering of priority of payment for a creditor's claim in the Bankruptcy Code's distribution scheme, the doctrines themselves are distinct").

375. *SubMicron*, 432 F.3d at 455 n.6.

376. *See* Dorula v. Holmes (*In re* Starlight Grp., LLC), 531 B.R. 611 n.1 (Bankr. E.D. Va. 2015) (noting that it is not necessary to reach recharacterization once equitable subordination is ordered since the relief would be identical); Bunch v. J.M. Capital Fin., Ltd. (*In re* Hoffinger Indus., Inc.), 327 B.R. 389, 407 (Bankr. E.D. Ark. 2005) (stating that "recharacterization has the *effect* of subordinating the loan because capital contributions would be repaid only after all other corporate obligations have been met" and, thus, financial consequences are the same as equitable subordination); *see also* Templeton v. O'Cheskey (*In re* Am. Hous. Found.), 785 F.3d 143, 152 n.12 (5th Cir. 2015) (taking a similar approach to *Starlight* on the lack of any need to examine recharacterization once it was determined that subordination was mandated under § 510(b)).

377. The overlap was apparent as far back as *Pepper*, which noted that bankruptcy court proceedings are inherently equitable in nature and that the bankruptcy courts possess the power to "reject[] in whole or in part 'according to the equities of the case' . . . claims previously allowed." Pepper v. Litton, 308 U.S. 295, 304 (1939).

378. *See* Aquino v. Black (*In re* AtlanticRancher, Inc.), 279 B.R. 411, 433 (Bankr. D. Mass. 2002); *see also supra* notes 177, 336.

379. *See supra* text accompanying note 236 (providing an explanation for why it makes more sense to deal with debt recharacterization issues as part of the § 510(c) analysis, rather than to attempt to invigorate a greater receptivity to equitable disallowance); *see also supra* Part I.D.2; *supra* note 161 and accompanying text.

objectives of a federal bankruptcy case.[380]

CONCLUSION

Equality of distribution is a fundamental tenet of the bankruptcy creed.[381] To preserve and protect this pivotal norm, bankruptcy courts must maintain the ability to reclassify a disguised equity contribution such that bankruptcy outcomes are based on the true economic realities of the claims and interests that comprise the case.[382] Determining what circumstances that authority is exercised under should not hinge on state law, the apparent (although not inevitable) byproduct of the view that insists the power to recharacterize does not exist independent from the courts' authority to allow or disallow claims under § 502.[383] Approaching the question as governed by state law belies the reasons why the bankruptcy courts need to be able to exercise the authority in the first instance: to subordinate a previously allowed claim, regardless of how it might be classified under state law, to ensure a principled and consistent application of the Code. Hence, identification of the proper standards governing recharacterization is no less important than the threshold recognition of the courts' power to engage in the exercise in the first place.

State law does not, except in rare cases involving assignments for the benefit of creditors,[384] embrace an equality ethos; in fact, quite the

380. As the Court put it in *Pepper*, in describing the purpose of the doctrine of equitable subordination: to ensure "that technical considerations will not prevent substantial justice from being done." 308 U.S. at 305. This proposal also assures that the test for deciding whether to recharacterize debt as equity is applied separately from, rather than as part of, the claims allowance process.

381. Historically, ratable distribution to creditors has been one of the traditional goals of federal bankruptcy law. Howard Delivery Serv., Inc. v. Zurich Am. Ins. Co., 547 U.S. 651, 655 (2006). To achieve this goal, the Code creates a comprehensive and intricate scheme designed to equitably distribute the debtor's nonexempt assets. Sherwood Partners, Inc. v. Lycos, Inc., 394 F.3d 1198, 1203–04 (9th Cir. 2005). Hence, the old adage that, in bankruptcy, "equality is equity." *See* Columbus Elec. Co. v. Warden (*In re* Fort Wayne Elec. Corp.), 99 F. 400, 402 (7th Cir. 1900).

382. *See, e.g.*, Redmond v. Jenkins (*In re* Alt. Fuels, Inc.), 789 F.3d 1139, 1146 (10th Cir. 2015) (making the critical point that the bankruptcy courts' ability to recharacterize putative debt as equity when appropriate is essential to implementing the priority scheme of the Code); *see also supra* notes 254–256 and accompanying text.

383. *See supra* Part I.D.1.

384. Some, but not all, state assignments for the benefit of creditor statutes even contemplate recovery of preferential transfers. *See* Vivian Luo, Comment, *A Preference for States? The Woes of Preempting State Preference Statutes,* 24 EMORY BANKR. DEV. J. 513, 525 (2008) (noting that fifteen states, in addition to California, permit the assignee under an assignment for the benefit of creditors to avoid preferences). There is some question,

opposite, as under state collection norms the race goes to the swiftest and the devil takes the hindmost.[385] Allowing jurisprudence developed under a system that advances a different policy agenda than the objectives pertaining in a bankruptcy case—and which achieves those objectives in a different manner—to decide the true nature of an investment for bankruptcy priority and distribution purposes makes no sense. It assures not only that the results will be inconsistent, but also that its application will produce the "right" result haphazardly, at best, and the "wrong" result more often than not.

Therefore, the current majority view on recharacterization is more appropriate: it has the capacity to promote more consistent, predictable results[386] and, more importantly, results congruent with the larger purposes and policies of the federal debt collection law.[387] However, anticipation of further incursions on the general equitable authority of the bankruptcy courts under § 105(a) puts that view at risk. Thus, recognizing the authority of the courts to recharacterize contributions to the debtor from debt to equity under the courts' statutory power of equitable subordination would safeguard the bankruptcy courts' continued ability to assure that substance does not give way to form. It would likely also have the subsidiary benefits of: (1) clarifying that the power to recharacterize is equitable in nature, thereby resolving the current circuit split; (2) resolving the disagreement in the case law as to the standards that should guide the analysis (as well as the standard of review of the bankruptcy courts' determination);[388] (3) eliminating the current confusion between the two doctrines;[389] and, (4) because recharacterization claims are almost invariably brought in tandem with an alternative cause of action under § 510(c), streamlining litigation in the bankruptcy courts, thereby promoting the expeditious resolution of bankruptcy cases. All in all, not a bad deal.

however, as to whether such provisions are preempted by the Code. *See Sherwood Partners*, 394 F.3d at 1203.

385. *See, e.g.*, Susan Block-Lieb, *Fishing in Muddy Waters: Clarifying the Common Pool Analogy as Applied to the Standard for Commencement of a Bankruptcy Case*, 42 AM. U. L. REV. 337, 356 (1993) (describing the individual creditor remedy approach of state law as "grab law," in contrast with bankruptcy's collective remedy approach).

386. *See supra* text accompanying notes 244–256.

387. *See Sherwood Partners*, 394 F.3d at 1203 (describing this as the "unique contribution of the Bankruptcy Code [and one] that makes bankruptcy different from a collection of actions by individual creditors"); *see also supra* text accompanying notes 253, 385.

388. *See supra* notes 123, 343.

389. *See supra* note 78 and accompanying text.