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RECHARACTERIZATION OF DEBT TO EQUITY UNDER U.S. LAW AND ITS EFFECT ON CORPORATE GOVERNANCE

I. INTRODUCTION

This Paper examines the practice of recharacterization under U.S. law and focuses, in particular, on the standard of review applied by bankruptcy courts in order to determine whether a purported debt transaction should be considered as an equity contribution and on the effect of such a recharacterization of debt to equity on corporate governance. In doing so, Part II provides a brief overview of the concept of recharacterization in general. Part III describes some of the most commonly accepted factors taken into account by bankruptcy courts and tries to identify two main approaches that may be taken in weighting these factors. Finally, Part IV identifies some of the policy reasons underlying the concept of recharacterization and explores whether this practice has an impact on corporate governance.

II. RECHARACTERIZATION OF CLAIMS IN GENERAL

Recharacterization consists in the authority of bankruptcy courts to rule that a claim against the trustee, or debtor in possession, should not be considered as an actual debt claim but rather as an equity interest.[1] The result of such a ruling is that the recharacterized claim is subordinated to *all* the debt claims of (other) creditors and is treated *pari passu* with the claims of the equity holders.

Recharacterization is often considered a confusing device, probably because it shows some similarities with another instrument used by bankruptcy courts, namely the "equitable subordination". Quite surprisingly, even some bankruptcy courts have shown a certain degree of uncertainty in determining whether certain claims had to be recharacterized or equitably subordinated, with the result that some courts have recharacterized claims that other would equitably subordinate.[2] However, once the proper role of recharacterization has been understood,

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[1] It is worth noting that a minority of the bankruptcy courts does not recognize the authority to provide such a relief. See e.g., *In re Outboard Marine Corp.*, 50 Collier Bankr. Cas. 2d (MB) 931, 2003 WL 21697357 (N.D. Ill. 2003); In re *AutoStyle Plastics, Inc.*, 269 F.3d 726, 748, 45 U.C.C. Rep. Serv. 2d 964, 2001 FED App. 0378P (6th Cir. 2001) (citing *In re Cold Harbor Associates*, L.P., 204 B.R. 904, 915, 30 Bankr. Ct. Dec. (CRR) 336, 37 Collier Bankr. Cas. 2d (MB) 753 (Bankr. E.D. Va. 1997), all cited in 2004 Annual Survey of Bankruptcy Law, Sprayregen, Friedland, Brighton, Bianca, *Recharacterization of Debt to Equity: An Overview, Update, and Practical Guide to an Evolving Doctrine*, footnote 3.

[2] Matthew Nozemack, Note, *Making Sense Out of Bankruptcy Court's Recharacterization of Claims Why Not Use Section 510(c) Equitable Subordination?* 56 Wash. & Lee L. Rev. 689, 716 (1999). See also *In re AutoStyle Plastics,*

the distinct purpose of equitable subordination and recharacterization becomes clear and confusion can easily be avoided.[3]

In brief, recharacterization and equitable subordination come into play at different stages and serve different purposes. The former is used to determine whether a purported debt claim actually exists (or should rather be considered as an equity interest), while the latter is used to subordinate an actually existing debt claim to those of other creditors, because of some inequitable conduct engaged into by the subordinated creditor, and only to the extent necessary to remedy to the inequitable conduct.[4] Thus, when (and only if) a claim is recognized as being an existing debt claim, equitable subordination may be considered. In other words, if a claim is recharacterized, equitable subordination never comes into play.[5] An important difference between recharacterization and equitable subordination is that the former, unlike the latter, does not require any finding of inequitable conduct on behalf of the "lender". Therefore, recharacterization exclusively involves the determination by a court that a transaction that the parties have characterized as debt should be actually treated as an equity contribution.[6]

It is important to note that the 3rd U.S. Circuit Court of Appeals, in the opinion of *In re Submicron Systems Corporation*,[7] citing a dicta of the U.S. Supreme Court in *Pepper v. Litton*, held that the bankruptcy court's 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 does not give way to form and that technical considerations do not prevent substantial justice from being done*.[8] The interplay between substance and form in the context of recharacterization will be discussed again in Part III of this Paper.

Inc., 269 F.3d 726, 748, 45 U.C.C. Rep. Serv. 2d 964, 2001 FED App. 0378P (6th Cir. 2001).

[3] 2004 Annual Survey of Bankruptcy Law, cit., p. 3.

[4] *In re AutoStyle Plastics, Inc.*, 269 F.3d 726, 747, 45 U.C.C. Rep. Serv. 2d 964, 2001 FED App. 0378P (6th Cir. 2001). See also 2004 Annual Survey of Bankruptcy Law, cit., footnote 11 and accompanying text.

[5] LLBL 6.03A, 2010 WL 3878862; *In re Georgetown Bldg. Associates, Ltd. Partnership*, 240 B.R. 124, 137, 35 Bankr. Ct. Dec. (CRR) 95, 42 Collier Bankr. Cas. 2d (MB) 1946, 42 U.C.C. Rep. Serv. 2d 1050 (Bankr. D. D.C. 1999). See also 2004 Annual Survey of Bankruptcy Law, cit., footnote 12 and accompanying text.

[6] See 2004 Annual Survey of Bankruptcy Law, cit., footnote 59 and accompanying text.

[7] 432 F.3d 448, 455-56 (3d Cir. 2006).

[8] 308 U.S. 295, 305, 60 S.Ct. 238, 84 L.Ed. 281 (1939), emphasis added.

III. THE MULTI-FACTOR TESTS

The major difficulty in determining a clear standard for recharacterization is probably due to the fact that courts employ many different standards of review, without clear indications about what elements – or group of elements – should have prominent relevance. On the contrary, courts say that all the factors taken into account must be weighted as a unique group, so that none of them should be decisive. Recharacterization requires a fact intensive analysis and courts usually prefer to have a case-by-case approach, rather than developing a rigid doctrine to be applied to all cases. Even if such a flexible approach seems appropriate in the context of recharacterization, its inevitable result is uncertainty: insiders willing to provide cash to a struggling corporation are left without clear indications as to whether their advance will be characterized as equity or debt.

In *AutoStyle Plastic* the court applied an 11-factor test derived from a tax case, *Roth Steel Tube*, in which the issue was recharacterization of tax claims.[9] These are the most commonly accepted factors used by courts to evaluate whether a claim should be recharacterized. In listing these factors this Paper will not follow the order used by the *AutoStyle Plastic* court because, for the purposes hereof, it seems more useful to divide such factors in three categories, on the basis of the different elements on which each category focuses, namely: (1) the formalities of the alleged loan agreement; (2) the financial situation of the company and how the parties actually treated the advance, and (3) the relationship between the creditor and the debtor.[10]

The first group includes those elements that may be referred to as the "formal factors"; their purpose is to evaluate whether the transaction respects the formalities of proper debt transaction. Factors in this group are: (i) the name given by the parties to the instruments, if any, evidencing indebtedness; (ii) the presence of a fixed maturity date and schedule of payments; (iii) the presence of an interest rate and interest payment; (iv) the security, if any, provided by the borrower; (v) the extent to which the claims were subordinated to those of outside creditors; and (vi) the presence of a sinking fund to provide repayments.

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[9] *Roth Steel Tube Co. v. C.I.R.*, 800 F.2d 625, 86-2 U.S. Tax Cas. (CCH) ¶ 9676, 58 A.F.T.R.2d 86-5808 (6th Cir. 1986).

[10] These categories are a re-elaboration of those described by Matthew Nozemack, Note, cit., 709.

The second group includes: (i) adequacy of the capitalization of the company; (ii) the sources used for the repayments; (iii) the extent to which advances were used to acquire capital assets; and (iv) the corporation ability to obtain outside financing.

The third group is composed by a sole factor among those elaborated in *AutoStyle Plastic*, namely the identity of interest between the creditor and stockholder. In addition to this, however, the court of *In re Outboard Marine Corporation* elaborated two factors that can be properly included in the third group: (a) the ratio of shareholder loans to capital; and (b) the amount or degree of shareholder control.[11]

For the purposes of this Paper, the factors falling into groups two and three shall be collectively referred to as the "substantial factors".

1. THE ROLE OF THE FORMAL FACTORS

With regard to the formal factors one could wonder: why should courts use them in determining whether a claim is debt or equity? In other words, what function do these factors serve? If we move form a presumption that the parties acted in good faith, the formal factors may be seen as a tool used in order to determine the actual intent of the parties with respect to their agreement. One could argue that, if the parties called the relevant instruments with names evidencing a debt transaction, provided for collaterals to secure the repayments and so on, they actually wanted to conclude a debt transaction and, therefore, the court should not recharacterize it as debt.

However, a more pragmatic approach suggests that the formal factors have very little effectiveness, if any, in discovering the actual intent of the parties. To the contrary, if courts relied too much on them, it would become relatively easy for sophisticated parties to obviate the court's scrutiny. This could be done by simply executing a "loan" agreement which provides for: (i) a fixed (but illusory) maturity date; (ii) a fixed interest rate (payment for which can be deferred until the maturity date); and (iii) the granting of securities for the advance. The unsecured creditors would then be left with the difficult task of uncovering a "smoking gun" that demonstrates that the true intent of the parties

[11] These factors have been elaborated by the court of *In re Outboard Marine Corp.*, 50 Collier Bankr. Cas. 2d (MB) 931, 2003 WL 21697357 (N.D. Ill. 2003) and derived from *In re Hyperion Enterprises*, Inc., 158 B.R. 555, 29 Collier Bankr. Cas. 2d (MB) 1281, 24 U.C.C. Rep. Serv. 2d 670 (D.R.I. 1993).

was different.[12] The inevitable result would be that recharacterization claims would almost always be rejected, if ever brought to courts.

An example of a situation of this kind can be found in *AutoStyle Plastic*, precisely in the part of the opinion where the court analyzes the presence of a fixed interest rate and interest payments.[13] The court says that the agreement provided *ab initio* for both an interest rate and interest payments. The parties subsequently agreed to defer interest payments. However, according to the court, this factor is not indicative of equity but, at best, it "cuts both ways, since the deferral of interest payment indicates the possibility that during the course of the transaction the defendants eventually never expected to get repaid and converted their debt to equity. Still, it does not change the fact that, initially at least, there was a fixed rate and interest payments, *indicating that the transaction was originally intended to be debt, not equity*."[14] Thus, according to the court, (a) the original intent of the parties may be inferred by an analysis of the formal factors and, (b) even if the parties eventually acted inconsistently with the intentions stated in the transaction documents, this simply means that they changed their mind during the course of the transaction. However, the court, relying on *In re Cold Harbor*, stated that such change in the intent of the parties should not be taken into account because "recharacterization applies to transactions that were equity contributions *ab initio*".[15]

Conversely, the court of *Submicron System* held that the determinative inquiry in classifying advances as debt or equity is the intent of the parties *as it existed at the time of the transaction*.[16] In this case, the court (which included now Supreme Court Justice Alito) refused to apply a multi-factor tests and, rather, focused more generally on the intent of the parties. The court stated that the multi-factor tests undoubtedly include pertinent factors, but they devolve to an overreaching inquiry: the characterization as debt or equity is a court's attempt to discern whether the parties *called an instrument one thing* when in fact *they intended it as something else*. Then the court goes on saying that the intent of the parties may be inferred, among other things, also *from what they say in their contracts*.[17] However, thereafter the court adds that *form is no doubt a factor, but in the end*

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[12] Michael Klein, Ronald R. Sussman, *Recharacterization Battles Likely in Next Round of Bankruptcies*, Turnaround Management Association, 5.

[13] *AutoStyle Plastics, Inc.*, 269 F.3d 726, 751.

[14] Ibid., emphasis added.

[15] Ibid.

[16] 432 F.3d 448, 457 (3rd Cir. 2006).

[17] *In re Submicron System Corporation*, 432 F.3d 448, 456 (3rd Cir. 2006).

it is no more than an indicator of what the parties actually intended and acted on. In the same page of the opinion, the court also recognizes that no mechanistic scorecard suffices and that answers lie in facts that confer context case-by-case. It is worth to underline that the other two elements mentioned by the court as indicators of the parties' intent are: (i) what the parties do through their actions and (ii) the economic reality of the surrounding circumstances, which indeed appear to be more powerful tools than a mere review of the formalities set up by the parties. Interestingly, as will be discussed in Section 2 below, these two elements may actually be included among the substantial factors according to the classification described above in this Paper.[18]

An increased focus on the substantial elements of the transaction is clearly shown by the Courts of Appeal for the Eleventh and Fifth Circuits in some tax cases.[19] In these cases, the courts employed a 13-factor test, very similar to the *AutoStyle Plastic* test, with the significant difference that they mentioned the "intent of the parties" as a distinct and additional factor with respect to the formal ones. In particular, in *Estate of Mixton* the court draws a distinction between the *subjective* and *objective* intent of the parties.[20] According to the court, the parties' intent to create either a debt or equity relationship is the ultimate issue to be determined. However, the court goes on, notwithstanding their *subjective* belief, the parties may *objectively* manifest their intent through their actions, also taking into account the economic reality in which they acted. Therefore, the crucial point of this issue is understanding whether the *subjective* intent of the parties, as expressed in the corporate documentation, should be disregarded in characterizing the transaction. The answer of the court to this question is that there is a well-recognized principle in all areas of the law: that a *subjective* intent on the part of an actor will not alter the relationship or duties created by an otherwise *objectively* indicated intent. This approach clearly recalls a *substantial* way of thinking of recharacterization, indicating that the substantial factors should have prominent importance in order to infer the (objective) intent of the parties.[21] In other words, the actual behavior of the parties, in connection with the economic reality in which they acted, can say more about their intent than the facial appearance of the transaction. This is what the court implies when, citing *Tyler v.*

[18] See pages 3-4 above.

[19] *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)) both cited in *Submicron System*.

[20] *Estate of Mixon v. United States,* cit., 407.

[21] This issue will be discussed in further detail in Section 2.1. Furthermore, as will be discussed in Section 2.2 below, this Paper suggests that some of the substantial elements should also be taken into account in determining the level of *dangerousness* of the transaction with respect to the rights of outside *bona fide* creditors.

Tomlinson,[22] it says that law requires that creditorship have genuine existentiality and that "*this requires more than a declaration of intention to create an indebtedness and more than the existence of corporate paper encrusted with the appropriate nomenclature captions*".[23]

In the same line of reasoning, in *Stinnett's Pontiac* the court, recalling somehow the wording of the Supreme Court in *Pepper v. Litton*, says that to hold that the *subjective* intent of the parties should prevail over their *objective* intent would be to ignore the plain facts and to elevate form over substance.[24]

Thus, if – as suggested above – the formal factors should not be considered in order to determine the intent of the parties, what is their proper role in the context of recharacterization? Should courts continue to take into account these elements?

A possible answer to these questions might be that, due to the scarce effectiveness these factors have in understanding the real nature of a transaction, courts should give them a more limited consideration. In particular, the suggestion is that these factors should be treated as "negative" factors, meaning that their *presence* should be generally seen as a (very weak) indication of a debt transaction, but only if the analysis of the substantive aspects of the transaction points to the same conclusion; conversely, their *absence* should be seen – of course always in the light of the other factors – as a strong indication of an equity contribution, especially (or maybe even exclusively) in the context of a transaction between *sophisticated parties*, which would very unlikely enter into a real debt transaction without the proper transaction documentation and adequate guarantees in place. This seems particularly evident, for example, if we think about elements such as: (i) the name given by the parties to the instruments, if any, evidencing indebtedness; (ii) the presence of a fixed maturity date and schedule of payments; (iii) the presence of an interest rate and interest payment; (iv) the security provided by the borrower; or (v) the presence/absence of a sinking fund.

2. THE ROLE(S) OF THE SUBSTANTIAL FACTORS

As discussed above, the other groups of factors elaborated in *AutoStyle Plastic* and in *Outboard Marine* include the following elements:

[22] *Tyler v. Tomlinson,* 414 F.2d at 850.

[23] *Estate of Mixon v. United States,* cit., 407.

[24] *Stinnett's Pontiac,* cit., at 639 (citing *Tyler v. Tomlinson*, cit., at 850).

- the financial situation of the company and how the parties actually treated the advance, including:
    a. the adequacy or inadequacy of capitalization;
    b. the sources used for the repayments;
    c. the extent to which advances were used to acquire capital assets;
    d. the corporation ability to obtain outside financing; and

- the relationship between the creditor and the debtor, including:
    e. identity of interest between the creditor and stockholder;
    f. the ratio of shareholder loans to capital; and
    g. the amount or degree of shareholder control.

Instead of describing individually each of the substantial factors, this Paper will analyze them as a unique group, in the light of the collective role(s) they can assume in a recharacterization analysis.

2.1 The intent of the parties

As discussed in Section 1. above, the substantial factors can be used by courts for determining the real intent of the parties in connection with a given transaction. Some courts, following the approach indicated by *Submicron System*, are starting to refuse the application of a multi-factor test, while privileging a case-by-case approach that can lead to a *common sense* evaluation of the facts and circumstances surrounding a transaction.[25] However, as we have already seen, such *common sense* approach will not differ too much, and probably cannot prescind from, an analysis of at least some of the substantial factors, in particular (i) what the parties do through their actions and (ii) the economic reality of the surrounding circumstances.[26]

In this context, certain substantial factors may assume a particular relevance. For example, in order to be able to characterize a claim as an equity interest, it is necessary to find an identity of interest between the creditor and stockholder: it would be unreasonable to think that an external lender, simply because has provided money to a struggling company, actually intended to realize an equity contribution into such company. However, the insider status of the lender alone would have little meaning, if it is not put in connection with the overall relationship between lender(s) and borrower. For instance, if shareholders advance money to the corporation in proportion to their respective

[25] *Radnor,* 353 B.R. 820, 838; 2006 Bankr. LEXIS 3699, 36.

[26] See text accompanying footnote 21 above.

equity interests, this evidence standing alone is almost overwhelming in showing that, with the loan, the parties actually intended to conceal an equity contribution.[27] Conversely, if there is a disproportionate ratio between the lender's equity interest in the corporation and the loan, there is an indication of *bona fide* debt.[28] Also, if the amount of control exercised by the lender on the corporation is increased as a result of the transaction the courts will probably characterize the latter as equity contribution.[29] More generally, any time a lender obtains the right to control the company's operations, the court considers the transaction an equity contribution.[30]

The intent of the parties may also be inferred by the analysis of the way they expect the borrower to use the advances and of the way they expect such advances to be repaid. As to the first issue, generally courts deem that the use of advances to meet the daily operating needs of the corporation, rather than to purchase capital assets, is indicative of *bona fide* indebtedness.[31] However, it must be noted that in one case the court read the same circumstances in a completely opposite manner, holding that the debtor was in need of working capital and that, therefore, the parties' intent was to provide an equity contribution.[32] As to the issue of the source of repayment, the general rule is that if the expectation of repayment depends solely on the success of the borrower's business, the transaction has the appearance of a capital contribution.[33] The reason for this rule is clear: if the capital provided is treated by the parties as "risk capital", then the "lender" cannot escape the inherent consequences of business ownership by labeling its investment as "loan". Consistently, the court of *In re Phase-I Molecular Toxicology* was persuaded that the transaction was a loan and not an equity contribution, *inter alia*, by the fact that the intended repayment was expected to be received from the sale of assets and, therefore, was not entirely dependent on the future success of the debtor's business.[34]

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[27] *In re Cold Harbor,* 204 B.R. at 919.

[28] *AutoStyle Plastics, Inc.*, 269 F.3d 726, 751.

[29] See *Estate of Mixon*, 464 F.2d 394, 406 (5th Cir. 1972) (noting that when debtor grants creditor participation in management as result of advances, management participation is evidence of capital contribution by creditor); *Cold Harbor*, 204 B.R. at 917 (observing that one characteristic of equity contribution is participation in management), both cited in 2004 Annual Survey of Bankruptcy Law, cit., at 711.

[30] Matthew Nozemack, Note, cit., at 711.

[31] *AutoStyle Plastics, Inc.*, 269 F.3d 726, 752 (citing *Roth Steel Tube*, 800 F.2d 625, 632).

[32] *Matter of Transystems, Inc.*, 569 F.2d 1364, 1370 (5th Cir. 1978).

[33] *AutoStyle Plastics, Inc.*, 269 F.3d 726, 751 (citing *Roth Steel Tube*, 800 F.2d 625, 631).

[34] *In re Phase-I Molecular Toxicology*, 287 B.R. 571, 577, 49 Collier Bankr. Cas. 2d (MB) 1375 (Bankr. D. N.M. 2002).

2.2 Protection of outside creditors

As discussed above, several bankruptcy courts relied on substantive factors in order to determine the actual intent of the parties. However, the role of such factors should not be limited to this. Courts have often relied on these factors also in order to determine the *degree of dangerousness* of a transaction with respect to the outside *bona fide* creditors of the company.

Trying to simplify the issue as much as possible, the equity capital of a company may be regarded as a minimal and basic protection granted to: (i) unsophisticated third parties that decide to deal with a company but cannot or do not want to provide independently for more intensive tools (e.g., trade creditors);[35] or (ii) involuntary creditors of the company (e.g., holders of a credit deriving from a damage claim). Many legal systems, especially those of European civil law Countries, set forth specific rules on the constitution of the corporate capital and its minimum amount, which vary depending on the kind of corporate entity and on the industry in which the latter is involved (i.e., the minimum amount of capitalization increases according to the presumed magnitude of the activities carried out and the inherent amount of risk with respect to third parties). The adoption of rules on minimum capitalization is perhaps more justified in civil law systems, where judges prefer to enforce relatively bright-line rules, rather than developing standards for the protection of corporate creditors, such as fiduciary duties, piercing the veil, fraudulent conveyance, equitable subordination, recharacterization, and other instruments developed in common law jurisdictions.[36]
Although the balance points between the privilege of limited liability and a fair use of the corporate entity vary from one to the other legal system, in any case, the ultimate goal may be considered as similar: preventing shareholders from avoiding the responsibilities and risks related to entrepreneurial activities by unfairly manipulating the corporate instruments to their advantage[37].

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[35] Marcus Lutter, *Das Kapital der Aktiengesellschaft in Europa*, 2006, p. 643.

[36] Ibid., p. 653.

[37] For a comparative corporate governance perpspective see: Dooley M.P., *Two Models of Corporate Governance*, in Bus. Law., 1992, n.48, p. 470; Enriques L., *Codici di Corporate Governance, diritto societario e assetti proprietari: alcuni aspetti preliminari*, in Banca Impr. Soc., 2003, n.1, p. 97; - Hopt K.J., Kanda H., Roe M.J., Wymeersch E., Prigge S. (edited by), *Comparative Corporate Governance - The State of Art and Emerging Research* - , Oxford,1998; Mattei U., Sartori F. , *Conflitto continuo. A un anno da Enron negli Stati Uniti e in Europa* in Politica del diritto, anno XXXIV, 2003 p. 177; Visentini G., *Compatibility and Competition between European and American Corporate Governance: Which Model of Capitalism*?, in Brook. J. Int'l L., 1998, n.3, p. 833; B. Cheffins, *The History of Corporate Governance*, ECGI Law Working Paper No. 184/2012, January 2012; K. Hopt, *Corporate Governance of Banks after the Financial Crisis*, ECGI Law Working Paper No. 181/2011, September 2011; K. Hopt, *Comparative Corporate Governance: The State of the Art and International Regulation* ECGI Law Working Paper No. 170/2011, November 2010.

With respect to recharacterization, the undercapitalization of the borrowing company is constantly seen by bankruptcy courts as an index of a suspicious transaction. Doctrinally, undercapitalization may be divided into two categories: “nominal” and “material” undercapitalization. A corporation is “nominally undercapitalized” when, even though it actually has sufficient financial means to pursue its corporate purpose and to face its obligations towards outside creditors, such financial means are mainly provided by the shareholders as debt capital, rather than as “risk capital” (i.e., equity, which is instead provided to an insufficient extent). Conversely, a corporation is “materially undercapitalized” when both equity and debt contributions are insufficient, with the result that the corporation is unable to face its obligations as they become due.[38]

It is useful to bear in mind that the event that triggers the possibility to bring a claim for recharacterization is the initiation of a bankruptcy proceeding, meaning that the corporation, at a certain moment in its life, became “materially undercapitalized”. However, when bankruptcy courts analyze the capitalization of a corporation in order to understand whether it is adequate or inadequate, they implicitly refer to the concept of “nominal undercapitalization”, which is generally seen as a strong evidence of an equity contribution. For example, the court of *In re Cold Harbor* stated that the issue of undercapitalization is particularly important when the corporation is started by the shareholders with a minimal amount of capital who then make a large loan of money to the newly formed corporation.[39] Also, in *Pepper v. Litton* the U.S. Supreme Court stated that so-called loans or advances by a dominant or controlling shareholder will be subordinated to claims of other creditors, and thus treated as capital contributions, where *the paid-in capital is purely nominal*, the capital necessary for the scope and magnitude of the operations of the company being furnished by the stockholders as a loan.[40] In such cases, the Supreme Court goes on, shareholders should not be allowed to manipulate the corporate device in order to avail themselves of privileges normally permitted to outside creditors. From these decisions it can be inferred that, for a transaction to be characterized as equity, it is not necessary that the borrower was materially undercapitalized, being it is also sufficient that there was an ongoing situation of nominal undercapitalization before the relevant transaction was carried out.

The definition of inadequate capitalization adopted by some U.S. bankruptcy courts somehow recalls the same policy reasons underlying the rules on minimum corporate capital of civil law

[38] G.B. Portale, Rivista delle società, n. 1/1991, *Capitale sociale e società per azioni sottocapitalizzata*, 29.

[39] *In re Cold Harbor*, 204 B.R. at 917.

[40] *Pepper v. Litton*, cit. at 309-310.

systems: the higher is the risk for third parties in connection with the activities carried out by the corporation, the higher must be the capitalization. For instance, the court of *Diasonics, Inc. v. Ingall* stated that capitalization is inadequate if, in the opinion of a skilled financial analyst, it would definitely be insufficient to support a business of the size and nature of the bankrupt in light of the circumstances existing at the time the bankrupt was capitalized.[41]

The efforts to protect outside creditors have been brought to extreme consequences by some courts, which held that shareholder loans may be deemed capital contribution in one of two circumstances: (i) where the plaintiff proves initial undercapitalization; or (ii) where the plaintiff proves that the loans where made when no other disinterested lender would have extended credit.[42] In particular, the court of *Diasonics* held that this is the appropriate standard of review to be applied in the 11th Circuit.[43] Interestingly, these two circumstances are not cumulative, therefore in order to recharacterize a claim in the 11th Circuit, it is sufficient that only one of them is proven by the plaintiff.[44]

Furthermore, from a literal reading of the opinion, it seems sufficient that a corporation was *initially* undercapitalized in order to characterize as capital contribution any shareholder loan extended to such corporation. The following hypothetical can probably show the limits of this approach: a corporation is started with insufficient capital but, during the course of its life, is adequately capitalized with equity contributions by stockholders. After several years during which the corporation entered in dealing with third parties and regularly met its obligations, the corporation begins to suffer overwhelming losses due to deteriorated market conditions. In such a situation, an insider would probably be the only entity willing to extend credit to the corporation. In this case, the

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[41] *Diasonics, Inc. v. Ingall*, 121 B.R. 626, at 631 (citing *In re Multiponics*, 622 F.2d 709, 717 (5th Cir. 1980).

[42] *In re N&D Properties, Inc.*, 799 F.2d 726 (11th Cir. 1986).

[43] *Diasonics, Inc. v. Ingall*, 121 B.R. 626, at 631.

[44] See also *In re N & D Properties, Inc.*, 799 F.2d 726, 733, 15 Bankr. Ct. Dec. (CRR) 254, 15 Collier Bankr. Cas. 2d (MB) 726 (11th Cir. 1986) (''Shareholder loans may be deemed capital contributions in one of two circumstances: where the trustee proves initial undercapitalization or where the trustee proves that the loans were made when no other disinterested lender would have extended credit.''); *Matter of Herby's Foods, Inc.*, 2 F.3d 128, 132, 24 Bankr. Ct. Dec. (CRR) 1116, 29 Collier Bankr. Cas. 2d (MB) 1375, Bankr. L. Rep. (CCH) ¶ 75446 (5th Cir. 1993) (''[I]f an insider makes a loan to an undercapitalized corporation, the combination of undercapitalization and the insider loan may allow the bankruptcy court to recharacterize the loan as a capital contribution''); *Matter of Fabricators, Inc.*, 926 F.2d 1458, 1469, 21 Bankr. Ct. Dec. (CRR) 809, 24 Collier Bankr. Cas. 2d (MB) 1489, Bankr. L. Rep. (CCH) ¶ 73875 (5th Cir. 1991) (''When an insider makes a loan to an undercapitalized corporation, a court may recast the loans as contributions to capital").

application of a strict *Diasonics* test would certainly lead to the recharacterization of any shareholder loan extended to the corporation. In particular, a *per se* application of the second factor mentioned above would prevent any shareholder or insider from ever loaning money to a company experiencing distress.[45]

It is true that shareholders should not be left entirely free to manipulate the corporate devices as to avoid the consequences of business ownership; however, the test developed by the 11th Circuits seems to lead to undesirable results. What is then the standard of review that should be adopted by bankruptcy courts?

Furthermore, analyzing the recharacterization issue from a corporate governance point of view – considering the combination and the bi-lateral effects of inside and outside corporate governance elements and controls – it may be possible to determine whether a potential effect of recharacterization on a company's "inside" corporate governance (shareholders-directors relationships and controls) could generate a benefit also for outside creditors and other stakeholders. Part IV tries to answer these questions in the light of some policy considerations.

IV. POLICY REASONS UNDERLYING RECHARACTERIZATION

It is now time to formulate the basic policy questions underlying the issue of recharacterization. These questions are: should shareholder loans to distressed companies be permitted or prohibited? Do transactions of this kind impair the rights of outside *bona fide* creditors?[46] Does the recharacterization influence the corporate governance of the company?

The basic answer that should be given to these questions is that shareholder loans to a company facing liquidity crisis should not be *per se* prohibited. As discussed above, if a shareholder loan is the only way to keep the corporation alive and avoid bankruptcy, it seems excessive to think that shareholders should not be permitted to extend such a loan to the corporation.

An argument that could be used to justify the permissibility of shareholder loans in the abovementioned situation is that, if the corporation is facing *material* undercapitalization, a cash contribution by an insider can be beneficial also to pre-existing outside unsecured creditors. In fact, cash streams going into the company, would normally be used to meet the debtor's obligations

[45] 2004 Annual Survey of Bankruptcy Law, cit., footnote 88 and accompanying text.

[46] Furthermore, assuming that in certain circumstances shareholders are the only subjects willing to provide cash to a struggling corporation, how should the legitimate purpose of keeping the corporation alive be balanced with the rights of outside *bona fide* creditors?

toward outside creditors as they become due and, therefore, would be somehow "distributed" to them. In this context, the rule developed by *AutoStyle Plastic* – that the use of advances to meet the daily operating needs of the corporation, rather than to purchase capital assets, is indicative of *bona fide* indebtedness[47] – assumes a new significance: besides the aim of determining the parties' intent, such factor may also be used in order to evaluate whether the transaction is beneficial or detrimental to pre-existing outside creditors. In any case, without such transaction, the company would remain "materially undercapitalized" and, therefore, outside unsecured creditors would normally not be able to recover the whole amount of their respective credits from a bankruptcy proceeding.

This argument seems acceptable if analyzed in the perspective of pre-existing creditors. However, one could wonder: what happens after the shareholder loan is extended to the company? Starting from that moment, the corporation will not be *materially* undercapitalized anymore, but would then become *nominally* undercapitalized. Such corporation will then continue to deal with pre-existing creditors accumulating new indebtedness (e.g., trade creditors will probably continue to provide goods or services to the corporation) and probably will also enter into some kind of relationship with new voluntary creditors (e.g., new suppliers) or even with involuntary creditors (e.g., someone who is damaged by the corporation). In this case, the post-transaction creditors will be dealing with a *nominally* undercapitalized company and, in case of insolvency of the latter, they will concur *pari passu* with the insider-lender for the satisfaction of their credit. Actually, given that insider-lenders will usually secure their credit with a lien over (some of) the assets of the corporation, the post-transaction outside creditors will also be deprived of the value of such assets as a source for the repayment of their credit. In the context of recharacterization, this risks are not merely theoretical: it must be borne in mind that, if a recharacterization claim has been brought before a court, it means that the debtor eventually became insolvent and that there is an actual ongoing bankruptcy proceeding. In these circumstances, it is hard to argument that the shareholder loan was beneficial to post-transaction outside unsecured creditors, especially those who became creditors of the corporation in a period of time close to the beginning of the bankruptcy proceeding.

It is difficult to find the right balance between the legitimate reasons of creditors and the equally legitimate interest of stakeholders of keeping the corporation alive and protecting their initial equity interest. The *Diasonics* test is probably overreaching, given that its second prong actually prohibits any insider loan to undercapitalized entities. On the other hand, it seems reasonable to hold that if a company was undercapitalized *both* at the beginning of its life and at the time of the transaction,

[47] *AutoStyle Plastics, Inc.*, 269 F.3d 726, 752 (citing *Roth Steel Tube*, 800 F.2d 625, 632).

shareholders should not be allowed to have their claim repaid before, or *pari passu* with, outside creditors. It is worth mentioning that, consistently with the above considerations, the majority of courts does not believe that undercapitalization must be present only at the beginning of the life of the corporation. For example, the *AutoStyle Plastic* court pointed out that capitalization is not to be assessed only at the moment of initial capitalization, but also at the time when the advance was made.

Enduring undercapitalization is therefore one of the most important elements to be considered by courts, with the specification that this element should not be considered *per se* sufficient to characterize a purported debt claim as equity. In fact, the Fourth Circuit noted that a claimant's insider status and a debtor's undercapitalization alone will normally be insufficient to support the recharacterization of a claim, pointing out that "in many cases, an insider will be the only party willing to make a loan to a struggling business, and recharacterization should not be used to discourage good-faith loans."[48] An interesting approach, with respect to undercapitalization, has been taken in *AtlanticRancher*, where the court tried to put in relation the financial failure of the debtor with its “chronic undercapitalization”. One of the factors analyzed by the court was, in fact, whether or not undercapitalization was the most important cause of the debtor’s financial failure.[49] Therefore, one could argue that, if the company is deliberately kept by shareholders in a chronic condition of undercapitalization (even only nominal), when such shareholders decide – in order to remedy to a contingent situation of material undercapitalization – to extend a loan to the company, they should not be allowed to the protections of genuine creditorship if the corporation then actually goes bankrupt.

An additional element that could be – and in fact has been – evaluated by some courts is whether the loan had the character of an arm’s length transaction and, in particular, whether bankruptcy was actually evitable when the loan has been extended to the debtor. In particular, the court of *Trimble* held that at the time of the loan no financial institution would have been willing to extend credit, because the business was a “hopelessly insolvent corporate structure”.[50] If it is true that one of the policy reasons why insider loans should not be discouraged is that they may be the only means to keep a distressed corporation alive, then it is also true that, if from an *ex-ante* evaluation of the

[48] 28-2 ABIJ 42, 42-43, citing *In re Official Committee of Unsecured Creditors for Dormer Aviation* (N. Am.) Inc., 453 F.3d 225, 234 (4th Cir. 2006).

[49] *In re AtlanticRancher, Inc.*, 279 B.R. 411, 436 (Bankr. D. Mass. 2002).

[50] *In re Trimble Co.*, 479 F.2d 103, 118 (3d Cir. 1973).

overall circumstances – the corporation seems to be "hopelessly insolvent", the insider should not be encouraged to extend a useless loan to such a corporation. One of the elements that could be considered in order to determine whether the insider-lender was aware (or ought to be aware) of the inevitability of bankruptcy could be the closeness of the transaction to the actual beginning of the bankruptcy proceeding. Even if it would be risky to give too much relevance to such a temporal factor, it seems certainly reasonable to think that a shareholder loan extended on the verge of bankruptcy should be subject to careful judicial scrutiny.

The above mentioned conclusions have also an impact on the corporate governance of corporations. Notably, corporate governance systems around the world are converging towards the long-term growth of the companies because corporate managers' obsession with short-term shareholder wealth maximization has, in many instances, diverted their attention from the efficient operation of their companies. In order to make the company profitable in the long run, corporations need to invest capital in the long-term endeavours, which often have a significant time lag between the time of investment and the eventual returns.

Therefore, assuming that companies should be managed with a long-term view, whenever equity prevails over debt, corporate managers could pursue the creation and preservation of the sustainable economic long-term growth of their company because the interest represented by the stock is generally of unlimited duration[51] – so allowing directors to invest in long-term strategies – while short loan duration is generally preferred by lenders to limit the danger to debtholders of wealth transfers to equityholders resulting from investment and dividend decisions.[52]

In a nutshell, legal devices like the practice of recharacterization of debt to equity better stimulate better corporate governance by helping management and directors to act with a long-term focus. And, moving the lens back to the global corporate governance overview, this also means that a "two-tier benefit" could reach the outside creditors of the corporation: on one hand, a device such as recharacterization directly protects the corporation's capitalization, on the other hand, long-term corporate strategies, focusing on the corporation's stability and development process[53], provide an

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[51] In other words, there is usually no initially agreed-upon point in time when a common shareholder becomes entitled to demand the return of his or her initial contribution or some other amount.

[52] William A.Klein, John C.Coffee Jr., Frank Partonoy, Business Organization and Finance, Foundation Press, New York, 2010, 282.

53 Also considering the potential economic impact of corporate governance, as reflected in R.J. Gilson, *Corporate Governance and Economic Efficiency: When do Institutions Matter*, in Washington University L. Q., 1996, vol. 74, p. 327. For general economic causes and effects of corporate governance see F.H Easterbrook, D.R. Fischel, *The Economic Structure of Corporate Law, Harvard University Press*, Cambridge (MA), London 1991.

indirect protection for outside creditors and for the qualified interests of the stakeholders in general[54].

IV. CONCLUSION

There is no magical formula that can be provided in the context of recharacterization; every solution one can elaborate will certainly have its merits and flaws. Some standards of review may be too rigid and overreaching (such as the *Diasonics* factors) and some others are probably too loose (such as those standards that give too much relevance to the formal factors).

An acceptable mean solution can perhaps be found in those standards of review that refuse a mechanical application of the multi-factor tests and privilege a comprehensive approach that can lead to a *common sense* evaluation of the facts and circumstances surrounding a transaction.[55]

As already discussed, some of the factors developed by courts – in particular those referred to above as "substantial factors" – shall certainly be helpful in reaching such a common sense understanding of the transaction; mainly because these elements may be used to infer the *objective intent* of the parties. In this context, it seems helpful to take into account, without limitations: (i) the ratio between shareholder loan and equity interest; (ii) the amount of control exercised by the lender pre and post transaction; and (iii) the source of repayments.

Courts should also take into account the policy principles underlying recharacterization and, therefore, consider whether: (aa) streams of cash deriving from the transaction are used by the borrower to finance its day-by-day operation (including, *inter alia*, payment of payrolls or trade debts as they become due), rather than to purchase capital assets; (bb) undercapitalization seems to derive from temporary contingencies or seems to be *chronic* and *deliberate*; and (cc) the insider-lender, at the time of the facts, could reasonably believe that the transaction could actually be used to avoid bankruptcy.

In any case, when an insider cannot be relatively sure that its loan would not be recharacterized as debt, the only solution that may grant an acceptable degree of certainty would be to extend a loan

[54] Considering the stakeholder definition as "any group or individual that can affect or be affected by a company's purpose", or "the community from which the business draws its resources", given by R. Edward Freeman, *Strategic management: a stakeholder approach*, Cambridge University Press, 2010. See also R. Edward Freeman, W. Evan, *A stakeholder theory of modern corporation: the Kantian capitalism*, in Ethical Theory and Business, 1988.
[55] *Radnor,* 353 B.R. 820, 838; 2006 Bankr. LEXIS 3699, 36.

with court approval after the business files a petition for reorganization (or a combination of a capital infusion with a debt restructuring, commonly referred to as Shared Pain Restructuring).[56] By proceeding in this manner, insiders not only avoid the risk of recharacterization, but also may obtain a first priority as an administrative expense.[57] This solution would certainly lead to an increase in the number of filings for bankruptcy, but would also ensure – through the authority of bankruptcy courts – a reasonable balance between the need to preserve the value of the going concern and the protection of the rights of pre-existing and post-restructuring outside creditors.

Last but not least, judicial tools that legitimate and expand the recharacterization of debt to equity indirectly influence the long-term growth of the company because – extending the duration of its financial resources - allows directors to manage their enterprises in a manner that emphasizes the long-term over the short-term.

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[56] 2004 Annual Survey of Bankruptcy Law, cit., p. 28.

[57] Bankruptcy Law Manual § 6:66 (5th ed.), BKRLAWML § 6:66.