Bankruptcy Risks for Secured Creditors: Equitable Subordination and Recharacterization

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Many estate representatives and creditors pursue claims against creditors for equitable subordination and recharacterization. The claims are often asserted for claims allowance purposes or in conjunction with a number of claims against the creditor. While equitable subordination and recharacterization claims are frequently brought together and may have the similar effect of subordinating payment on a claim, they are different claims. Not only do they have different elements, but the remedies for each differ significantly.

I. Equitable Subordination: Subordinating an Allowed Claim.

Equitable subordination is based in statute. Section 510(c) of the Bankruptcy Code provides:

> (c) Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may—
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> (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 . . . .[1]

The statute provides a few elements of the claim. First, equitable subordination only applies to "allowed" claims. Thus, the validity of a claim is not in issue. Instead, the question is only what priority the claim will have for purposes of distribution.[2] Because the remedy depends on the existence of a distribution, courts have dismissed equitable subordination claims where there is no distribution in the underlying case.[3] Second, the statute provides that a court may subordinate a claim after "notice and a hearing," meaning that any subordination does not occur until the bankruptcy court rules.[4]

A. *Mobile Steel* Elements.

The Bankruptcy Code does not specify what circumstances warrant subordination of an allowed claim to one or more other allowed claims, but courts have filled in the gap through case law and interpretation. The analysis for equitably subordinating a claim is not focused on the nature of the transaction, but instead on the creditor's conduct.[5] In order to hold that a claim should be subordinated, most courts, including the Fourth Circuit, require the existence of the following three factors established by the Fifth Circuit in *Matter of Mobile Steel Co*.:

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1 11 U.S.C. § 510(c)(1).

2 *Antioch Co. Litig. Tr. v. Morgan*, 633 Fed. Appx. 296, 301 (6th Cir. 2015); *see also In re: Dornier Aviation (N. Am.), Inc.*, 453 F.3d 225, 232 (4th Cir. 2006).

3 *Nat'l Emergency Serv. v. Williams*, 371 B.R. 166, 168–69 (W.D. Va. 2007) (affirming bankruptcy court's dismissal finding statute inapplicable in case with no distributions).

4 11 U.S.C. § 510(c)(1).

5 *Dornier Aviation (N. Am.)*, 453 F.3d at 232.

1. The claim holder engaged in inequitable conduct;

2. The misconduct caused injury to one or more creditors or conferred an unfair advantage on the claim holder; and

3. Subordination is not inconsistent with the Bankruptcy Code.[6]

The courts have further elucidated the proof required for each factor.

1. Inequitable Conduct.

While the United States Supreme Court has not required evidence of a creditor's misconduct before equitable subordination can be ordered,[7] the lower courts deem some kind of "fault" a necessary element of the cause of action that is required in all but rare circumstances.[8] The fault required for a finding of "inequitable conduct" requires more than the appearance of inequity or a detriment, and the level of scrutiny used to evaluate the conduct to determine whether it meets the standard varies depending on whether the creditor at issue is an insider or a non-insider.

a. Insiders

The term "insider" is defined under the Bankruptcy Code. For corporate debtors, "insiders" include several categories of individuals and entities.[9] Some courts have analyzed a person or entity merely holding stock as an "insider" for purposes of equitable subordination.[10] In addition, a party may be deemed a "non-statutory insider" where its relationship to the debtor is sufficiently close to exercise control or influence over the debtor.[11] The key trait of insiders is their ability to control or have access to the debtor such that they have more opportunities to engage in inequitable conduct or negotiate transactions that are not at arm's length.[12] Because of this trait, an insider's conduct is subject to heightened scrutiny for equitable subordination claims.[13]

Nevertheless, a creditor is not strictly liable simply because it is an insider.[14] Thus, for an insider's conduct to rise to the level required for equitable subordination, there must be proof of "(1) fraud, illegality, and breach of fiduciary duties; (2) undercapitalization; or (3) claimant's

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6 *Matter of Mobile Steel Co*., 563 F.2d 692. 699–700 (5th Cir. 1977); *In re ASI Reactivation, Inc*., 934 F.2d 1315, 1321 (4th Cir. 1991) (citing *Mobile Steel* for factors).

7 *U.S. v. Noland*, 517 U.S. 535, 543 (1996).

8 *Nat'l Emergency Serv*., 371 B.R. at 170 (citing cases and noting no-fault equitable subordination limited to tax penalties, stock redemption claims, and punitive damages claims).

9 11 U.S.C. § 101(31)(B)(i)-(vi); *Va. Broadband, LLC v. Manuel*, 538 B.R. 253, 261 (W.D. Va. 2015).

10 *In re AutoStyle Plastics, Inc.*, 269 F.3d 726, 745 (6th Cir. 2001).

11 *Spradlin v. Monday Coal, LLC (In re Licking River Mining, LLC)*, 571 B.R. 241, 253 (Bankr. E.D. Ky. 2017).

12 *Id*.; *AutoStyle Plastics*, 269 F.3d at 745.

13 *AutoStyle Plastics*, 269 F.3d at 745.

14 *See AutoStyle Plastics*, 269 F.3d at 745 ("We note that 'the mere fact of an insider relationship is insufficient to warrant subordination.'"); *Va. Broadband*, 538 B.R. at 264 (insider-creditor status does not automatically warrant equitable subordination); *In re ASI Reactivation*, 934 F.2d at 1321 ("There is nothing in the bankruptcy act which per se forbids a principal from obtaining and asserting rights as a lien creditor."); *In re Dornier Aviation (N. Am.) Inc.*, 2005 WL 4781236, at *16 (Bankr. E.D. Va. Feb. 8, 2005), *subsequently aff'd sub nom. In re: Dornier Aviation (N. Am.), Inc.*, 453 F.3d 225 (4th Cir. 2006) ("[S]imply because a creditor is an insider does not warrant subordination of an otherwise valid claim.").

use of the debtor as a mere instrumentality or alter ego."[15] Not surprisingly, equitable subordination of an insider's claim often arises alongside breach of fiduciary duty claims, such as mismanagement, fraud, self-dealing, or other breaches.[16]

After a creditor establishes the amount and validity of its claim under Bankruptcy Rule 3001(f), the burden of proof rests initially with the plaintiff to satisfy the *Mobile Steel* elements.[17] In the case of an insider defendant, the plaintiff must present material evidence of unfair conduct.[18] This requires a showing of "a substantial factual basis for subordination."[19] If the plaintiff provides the requisite evidence, the burden shifts to the defendant creditor to prove good faith and fairness in the conduct or an arms-length transaction.[20] This is very similar to the burden shifting for a fiduciary duty claim.

Examples of conduct sufficient to meet the plaintiff's burden include (i) an insider acting to protect its creditor position, including by hiding assets from other creditors, without authorization and board approval[21] and (ii) an insider who advances funds and obtains liens on the debtor's most valuable assets, "leap-frogg[ing]" the debtor's other unrelated creditors.[22] These instances are distinguished from transactions that resemble arms-length transactions, such as where a creditor-insider purchases existing secured debt or where the insider's actions are independently approved, or are not rejected, by the debtor's informed board.[23]

b. Non-insiders

The conduct of non-insider creditors is subject to less exacting scrutiny than that of insider creditors.[24] In addition, the party seeking subordination must prove the egregious conduct with particularity by a preponderance of the evidence.[25]

Courts commonly recognize that normal lender conduct, including enforcement of contract rights in accordance with the contract, is generally not inequitable conduct. A lender's

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15 *Va. Broadband*, 538 B.R. at 264 (quoting *Matter of Fabricators, Inc.*, 926 F.2d 1458, 1467 (5th Cir.1991)); *see also AutoStyle Plastics*, 269 F.3d at 747 (describing inequitable conduct as "fraud, spoliation, mismanagement or faithless stewardship").

16 *In re LandAmerica Fin. Group, Inc.*, 470 B.R. 759, 806 (Bankr. E.D. Va. 2012) (allegations of breach of fiduciary duty sufficient to allege claim for equitable subordination where alleged breach caused harm to creditors); *Matter of Teltronics Serv., Inc.*, 29 B.R. 139, 169 (Bankr. E.D.N.Y. 1983) (noting overwhelming majority of cases involve fiduciaries).

17 *Fabricators, Inc*., 926 F.2d at 1465.

18 *In re Va. Broadband, LLC*, 521 B.R. 539, 569 (Bankr. W.D. Va. 2014), *aff'd sub nom. Va. Broadband, LLC v. Manue*l, 538 B.R. 253 (W.D. Va. 2015).

19 *Id.*

20 *Id.*; *Va. Broadband*, 538 B.R. at 264; *In re Starlight Group, LLC*, 531 B.R. 611, 636 (Bankr. E.D. Va. 2015).

21 *Fabricators*, 926 F.2d at 1467–69 (without authorization, insider induced creditors to advance unsecured credit knowing debtor in financial straits, obtained security for capital contributions, opened bank accounts to deposit funds in new bank to avoid setoff by creditor deposit bank).

22 *In re Daugherty Coal Co*., 144 B.R. 320, 327 (N.D. W. Va. 1992) (co-owner of closely-held debtor company used his position to give his companies liens on debtor's most valuable equipment).

23 *Va. Broadband*, 538 B.R. at 264–65 (informed board approved note purchased by insider and did not make changes to note).

24 *Teltronics Serv.*, 29 B.R. at 169.

25 *Id.*

goal is to recover as much of the outstanding amount as possible, which is "understandable" and "permissible."[26] Thus, to be actionable, the conduct of a non-insider must rise to the level of "gross misconduct tantamount to fraud, misrepresentation, overreaching, or spoliation."[27] This type of conduct usually involves deception that causes other creditors to waive rights or extend credit in reliance on the misrepresentations of the creditor.[28]

2. Injury.

The proof required for equitable subordination includes quantification of the injury to other creditors. Proof of injury is required because the creditor's claim will be subordinated only "to the extent necessary to offset the harm."[29] The identification of the harm or unfair benefit obtained depends on the particular facts of the case.[30]

The party seeking equitable subordination must demonstrate with some specificity how the misconduct of the claimant injured other creditors or resulted in an unfair advantage in favor of the claimant over other creditors.[31] While the party seeking subordination need not put a specific "price tag" on the loss suffered—since such quantification may not always be feasible—it is necessary to show *some* identification of the nature and extent of the harm so that the court can craft an appropriate remedy.[32]

3. Not Inconsistent with the Bankruptcy Code.

The third equitable subordination factor—that subordination is not inconsistent with the Bankruptcy Code—is not discussed often in the case law. Essentially, the concept is that the court must find that the first and second *Mobile Steel* factors are present before subordinating. A court may not subordinate and alter the statutory priority scheme when an innocent party asserts a claim in good faith.[33]

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[26] *In re M Paolella & Sons*, 161 B.R. 107, 120 (E.D. Pa. 1993) ("Generally, a creditor does not act inequitably in exercising its contractual rights.").

[27] *Dornier Aviation (N. Am.)*, 2005 WL 4781236, at *17; *In re Wilson*, 359 B.R. 123, 138 (Bankr. E.D. Va. 2006).

[28] *In re Just for the Fun of It of Tenn., Inc*., 7 B.R. 166, 180 (Bankr. E.D. Tenn. 1980) (mechanics lien creditor filed misleading notice in property records causing creditors to delay or abstain from filing lien documents, improperly influencing priority of claims); *In re Osborne*, 42 B.R. 988, 1000 (W.D. Wis. 1984) (subordinating secured creditor to injured creditor that extended credit in reasonable reliance on secured creditor's representation that payment was forthcoming).

[29] *Mobile Steel*, 563 F.2d at 701; *see AutoStyle Plastics*, 269 F.3d at 749 (stating subordination will only be granted as "necessary to offset injury or damage suffered by the creditor in whose favor the equitable doctrine may be effective" (quoting *In re W.T. Grant Co.*, 4 B.R. 53, 74 (Bankr. S.D.N.Y. 1980))).

[30] *In re Beverages Int'l Ltd.*, 50 B.R. 273, 283 (Bankr. D. Mass. 1985).

[31] *Citicorp Venture Capital, Ltd. v. Comm. of Creditors Holding Unsecured Claims*, 160 F.3d 982, 991 (3d Cir. 1998) (finding that subordination may be appropriate, but only if supported by findings that justify the remedy chosen with reference to equitable principles).

[32] *Mobile Steel*, 563 F.2d at 701.

[33] *Citicorp Venture Capital*, 160 F.3d at 990.

B. Procedural Considerations.

Several procedural considerations affect equitable subordination claims, including standing to bring the claim and how to bring the claim.

The trustee or estate representative and creditors have standing to bring an equitable subordination claim, but a creditor's claim may be analyzed to determine if the injury is particular to the creditor (*i.e.*, the creditor was the one harmed by the conduct).[34] Absent subordination in a plan, an equitable subordination claim must be asserted in an adversary proceeding.[35]

C. Remedies.

It is important to note that even if a plaintiff successfully proves all three *Mobile Steel* elements, the decision of whether to subordinate the claim is left to the court's discretion—subordination is not required just because the plaintiff met its burden of proof.[36] Indeed, the case law provides that the doctrine should be applied sparingly as an extraordinary remedy.[37] It is also important to note that subordination does not result in disallowance of the claim, but only the subordination of its priority with respect to other creditors.[38]

Equitable subordination is intended to be remedial and not penal and, thus, just as the party seeking subordination must provide evidence of a specific injury caused by the inequitable conduct under the *Mobile Steel* factors, the court must narrowly tailor the relief to address that specific injury.[39] The relief must be proportional to the harm caused.[40] The example provided by the Fifth Circuit in *Mobile Steel* was a culpable creditor with two, separate $10,000 claims. If the harm caused to the other creditors only totaled $10,000, only one of the $10,000 claims should be subordinated and subordinating the other claim "would be improper."[41]

In summary, an equitable subordination claim subordinates a valid, allowed claim of a creditor who has acted inequitably, to the claims of other creditors harmed by that creditor and who would otherwise have received a lesser or lower priority distribution. A successful recharacterization claim, on the other hand, has broader implications for the affected creditor and the estate.

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[34] *See Black Palm Dev. Corp. v. Barlage*, 2011 WL 4858420, at *4 (W.D.N.C. Oct. 13, 2011) (trustee may bring claims on behalf of all creditors and creditors may bring claims for particularized injury); *id.* (contemplating creditor bringing particularized claim in addition to trustee claim); *In re Tara Retail Group, LLC*, 595 B.R. 215, 224 (Bankr. N.D.W. Va. 2018) (requiring further proceedings to determine if creditor's subordination claim was independent from debtor's subordination claim).

[35] Fed. R. Bankr. P. 7001(8); *In re Protea Biosciences, Inc.*, 2018 WL 5734464, at *3 (Bankr. N.D. W. Va. Oct. 30, 2018).

[36] *AutoStyle Plastics*, 269 F.3d at 744; *Spradlin v. East Coast Miner, LLC (In re Licking River Mining, LLC)*, 603 B.R. 336, 360 (Bankr. E.D. Ky. 2019), as amended (July 19, 2019); *In re Octagon Roofing*, 157 B.R. 852, 857 (N.D. Ill. 1993).

[37] *Nat'l Emergency Serv.*, 371 B.R. at 170 (citing *Fabricators, Inc.*, 926 F.2d at 1464).

[38] 11 U.S.C. § 510(c); *Mobile Steel Co.*, 563 F.2d at 699.

[39] *Fabricators*, 926 F.2d at 1464; *Teltronics Serv.*, 29 B.R. at 168; *In re SubMicron Sys. Corp*., 432 F.3d 448, 462 (3d Cir. 2006).

[40] *Citicorp Venture Capital*, 160 F.3d at 991; *Mobile Steel Co.*, 563 F.2d at 701.

[41] *Mobile Steel Co.*, 563 F.2d at 701.

II. Recharacterization: Determining the True Nature of a Claim.

On its face, recharacterization of a debt is similar to equitable subordination because it effectively changes the priority of the claim. Debt recharacterization, however, is quite different from equitable subordination in its analysis and effect. Equitable subordination is applied to subordinate true debt due to inequitable conduct. By contrast debt recharacterization is a determination of whether a claim was a true debt or an equity contribution from the outset of the transaction.[42] The court determines whether the creditor even held a debt to begin with to provide a basis for a claim.[43] Thus, the effect of recharacterization is to subordinate a claim the creditor treated as a loan to equity, moving that claim to last in priority, and in all likelihood, negating any chance of recovery.

Unlike equitable subordination, recharacterization is not a cause of action set forth in the Bankruptcy Code. Instead, several circuit courts,[44] including the Fourth Circuit, recognize that the cause of action is based on "the authority vested in the Bankruptcy Court to use its equitable powers to test the validity of debts."[45] To determine whether a debt is valid (i.e., whether it is really a debt or an disguised equity contribution), the courts look not only at the form of the transaction, but more importantly, at the substance of the transaction.[46]

A. The *AutoStyle* Recharacterization Factors.

To assess the substance and nature of the transaction in issue, the majority of courts recognizing recharacterization look at eleven factors, the *AutoStyle* factors,[47] typically used to determine whether advances to a corporation are loans or capital contributions for tax purposes:

(1) the names given to the instruments, if any, evidencing the indebtedness;
(2) the presence or absence of a fixed maturity date and schedule of payments;
(3) the presence or absence of a fixed rate of interest and interest payments;
(4) the source of repayments;
(5) the adequacy or inadequacy of capitalization;
(6) the identity of interest between the creditor and the stockholder;

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42 *AutoStyle Plastics*, 269 F.3d at 747–49; *In re Cold Harbor Assoc*., 204 B.R. 904, 915 (Bankr. E.D. Va. 1997).

43 *In re Franklin Equip. Co.*, 416 B.R. 483, 509 (Bankr. E.D. Va. 2009) (citing *Cold Harbor Assoc.*, 204 B.R. at 915).

44 *See, e.g., In re SubMicron Sys. Corp*., 432 F.3d 448 (3d Cir. 2006); *In re: Dornier Aviation (N. Am.), Inc.*, 453 F.3d 225 (4th Cir. 2006); *see also In re AutoStyle Plastics, Inc.*, 269 F.3d 726 (6th Cir. 2001); *In re Hedged–Inv. Assoc., Inc.*, 380 F.3d 1292 (10th Cir. 2004).

45 *Cold Harbor Assoc.*, 204 B.R. at 915 (citing *Pepper v. Litton*, 308 U.S. 295 (1939)).

46 *Indmar Prod. Co. v. C.I.R*., 444 F.3d 771, 776 (6th Cir. 2006); *see also In re Outboard Marine Corp*., 2003 WL 21697357, at *4 (N.D. Ill. July 22, 2003) ("Recharacterization is simply a factual inquiry that determines, in the first instance, whether an asserted debt is in fact a debt or a concealed equity contribution."); *Dornier Aviation (N. Am.)*, 453 F.3d at 231 ("If the court were required to accept the representations of the claimant, as GMBH appears to argue, then an equity investor could label its contribution a loan and guarantee itself higher priority—and a larger recovery—should the debtor file for bankruptcy."); *In re Villas at Hacienda Del Sol, Inc*., 364 B.R. 702, 709 (Bankr. D. Ariz. 2007)("The debt versus equity inquiry is not an exercise in recharacterizing a claim, but of identifying—to begin with—the advance's true character.").

47 Some jurisdictions look to state law as a basis for recharacterizing a claim. *See, e.g., In re Lothian Oil Inc.*, 650 F.3d 539, 544 (5th Cir. 2011) (applying Texas state law); *In re Fitness Holdings Int'l., Inc.*, 714 F.3d 1141, 1148 (9th Cir. 2013) (following *Lothian Oil* to apply state law to recharacterization claim).

(7) the security, if any, for the advances;
(8) the corporation's ability to obtain financing from outside lending institutions;
(9) the extent to which the advances were subordinated to the claims of outside creditors;
(10) the extent to which the advances were used to acquire capital assets; and
(11) the presence or absence of a sinking fund to provide repayments.[48]

The more a transaction resembles an arms-length transaction, the more likely that the court will find it is debt.[49] In contrast to an equitable subordination claim, the court does not look at the intent or the conduct of the creditor,[50] but instead applies the factors to the transaction objectively.[51] No single factor controls. All of the factors are to be considered in the particular circumstances of each case.[52]

Most recharacterization cases involve transactions between a debtor and an insider. Yet, insider status alone is not sufficient to support a recharacterization claim. The Fourth Circuit in *In re Dornier Aviation* stressed that the claimant's status as an insider and the debtor's undercapitalization are "normally insufficient" as the sole grounds to support the recharacterization of a claim.[53] The court cautioned against applying such rigid rules because it is often an insider that tries to keep a struggling company afloat so that it can survive a rough financial period to continue to pay its creditors.[54] Automatic recharacterization of these loans may "discourage good-faith loans" from insiders.[55]

The *AutoStyle* factors are generally self-explanatory, but the sixth factor, "the identity of interest between the creditor and the stockholder," has caused some confusion. As noted above, simply having a claimant who is also an insider or stockholder is not dispositive. The "identity of interest" factor refers to the transaction amount in light of the ownership interest of the claimant, not simply being a stockholder and also a creditor:

> "If advances are made by stockholders in proportion to their respective stock ownership, an equity contribution is indicated . . . . A sharply disproportionate ratio between a stockholder's percentage

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48 *Dornier Aviation (N. Am.)*, 453 F.3d at 233–34 (quoting *AutoStyle Plastics*, 269 F.3d at 749–50).

49 *AutoStyle Plastics*, 269 F.3d at 750.

50 *Dornier Aviation (N. Am.)*, 453 F.3d at 232 ("[A] bankruptcy court's recharacterization decision rests on the substance of the transaction giving rise to the claimant's demand. . . ." (emphasis in original)); *In re Adelphia Commc'ns Corp*., 365 B.R. 24, 74 (Bankr. S.D.N.Y. 2007), *aff'd in part sub nom. Adelphia Recovery Tr. v. Bank of Am., N.A.*, 390 B.R. 64 (S.D.N.Y. 2008), adhered to on reconsideration, 2008 WL 1959542 (S.D.N.Y. May 5, 2008) (finding conduct of creditors surrounding transaction irrelevant to recharacterization claim where court must look at "substance of the *transaction*" (emphasis in original)).

51 *See Indmar Prods.*, 444 F.3d at 776; *id*. at 779 (criticizing tax court for not examining objective indicia).

52 *Id*.

53 *Dornier Aviation (N. Am.)*, 453 F.3d at 234.

54 *Id*.

55 *Id.*; *Va. Broadband*, 521 B.R. at 573–74 (finding recharacterization not warranted using test considering factors in addition to the *AutoStyle* factors); *In re Phase-I Molecular Toxicology, Inc.*, 287 B.R. 571, 577–78 (Bankr. D.N.M. 2002) (granting summary judgment on recharacterization claim despite finding undercapitalization at the time of the transaction, which was not determinative); *In re SGK Ventures, LLC*, 2017 WL 2683686, at *8 (N.D. Ill. June 20, 2017), *appeal filed*, (7th Cir. July 6, 2017) (denying recharacterization claim because more is needed than facts of financial distress and insider status).

> interest in stock and debt is, however, strongly indicative that the debt is bona fide."[56]

In fact, while no one factor is controlling, courts have identified identity of interest as being one of the most critical factors in determining whether a claim is debt or equity.[57] Thus, if all of the owners of a debtor advance funds to the debtor and the amounts advanced are proportional to the ownership interests of each claimant, it may evidence an equity investment, even if the parties prepared the documentation as debt instruments.[58]

There is no template to apply to every claim and the application of the *AutoStyle* factors will vary depending the substance of the transaction. Thus, some examples may be helpful.

Recharacterized: In *Dornier Aviation*, the debtor's parent corporation asserted a $146 million claim for the sale of parts to the debtor. Despite having characteristics of a loan, the court found recharacterization was warranted where (i) the lender was an insider, (ii) the transaction did not have a fixed maturity date, (iii) the debtor was not required to pay until the debtor became profitable (i.e., characteristic of a distribution), (iv) the debtor had a long history of unprofitability and despite corporate restructuring, it was still significantly insolvent, and (v) the creditor assumed the debtor's losses.[59]

Not Recharacterized: Courts in other cases have found that a transaction was debt, despite a number of factors weighing in favor of equity. In *In re Business Intelligent Systems, LLC,* [60] a case in the Western District of Kentucky, a member of a closely held limited liability company loaned $1.6 million to the company after it ran out of its initial funding. The court found that five factors indicated that the advance was equity, including that the lender was a member of company, there was no documentation of the loan, the source of repayment depended on success, and there was no security.[61] The court, however, determined that the advance was debt because the debtor's operating agreement required a majority of the outstanding membership interests to approve of a capital contribution and the issuance of additional ownership, but did not require member approval for a loan. Further, the operating agreement required that a capital investment be in writing. Because the other member holding a significant interest refused to give the claimant any additional ownership, and refused to advance any money of his own, the advance could not be equity under both the debtor's operating agreement and the identity of interest *AutoStyle* factor.[62]

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56 *Cold Harbor Assoc.*, 204 B.R. at 919 (quoting *Roth Steel Tube Co. v. C.I.R.*, 800 F.2d 625, 630 (6th Cir. 1986)); *see also*, *In re Adelphia Commc'ns Corp*., 2006 WL 687153, at *9 (Bankr. S.D.N.Y. Mar. 6, 2006) ("[I]f the creditor advances funds in proportion to its ownership interest in the in the business, then the advance is likely equity (implicating Factor 6)").

57 *Cold Harbor Assoc.*, 204 B.R. at 919 (finding proportionality of advances to each partner's equity interest alone "overwhelming" evidence in determination that advances were equity, not debt); *AutoStyle Plastics*, 269 F.3d at 751 (same (quoting *Cold Harbor Assoc.*, 204 B.R. at 919)); *Adelphia Commc'ns Corp*., 2006 WL 687153, at *9 (citing *AutoStyle Plastics and* referring to identity of interest factor as "significant").

58 *See e.g.*, *Cold Harbor Assoc.*, 204 B.R. at 919.

59 *Dornier Aviation (N. Am.)*, 453 F.3d at 234.

60 *In re Bus. Intelligent Sys., LLC*, 325 B.R. 575 (Bankr. W.D. Ky. 2005).

61 *Id.* at 577–78.

62 *Id.* at 577–79.

B. Procedural Considerations.

Recharacterization can be an issue at different stages of a bankruptcy case. In many cases, claims are determined to be debt or equity during the claims allowance process. The Bankruptcy Court for the Northern District of West Virginia held recently that a recharacterization claim on its own does not have to be brought in an adversary proceeding like an equitable subordination claim.[63] The court reasoned that a claim for recharacterization does request the court to alter any portion of the claim, subordinate, or grant equitable relief as part of the claims allowance process, but only to determine the true nature of the claim. As such the court held that Bankruptcy Rules 3007(b) and 7001(2), (7), and (8) were not applicable.[64]

However, in other circumstances, a recharacterization claim may be asserted in an adversary proceeding with a number of other claims. For instance, a claim may be recharacterized in conjunction with an avoidance action.

C. Practical Implications of Recharacterization.

Finally, it is important to note one other distinction between recharacterization and equitable subordination. Where equitable subordination does not take effect until the bankruptcy court rules on the claim, recharacterization effectively relates back to the date of the transaction. This difference has other potential consequences for the creditor with respect to defenses to other potential causes of action. For example, creditors are often subjected to claims that prepetition payments to them constituted a constructive fraudulent transfer under Bankruptcy Code section 548(a)(1)(B). The provision of "reasonably equivalent value" is a defense to such a claim,[65] and courts have held that a dollar-for-dollar reduction in debt is "reasonably equivalent value."[66] In other words, payments applied to proportionally reduce a debt will likely not be deemed constructively fraudulent conveyances. If, however, the subject claim is recharacterized as equity, the defense of a dollar-for-dollar reduction in debt is no longer available. A payment to an equity holder is a distribution, not a dollar-for-dollar reduction in a debt. Thus, not only does recharacterization potentially affect distributions to a creditor, but it may also serve as a basis to assert, and recover on, chapter 5 causes of action against that creditor.

Conclusion

Equitable subordination and recharacterization are seemingly similar claims and are often brought together in the same action. The claims, however, have very different elements and can produce different results if successful. Equitable subordination adjusts the priority of payment for an allowed claim. Recharacterization can result in what may have been claimed debt to be found to be equity, and thus not only is the claim itself reprioritized in the distribution, but also, it may invalidate prior payments made years prior to the petition date, subjecting a creditor to monetary liability.

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63 *Protea Biosciences*, 2018 WL 5734464, at *4.

64 *Id.*

65 11 U.S.C. § 548(a)(1)(B).

66 *In re Yahweh Ctr., Inc.*, 27 F.4th 960, 968 (4th Cir. 2022); *In re Southeast Waffles, LLC*, 460 B.R. 132, 139–40 (B.A.P. 6th Cir. 2011), *aff'd*, 702 F.3d 850 (6th Cir. 2012) (granting motion to dismiss); *see also* 11 U.S.C. § 548 (d)(2)(A) (defining value as "satisfaction . . . of a present or antecedent debt of the debtor").