Supreme Court Declines to Resolve Circuit Split on Debt Recharacterization

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On August 10, 2017, the U.S. Supreme Court rescinded the grant of *certiorari* in *PEM Entities LLC v. Levin* on the grounds that review had been "improvidently granted." The case seemingly provided a perfect vehicle to resolve the circuit split on whether federal or state law governs debt recharacterization in bankruptcy, and less than two months after the Court first agreed to hear the case, its dismissal came as a surprise.

While the Bankruptcy Code does not expressly authorize the recharacterization of debt to equity, the Courts of Appeal that have considered the question have determined that, in an appropriate case, a bankruptcy court can properly recharacterize a claim. These courts have, however, taken different approaches in identifying the legal framework for debt recharacterization. Four Courts of Appeal have determined that the bankruptcy courts' general equitable authority under Section 105(a) of the Bankruptcy Code authorizes them to create a federal test for debt recharacterization. In contrast, two Courts of Appeal have determined that, pursuant to Section 502(b) of the Bankruptcy Code, state law provides the proper rule of decision.

With the Court choosing not to weigh in on the matter, for now recharacterization of insider debt will remain subject to the standard applied in the jurisdiction in which the borrower files for bankruptcy.

Background

A group of investors formed Province Grande Olde Liberty, LLC for the purpose of acquiring a golf and residential real estate development in North Carolina. To finance the acquisition, Province Grande took out a $6.47 million secured loan from Paragon Commercial Bank. When Province Grande defaulted on the loan, Paragon initiated foreclosure proceedings. In an effort to stave off foreclosure, members of the initial investment group formed a new company, PEM Entities LLC, for the purpose of purchasing the Paragon loan. PEM bought the Paragon loan at the discounted price of $1.24 million. The purchase price was funded with $300,000 in new capital contributions to PEM from individuals who were also members of Province Grande and $942,000 in third-party loans. These attempts to save Province Grande proved unsuccessful, and in March 2013, it filed for Chapter 11 protection in the U.S. Bankruptcy Court for the Eastern District of North Carolina. PEM asserted a $7 million secured claim in Province Grande's bankruptcy case based on its ownership of the Paragon loan. Junior creditors sought to recharacterize PEM's claim.

The bankruptcy court in *PEM* determined that it had the ability to recharacterize claims and applied the federal test articulated by the U.S. Court of Appeals for the Fourth Circuit in the 2006 case *In re Dornier Aviation*. The bankruptcy court in *PEM* found that all 11 factors in the test weighed in favor of recharacterizing the $300,000 portion PEM paid to purchase the Paragon loan from debt owed to it by Province Grande into an equity investment in the debtor. As a result, the bankruptcy court rendered PEM's purported $7 million secured claim void. On appeal, the district court and the Fourth Circuit affirmed the bankruptcy court's decision. The sole issue before the Supreme Court was whether the lower courts erred in applying the Fourth Circuit's federal multi-factor test for debt recharacterization.

The Circuit Split

In addition to the Fourth Circuit, the Third, Sixth and Tenth circuits have held that a bankruptcy court's general equitable powers include the ability to recharacterize claims based on Section 105(a) of the Bankruptcy Code, which authorizes a bankruptcy court

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to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of" the Bankruptcy Code. These courts reason that permitting a bankruptcy court to recharacterize claims is key to implementing the code's priority scheme (*i.e.*, that debt receives a higher priority than equity). Invoking their general equitable powers under Section 105(a), they have developed various multifactor tests for debt recharacterization.

In contrast, the Fifth and Ninth circuits have held that a bankruptcy court's ability to recharacterize claims must be grounded in state law. They point to Bankruptcy Code Section 502(b), which mandates the allowance of all claims other than those that are "unenforceable ... under any agreement or applicable law ... ," and *Butner v. United States*, in which the Court held that "applicable law" is state law. Taken together, Section 502(b) and *Butner* require bankruptcy courts to apply a state law standard to debt recharacterization, according to the Fifth and Ninth circuits.

Implications

Application of a federal or state law test for debt recharacterization can lead to very different results. For example, in the PEM case, PEM argued that a court following applicable North Carolina law would not have looked beyond the form of the transaction to determine whether the loan should be recharacterized as equity. Rather, PEM's arm's length purchase of a third-party loan would have been respected. The federal multifactor test applied by the bankruptcy court, on the other hand, allowed the court to look beyond form to the substance of the transaction. The PEM case thus highlights the potential conflict between a federal multifactor test, which gives bankruptcy courts considerable discretion to impose debt recharacterization, and state laws, which are often more protective of insider debt.

The PEM case was closely watched by the bankruptcy bar because of its potential impact on the likelihood of debt recharacterization in bankruptcy. A ruling in favor of PEM would have required bankruptcy courts to apply state law to the recharacterization analysis, and thereby, made debt recharacterization generally more difficult. This, in turn, would have given insiders considering whether to make rescue loans or third-party debt purchases of troubled companies more confidence that these transactions would be respected in the event of the borrower's bankruptcy. A ruling against PEM, on the other hand, would have left in place the various federal multifactor tests for debt recharacterization that have emerged from the equitable power circuits.

The Supreme Court's dismissal of the PEM case means that, for now, the circuit split continues over the proper standard for debt recharacterization in bankruptcy.

Federal Test on Recharacterizing Claims

The 11 factors of the federal test that the bankruptcy court applied to analyze whether to recharacterize PEM's claim are:

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;
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.