

Debt Recharacterization and Its Place in the Bankruptcy Code

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I. INTRODUCTION

Debt recharacterization occurs when a court reclassifies a claimant's debt claim as an equity interest.¹ That ostensibly nominal

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¹ *In re AutoStyle Plastics, Inc.*, 269 F.3d 726, 748 (6th Cir. 2001).

classification is rendered significant because of the Bankruptcy Code's priority scheme, which calls for the repayment of debt claims before equity interests.² In an asset distribution, a debt claim that has been recharacterized as an equity interest necessarily loses its priority status, thereby reducing the likelihood of it being repaid.³

Until recently, the circuits generally agreed that bankruptcy courts' recharacterization authority stemmed from the equitable authority grant in § 105 of the Bankruptcy Code.⁴ The Fifth Circuit ended that consensus when it shoehorned § 502 into the debt recharacterization analysis.⁵ Directing bankruptcy courts to categorize a claim or interest before allowing it to proceed under § 502,⁶ the Fifth Circuit found that an equity interest held by a non-insider did not constitute a claim and, as a result, could not proceed under § 502.⁷ In essence, the Fifth Circuit's decision meant that a court's categorization of a claim or interest became dispositive.⁸

In transposing the equitable authority to recharacterize a debt claim from § 105 to § 502, the Fifth Circuit has molded an approach that will likely produce overwhelmingly negative ramifications for businesses.⁹ Its adoption by other courts will lead to the unfair penalization of non-insiders whose funds are often necessary to keep flailing businesses afloat.¹⁰ Additionally, the *Lothian* approach would force bankruptcy courts to deal with complex issues at the front end of the case, thereby denying claimants the right to proceed with their claims.¹¹

This article evaluates the two approaches for determining the appropriate instance in which to consider debt recharacterization and ultimately rejects the approach adopted by the Fifth Circuit. Part I introduces the concept of debt recharacterization and its significance. Part II analyzes the disparate approaches that courts have developed. Part III examines the *Lothian* approach and the implications of its

² 11 U.S.C. § 726.

³ *In re AutoStyle Plastics*, 269 F.3d at 749.

⁴ *See, e.g., id.*; *In re Official Comm. of Unsecured Creditors for Dornier Aviation (N. Am.), Inc.*, 453 F.3d 225 (4th Cir. 2006) [hereinafter *In re Dornier Aviation, Inc.*]; *In re SubMicron Sys. Corp.*, 432 F.3d 448, 456 (3d Cir. 2006).

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

⁶ *Id.*

⁷ *In re Lothian Oil*, 650 F.3d at 543.

⁸ *See infra* Part II.B.

⁹ James M. Wilton & Stephen Moeller-Sally, *Debt Recharacterization Under State Law*, 62 BUS. LAW. 1257, 1278 (2007).

¹⁰ *See infra* Part III.B.

¹¹ *See infra* Part III.B.

adoption. The article concludes with a recommendation against adoption of the Fifth Circuit's approach to debt recharacterization.

II. UNDERSTANDING THE SOURCE OF BANKRUPTCY COURTS' DEBT RECHARACTERIZATION ANALYSIS

A. *The Traditional Approach: Authority to Recharacterize Grounded in § 105(a)*

The majority of circuits that have addressed the question cite § 105(a) of the Bankruptcy Code (the "Code") as the source of bankruptcy courts' recharacterization authority.¹² The most compelling reason for embracing § 105(a) is found in *In re Dornier Aviation (North America), Inc.*, a Fourth Circuit decision issued in 2006.¹³ The language of § 105(a) clearly states that a bankruptcy court has the equitable authority to "issue *any* order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."¹⁴ The Fourth Circuit understood § 105(a) to be a broad provision that vested bankruptcy courts with far-reaching powers.¹⁵ The expansiveness of § 105(a) is evidenced by its minimal requirements for the type of judgments it allows. That is to say, under § 105(a), a judgment need only be appropriate—not necessary—for furthering the objectives of the Code.

Congress intended for § 105(a) to give bankruptcy courts the equitable authority necessary to issue judgments aimed at implementing the priority scheme set forth in § 726.¹⁶ In fact, the Fourth Circuit noted that "implementation of the Code's priority scheme requires a determination of whether a particular obligation is debt or equity. Where, as here, the question is in dispute, the bankruptcy court must have the authority to make this determination in order to preserve the Code's priority scheme."¹⁷ The Fourth Circuit reemphasized the importance of upholding the Code's intentions when it asserted: "In light of the broad language of § 105(a) and the larger purpose of the Bankruptcy Code, we believe that a bankruptcy court's power to

¹² See, e.g., *In re AutoStyle Plastics, Inc.*, 269 F.3d 726, 744 (6th Cir. 2001); *In re Dornier Aviation, Inc.*, 453 F.3d 225 (4th Cir. 2006); *In re SubMicron Sys. Corp.*, 432 F.3d 448, 456 (3d Cir. 2006).

¹³ *In re Dornier Aviation, Inc.*, 453 F.3d at 231.

¹⁴ *Id.* (emphasis added).

¹⁵ See *id.* ("In our view, recharacterization is well within the broad powers afforded a bankruptcy court in § 105(a) and facilitates the application of the priority scheme laid out in § 726.")

¹⁶ *Id.*

¹⁷ *Id.*

recharacterize is essential to the proper and consistent application of the Code.”¹⁸

To buttress its grounding such authority in § 105(a), the Fourth Circuit touched on the insufficiency of § 502(b) for achieving that purpose. Significantly, the Fourth Circuit did not explicitly denounce § 502(b) as the basis for recharacterization.¹⁹ Instead, the court concluded that an analysis under § 502(b) was only the first of a two-step process.²⁰ Thereafter, a court must address the issue of recharacterization, whose analysis occurs under § 105(a). The Fourth Circuit held, “[e]ven 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 priority.”²¹ The Fourth Circuit concluded that bankruptcy courts should not consider recharacterization under § 502(b), because recharacterization does not determine a claim’s allowance.²² Instead, bankruptcy courts should postpone the recharacterization analysis until it becomes necessary for establishing a priority scheme for claims.²³ According to the Fourth Circuit’s articulate analysis, bankruptcy courts cannot examine recharacterization under § 502(b) without accounting for § 105(a).²⁴

B. Transition to Lothian (Equity Is Not a Claim Under § 502)

Indubitably, the *Dornier* court offered impelling reasons for the need to go beyond § 502(b) in determining recharacterization. Nevertheless, other courts have made compelling arguments for ending the inquiry at § 502(b) by expounding upon the definition of “claim” as it pertains to that provision.²⁵ By assuming a limited definition of the word “claim,” some courts have determined that, because equity interests are not claims, they cannot pass the threshold requirements for allowability under § 502(b).²⁶ The putative claim’s inability to survive § 502(b)

¹⁸ *Id.* at 231.

¹⁹ *See generally In re Dornier Aviation, Inc.*, 453 F.3d at 231.

²⁰ *Id.*

²¹ *Id.* at 232.

²² *Id.*

²³ *Id.* Bankruptcy courts determine the priority scheme pursuant to § 726; however, § 726 does not provide for recharacterization of claims. Instead, the courts derive their authority to recharacterize from § 105(a), the equitable authority provision. *See id.*

²⁴ *Id.* at 232.

²⁵ *In re Georgetown Bldg. Assocs.*, 240 B.R. 124, 138 (Bankr. D.D.C. 1999).

²⁶ *Id.* (citing *Bank of Am. Nat’l Trust & Sav. Ass’n v. 203 N. LaSalle Street Partnership*, 526 U.S. 434 (1999) (applying the term “interest” as contained in 11 U.S.C.

necessarily obviates any need for analysis under § 105(a).²⁷ According to that line of thought, the definition of “claim” includes debt claims but excludes equity interests.²⁸ One court explained:

Although 11 U.S.C. §§ 101(5) and 101(12) define “claim” as a right to payment and “debt” as liability on a claim, these definitions obviously do not include a right to payment based on an equity security or other interest in the debtor arising from capital contributions. That the interest in the debtor gives rise to a right to payment does not make that interest a claim.²⁹

The court provided only a vague explanation of how it reached the conclusion that the definition of “claim” obviously excludes equity interests.³⁰ The court opined that the Code intended to exclude equity holders from bringing claims for the repayment of debt in bankruptcy.³¹ The court made that assumption based upon a provision in § 1129(a)(10) which states that confirmation of a repayment plan requires acceptance by one or more classes of claims.³² The court then asserted, “acceptance by a class of interests does not suffice.”³³ The court failed to acknowledge, however, the possibility that those two concepts are not, in fact, mutually exclusive.

The Sixth Circuit has entertained the idea of disallowing so-called claims for equity interest under § 502(b) more than once.³⁴ In an unpublished decision, the Sixth Circuit opined, “a claim seeking to recharacterize debt to equity is the same as objecting to the claim’s ‘allowance.’”³⁵ The court reached that conclusion after deciding that a recharacterization from debt to equity nullifies a claim.³⁶ The court explained that “[a] debtor’s request to recharacterize a claim is a request for the bankruptcy court to hold a debt, and hence any claim, is non-

§ 1129(b)(2)(B)(ii) (“retain under the plan on account of such . . . interest any property”)); *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988).

²⁷ See *In re AutoStyle Plastics, Inc.*, 269 F.3d 726, 748–49 (6th Cir. 2001).

²⁸ *In re Georgetown Bldg. Assocs.*, 240 B.R. at 138.

²⁹ *Id.* at 139 (citing 11 U.S.C. § 101(5), (12) (1994)).

³⁰ See *id.*

³¹ *Id.*

³² *Id.* at 124 n.25.

³³ *Id.*

³⁴ See *In re AutoStyle Plastics, Inc.*, 269 F.3d 726, 748–49 (6th Cir. 2001); see generally *In re Russell Cave Co.*, 107 F. App’x 449 (6th Cir. 2004).

³⁵ *In re Russell Cave*, 107 F. App’x at 451 (citing *In re MicroPrecision Tech., Inc.*, 303 B.R. 238, 243 (Bankr. D.N.H. 2003)).

³⁶ *Id.* (citing *In re AutoStyle Plastics, Inc.*, 269 F.3d at 748–49; *In re Georgetown Bldg. Assocs.*, 240 B.R. at 137); 11 U.S.C. § 101(5), (12) (defining “claim” as a right to payment and “debt” as liability on a claim).

existent.”³⁷ In other words, while a creditor can bring a claim for debt, an equity holder cannot bring a claim.³⁸ Accordingly, recharacterization from debt to equity eliminates the claim in its entirety.³⁹

Despite the Sixth Circuit’s ostensible advocacy of using only § 502(b), both in *AutoStyle Plastics* and *Russell Cave*, it stated in *AutoStyle* that authority “stems from the authority vested in the bankruptcy courts to use their equitable powers to test the validity of debts. The source of the court’s general equitable powers is § 105 of the Code”⁴⁰ That statement seems to contradict the Sixth Circuit’s later suggestion that analysis under § 502(b) is sufficient.⁴¹ If reclassifying the debt claim under § 502(b) bars the claim from proceeding, then the claim would never even reach analysis under § 105(a).⁴²

For all of its discrepancies, the Sixth Circuit is not the only pre-*Lothian* court to indicate that the inquiry stops at § 502(b).⁴³ In 1999, one bankruptcy court articulated:

[I]f a particular advance is a capital contribution, it never becomes a claim. The debt-versus-equity inquiry is not an exercise in *recharacterizing* a claim, but of *characterizing* the advance’s true character. If the advance is not a claim to begin with, then equitable subordination never comes into play.⁴⁴

Classifying a claim as equity does not relieve a debtor from his obligation to repay the claimant, but it does prevent the claim from proceeding within the realm of bankruptcy.⁴⁵ When a court classifies a purported debt claim as an equity interest, the putative claimant no longer has a claim. Instead, he holds an interest in equity.

³⁷ *In re Russell Cave*, 107 F. App’x at 451; *see also In re AutoStyle Plastics, Inc.*, 269 F.3d at 748–49.

³⁸ *See In re AutoStyle Plastics, Inc.*, 269 F.3d at 748–49.

³⁹ *Id.* at 749; *see also In re Georgetown Bldg. Assocs.*, 240 B.R. at 126 (“[Claimant] first claims that the notes should be characterized as equity instead of debt, such that they are not claims in the case. [Claimant] claims alternatively that if the notes are characterized as debt and hence constitute claims in the case, the obligations nevertheless are subject to equitable or contractual subordination behind [claimant’s] claims.”).

⁴⁰ *In re AutoStyle Plastics, Inc.*, 269 F.3d at 748.

⁴¹ *In re Russell Cave Co.*, 107 F. App’x at 451 (citing *In re AutoStyle Plastics, Inc.*, 269 F.3d at 748–49) (“A debtor’s request to recharacterize a claim is a request for the bankruptcy court to hold a debt, and hence any claim, is non-existent.”).

⁴² *In re Dornier Aviation, Inc.*, 453 F.3d 225, 232 (4th Cir. 2006).

⁴³ *See, e.g., In re Georgetown Bldg. Assocs.*, 240 B.R. at 137; *In re Russell Cave Co.*, 107 F. App’x at 449.

⁴⁴ *In re Georgetown Bldg. Assocs.*, 240 B.R. at 137.

⁴⁵ *Id.* at 138 (“The classification of obligations as debt or equity is not a defense to the obligation; it is simply a function of administering the relations between creditors and equity interest holders.”).

III. ANALYSIS

A. *Analysis of the Lothian Approach*

The Fifth Circuit emphasized that the phrase “applicable law” refers to state law in *Lothian*.⁴⁶ The court relied heavily on the idea that “Congress has generally left the determination of property rights in the assets of a bankrupt’s estate to state law.”⁴⁷ Recognizing that the reasoning in *Butner* pertained to property rights, the Fifth Circuit understood the *Butner* reasoning to apply equally to bankruptcy proceedings.⁴⁸ In making that connection, the court cited part of the *Butner* decision explaining that “there is no reason why such [state law] interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.”⁴⁹ Therefore, the court assumed that the applicable law is, in fact, state law, excepting a congressional statement to the contrary.⁵⁰

The Fifth Circuit is no longer alone in its reliance on *Butner*.⁵¹ Following in the footsteps of its sister circuit, the Ninth Circuit reached the same conclusion in 2013, when it issued its decision in *Fitness Holdings*.⁵² In *Fitness Holdings*, the debtor corporation was financed primarily by two sources, with whom it entered into numerous loan agreements, which it later refinanced.⁵³ Although the debtor continued to make payments on its refinanced loans, its financial situation continued to deteriorate, eventually resulting in bankruptcy.⁵⁴ The committee of unsecured creditors brought action to avoid the pre-petition

⁴⁶ *In re Lothian Oil, Inc.*, 650 F.3d 539, 543 (5th Cir. 2011) (citing *Butner v. United States*, 440 U.S. 48, 54 (1979)).

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ *Id.* Compare *In re Lothian Oil, Inc.*, 650 F.3d at 543 (holding that, under the *Butner* principle, courts are required to define claims by reference to state law, and are thus required to recharacterize purported “debt” as equity where state law would treat the asserted interest as an equity interest), with *In re SubMicron Sys. Corp.*, 432 F.3d 448, 455 (3d Cir. 2006) (holding that a court has the equitable authority to recharacterize a transaction and determine if it is more like “debt” or “equity”), and *In re AutoStyle Plastics, Inc.*, 269 F.3d at 749–50 (announcing an eleven-factor test, derived from federal tax law, for determining whether a purported “debt” is in fact “equity”). See generally *In re Fitness Holdings Int’l, Inc.*, 714 F.3d 1141, 1148 (9th Cir. 2013) (noting the presence of a circuit split regarding which legal framework courts should apply in recharacterizing claims).

⁵¹ See *In re Fitness Holdings Int’l, Inc.*, 714 F.3d at 1146–47.

⁵² *Id.* at 1148.

⁵³ *Id.* at 1143.

⁵⁴ *Id.* at 1144.

loan repayments, arguing that such transfers were not, in fact, loan repayments but rather fraudulent transfers under 11 U.S.C. § 548(a).⁵⁵ The court found that the outcome rested on whether such transfers were considered “claims” under the Bankruptcy Code.⁵⁶ Applying *Butner*, the Ninth Circuit advised that “a court must determine whether the asserted interest in the debtor’s assets is a ‘right to payment’ recognized under state law.”⁵⁷ According to the Ninth Circuit, *Butner* meant that for purposes of bankruptcy law, whether or not a transfer constituted a claim turned on state property law.⁵⁸

The court concluded that, in combination with the *Butner* decision, § 502(b) affords bankruptcy courts the power to recharacterize debt claims of corporate non-insiders.⁵⁹ Because applicable law means state law, bankruptcy courts must disallow any claim that contravenes state law.⁶⁰ Before disallowing such a claim, however, the bankruptcy court must determine why state law prohibits such claims.⁶¹ More specifically, “where 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.”⁶² A bankruptcy court, in disallowing a claim, causes the claim to be dismissed in its entirety.⁶³ Total dismissal precludes a claimant from asserting any other rights against the debtor.⁶⁴ The *Lothian* court bemoaned the severity of such a result.⁶⁵ A bankruptcy court cannot ignore the attendant rights of a claimant whose principal claim it disallowed for contravening state law.⁶⁶ The court opined,

⁵⁵ *Id.* at 1147.

⁵⁶ *Id.*

⁵⁷ *In re Fitness Holdings Int’l, Inc.*, 714 F.3d at 1147.

⁵⁸ *Id.*

⁵⁹ *Id.* at 1148 (“We agree with the approach adopted by the Fifth Circuit in *Lothian Oil, Inc.*, 650 F.3d at 543, which is consistent with the *Butner* principle.”).

⁶⁰ *In re Lothian Oil, Inc.*, 650 F. 3d 539, 543 (5th Cir. 2011).

⁶¹ *Id.*

⁶² *Id.* The *Lothian* court also distinguished that “[o]ther circuits to have considered this issue have approved recharacterization, but they have generally grounded it in the bankruptcy courts’ equitable authority under 11 U.S.C. § 105(a).” *Id.* (citing *In re SubMicron Sys. Corp.*, 432 F.3d 448, 454 n.6 (3d Cir. 2006); *In re Dornier Aviation, Inc.*, 453 F.3d 225, 232 (4th Cir. 2006); *In re Hedged-Invs. Assocs.*, 380 F.3d 1292, 1292 (10th Cir. 2004); *In re AutoStyle Plastics, Inc.*, 269 F.3d 726, 748–49 (6th Cir. 2001)).

⁶³ *In re Lothian Oil, Inc.*, 650 F. 3d at 543 (citing *In re Dornier Aviation, Inc.*, 453 F.3d at 232).

⁶⁴ *Id.*

⁶⁵ *See id.*

⁶⁶ *In re Lothian Oil, Inc.*, 650 F.3d at 543 (citing *In re Dornier Aviation, Inc.*, 453 F.3d at 232).

“[t]hese rights, fixed by state law, are not irrelevant to the court’s decision to disallow a claim. To the contrary, recharacterizing the claim as an equity interest is the logical outcome of the reason for disallowing it as debt.”⁶⁷

The *Lothian* court’s reliance on *Butner* introduces several problems. First, *Butner* did not involve any recharacterization issues. The case examined property interests outside the realm of bankruptcy. Second, the Supreme Court issued the *Butner* decision before the promulgation of the Code. In effect, the *Lothian* court relied on a non-bankruptcy case to evaluate issues that are grounded in a statute not then in existence. Determining the proper Code provision is an undeniably challenging task for any court. The Fifth Circuit should not use that as an excuse to delegate that burden to the states.

The inapplicability of the facts in *Butner* to those in *Lothian* presents an ancillary problem. *Butner* concerned a bankrupt landowner who had defaulted on both of his mortgages and owed the petitioner money.⁶⁸ The petitioner requested that the bankrupt landowner repay the petitioner using rent earned on the property.⁶⁹ The bankruptcy court denied the petitioner’s claim, holding that the petitioner had no security interest on that rent, and that the rent profits should therefore be distributed in the same manner as an unsecured claim.⁷⁰ The case finally reached the Supreme Court, which held that “Congress has generally left the determination of property rights in the assets of a bankrupt’s estate to state law.”⁷¹

That issue has little relevance to the issue at bar in *Lothian*. In *Butner*, the Court evaluated an existing interest to determine whether it was secured.⁷² The Court was not tasked with classifying a purported

⁶⁷ *Id.*

⁶⁸ *Butner v. United States*, 440 U.S. 48, 48 (1979).

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ *Id.* at 54 (“The constitutional authority of Congress to establish ‘uniform Laws on the subject of Bankruptcies throughout the United States’ would clearly encompass a federal statute defining the mortgagee’s interest in the rents and profits earned by property in a bankrupt estate.”) (quoting U.S. CONST., art. I, § 8, cl. 4). Congress could have chosen to pass legislation regarding the distribution of rent earned from a bankrupt’s land; however, Congress did not exercise that authority. Therefore, state law controls the issue. See *id.* at 54 n.9 (“In view of this grant of authority to the Congress it has been settled from an early date that state laws to the extent that they conflict with the laws of Congress, enacted under its constitutional authority, on the subject of bankruptcies are suspended. While this is true, state laws are thus suspended only to the extent of actual conflict with the system provided by the Bankruptcy Act of Congress.”).

⁷² *Id.* at 48.

debt interest and therefore never even broached the issue of debt recharacterization.⁷³ In *Lothian*, on the other hand, the court had to figure out whether the purported loan even constituted a property interest.⁷⁴ It seems overly academic to contemplate whether a property interest is secured before knowing that a property interest even exists.

The Fifth Circuit relied heavily on one statement in the *Butner* opinion: “Property interests are created and defined by state law. Unless 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.”⁷⁵ Taken out of context, that statement could be read as applying broadly to all bankruptcy cases. More likely than not, however, the Court simply meant to say that with respect to property rights, one’s status as bankrupt or non-bankrupt should not affect the outcome of the case.⁷⁶ The *Butner* decision addressed potential remedies for a mortgagor who lacks any security interest on the rent profits of his mortgagee.⁷⁷ The *Lothian* decision, on the other hand, evaluated the potential extension of debt recharacterization to non-insiders.⁷⁸ The notion of insiders and non-insiders is salient in the *Lothian* decision,⁷⁹ but does not appear even once in *Butner*.⁸⁰

Regardless of the possible inapplicability of *Butner*, the resolution of the debt recharacterization issue in *Lothian* remains unsolved. *Butner* instructed courts to apply state law in decisions regarding the property rights of bankrupt debtors.⁸¹ The Fifth Circuit did follow the *Butner* rule and applied Texas law to the facts of the case.⁸² At best, reliance on *Butner* does nothing more than elucidate how a particular state would resolve the issue. In *Lothian*, the court noted that “[t]o distinguish between debt and equity, Texas courts have imported a multi-factor test

⁷³ See generally *id.*

⁷⁴ *In re Lothian Oil, Inc.*, 650 F.3d 539, 541 (5th Cir. 2011).

⁷⁵ *Butner*, 440 U.S. at 55.

⁷⁶ See *id.* (“Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving ‘a windfall merely by reason of the happenstance of bankruptcy.’”) (quoting *Lewis v. Mfrs. Ntn’l Bank*, 364 U.S. 603, 609 (1961)).

⁷⁷ *Id.* at 48.

⁷⁸ *In re Lothian Oil, Inc.*, 650 F. 3d at 543.

⁷⁹ *Id.*

⁸⁰ See *Butner*, 440 U.S. at 48.

⁸¹ *Id.* at 54. See *supra* note 71.

⁸² *In re Lothian Oil, Inc.*, 650 F. 3d at 544.

from federal tax law.”⁸³ The court justified its derivation of tax-law tests by citing other bankruptcy cases that had proposed using some form of the *Roth Steel* factors.⁸⁴ By suggesting use of the 11-factor test promulgated in *Roth Steel* and endorsed by the Sixth Circuit in *AutoStyle Plastics*, the *Lothian* court does nothing to show that recharacterization is based in § 502 rather than § 105.⁸⁵

B. Implications of Adopting the *Lothian* Approach

If recharacterization, allowance, and equitable subordination all lead to the same result, should anyone care which Code section the courts use to justify their holdings? In short: yes. In *Lothian*, the Fifth Circuit held that bankruptcy courts could end the recharacterization inquiry at § 502(b) without ever considering the intricacies of § 105(a).⁸⁶ In reaching its decision, the Fifth Circuit disregarded the potentially dire ramifications of its holding. In practice, application of the *Lothian* approach would result in a slew of changes for bankruptcy courts, debtors, creditors, and the general public. Some of those changes might prove beneficial; however, adopting the approach would have a negative net impact. Preserving the traditional approach, on the other hand, will allow for more uniformity and predictability in the realm of debt recharacterization.

Many scholars agree that “[b]ankruptcy is crucial to the functioning of credit markets and the reallocation of capital. As such, consistency in

⁸³ *Id.* (citing *Arch Petroleum, Inc. v. Sharp*, 958 S.W.2d 475, 477 n.3 (Tex. Ct. App. 1997)).

⁸⁴ *Id.*; see also, e.g., *In re Hedged-Invs. Assocs., Inc.*, 380 F.3d 1292, 1298 (10th Cir. 2004); *Jones v. United States*, 659 F.2d 618, 622 n.12 (5th Cir. 1981). The “*Roth Steel*” factors form the basis of a recharacterization analysis when a bankruptcy court is exercising its § 105 equitable authority. *Roth Steel Tube Co. v. Comm’r of Internal Revenue*, 800 F.2d 625, 630 (6th Cir. 1986), *cert. denied*, 481 U.S. 1014 (1987). The “*Roth Steel*” factors were formulated in a tax court case and subsequently applied to assessing recharacterization claims in the bankruptcy context. There are eleven nondispositive factors: (1) the names given to the debt instruments; (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 capitalization; (6) the identity of interest between the creditor and the stockholder; (7) collateralized 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. *Id.*

⁸⁵ See *In re AutoStyle Plastics, Inc.*, 269 F.3d 726, 748 (6th Cir. 2001) (advocating use of the *Roth Steel* factors to determine the appropriateness of debt recharacterization) (citing *Roth Steel Tube Co.*, 800 F.2d at 625 (6th Cir. 1986)).

⁸⁶ *In re Lothian Oil, Inc.*, 650 F.3d at 543.

the application of bankruptcy law is of critical importance to the smooth and unfettered conduct of business.”⁸⁷ No one disputes the importance of uniformity and predictability in the bankruptcy system; however, there is disagreement as to which approach will result in the desired uniformity.⁸⁸ The traditional approach suggests that bankruptcy courts derive their recharacterization authority from federal law, citing § 105(a) as the source of that authority.⁸⁹ Those holdings stand in sharp contrast with the conflicting but nonetheless popular notion that recharacterization authority must stem from state law.⁹⁰

Proponents of the Lothian approach mistakenly believe that deference to state law will generate a more predictable bankruptcy system. In an avant-garde article, James Wilton and Stephen Moeller-Sally argue that state law “offers a higher degree of predictability concerning the enforcement of insider debt and may serve as a means for reconciling the conflicting and inconsistent tests applied by the federal courts.”⁹¹ Interwoven in this argument are three separate, albeit related, points from that assertion. First, Wilton and Moeller-Sally believe that applying state law will result in greater predictability than that which exists in the current system.⁹² Second, the authors maintain that the

⁸⁷ Petition for Writ of Certiorari, *Lothian Cassidy, L.L.C. v. Lothian Oil, Inc.*, 132 S. Ct. 1573 (2011) (No. 11-792), 2011 WL 6468137 at *18; *see, e.g.*, James M. Wilton & Stephen Moeller-Sally, *Debt Recharacterization under State Law*, 62 BUS. LAW. 1257, 1279 (2007); David Gray Carlson, *Debt Collection As Rent Seeking*, 79 MINN. L. REV. 817, 836–37 (1995) (asserting that the major purpose of federal bankruptcy law is to guarantee competitive conditions in a national credit market); Note, *Switching Priorities: Elevating the Status of Tort Claims in Bankruptcy in Pursuit of Optimal Deterrence*, 116 HARV. L. REV. 2541, 2548 (2003) (concluding that the effects of the Chapter 7 and Chapter 11 priority schemes have significant effects on the credit market).

⁸⁸ Compare Wilton & Moeller-Sally, *supra* note 87, at 1257, 1278 (arguing that uniform treatment of state-created property interests, by both state and federal courts within a state, will achieve uniformity within the bankruptcy system, rather than inconsistent federal case law), with *In re Dornier Aviation, Inc.*, 453 F.3d 225, 232 (4th Cir. 2006) (holding that § 105(a) of the Code authorizes bankruptcy courts to recharacterize debt claims).

⁸⁹ *See, e.g.*, *In re Dornier Aviation, Inc.*, 453 F.3d at 225; *In re AutoStyle Plastics, Inc.*, 269 F.3d at 745; *In re Hedged-Invs. Assocs.*, 380 F.3d at 1292.

⁹⁰ *See In re Lothian Oil, Inc.*, 650 F.3d at 543; Wilton & Moeller-Sally, *supra* note 87, at 1257; Niel M. Peretz, *Recharacterization in the Ninth Circuit: Has the Supreme Court Finally Derailed the Pacific Express?*, 17 J. BANKR. L. & PRAC. 2 Art. 4 (arguing that the Ninth Circuit should recognize debt recharacterization because it has firm support in applicable state law).

⁹¹ Wilton & Moeller-Sally, *supra* note 87, at 1257.

⁹² *Id.* at 1278 (“These [multi-factor] tests fail in the most important respect that legal standards can fail—they are vague and do not permit accurate prediction of the outcome of future cases.”).

current system entails federal courts applying inconsistent tests.⁹³ Finally, the authors suggest that use of state law is a convenient way to fix the problem of inconsistency.⁹⁴

Wilton and Moeller-Sally have communicated what they perceive to be the two greatest shortcomings of the current system: the variation that exists in the number of factors considered and the weight ascribed to each.⁹⁵ Such differentiation, the authors bemoan, leads to inconsistent results that provide no guidance to potential lenders.⁹⁶ By considering the facts on a case-by-case basis, the courts have rendered the multi-factor test an ineffective guide for predicting the outcome of a case.⁹⁷ Wilton and Moeller-Sally suggest that “[t]he difficulty that courts have encountered in consistently applying the *Roth Steel* factors in bankruptcy cases may arise, in part, from what some courts have opined is an improper application of tax court precedents in the very different context of priority disputes in bankruptcy.”⁹⁸ The authors argue that some of those factors are irrelevant or even injurious to a bankruptcy case.⁹⁹ Given the purported discretion of the judges with regard to which factors to apply and how heavily to weight them, extraneous factors should not diminish the courts’ ability to apply the test.

The authors preemptively reject the possibility of applying the multi-factor test in a more rigid fashion.¹⁰⁰ An inflexible application of the multi-factor test, the authors warn, would not account for the complex nature of debt and equity instruments.¹⁰¹ They emphasize that debt and equity lie on a continuum and are not separated by any fixed line of demarcation. Determining the appropriate label, therefore, necessitates the use of a flexible test allowing for the consideration of the facts specific to the case.¹⁰² Although the authors make an important point, it does nothing to strengthen their argument, because federal courts do not apply the multi-factor test in such a rigid manner.

⁹³ *Id.* (“To the extent that the *Roth Steel* factors render uncertain the enforceability of debt instruments with conventional debt terms, state law is improperly preempted.”).

⁹⁴ *Id.* at 1279.

⁹⁵ *Id.* at 1263; see also Hilary A. Goehausen, Comment, *You Said You Were Going To Do What To My Loan? The Inequitable Doctrine of Recharacterization*, 4 DEPAUL BUS. & COM. L.J. 117 (2005).

⁹⁶ Wilton & Moeller-Sally, *supra* note 87, at 1263–64.

⁹⁷ *Id.*

⁹⁸ *Id.* at 1265.

⁹⁹ *Id.* at 1266.

¹⁰⁰ *Id.* at 1263.

¹⁰¹ *Id.*

¹⁰² Wilton & Moeller-Sally, *supra* note 87, at 1263.

Despite their assertion that the multi-factor test results in inconsistency and unpredictability, the authors propose an alternative that would exacerbate those problems. Turning to state law imposes two major issues concerning inconsistency. Most significantly, by propagating multitudinous recharacterization tests, such a system would deter potential lenders by generating confusion as to which state's law will govern their contribution. The transactions surrounding a financial contribution to a corporation are not confined to any particular state. More likely than not, the transaction will implicate the laws of numerous states. If the laws conflict with each other, how does one determine which law to apply? Does applicable law mean the debtor's state of incorporation? What about the place in which the debtor conducts its business? Perhaps the contributor's state of domicile should determine the applicable law. Then again, the state in which the contributor executed the documentation might prove more relevant. What if a bank facilitated the transaction? Should courts consider the bank's charter state?

To support their conclusion Wilton and Moeller-Sally point to the Supreme Court case of *Raleigh v. Illinois Department of Revenue*, which involved a tax-evading corporation in bankruptcy.¹⁰³ The case did not address recharacterization.¹⁰⁴ The *Raleigh* Court concluded courts should apply state law to the substance of a claim, unless the Code would suggest a different result.¹⁰⁵ Where a federal interest contradicts the state law, the federal interest must prevail.¹⁰⁶ Unlike the law at issue in *Raleigh*, debt recharacterization is implicitly addressed in the Code.¹⁰⁷ Therefore, the holding in *Raleigh* provides neither binding nor particularly persuasive precedent for the debt recharacterization issue.

Several circuits have agreed that the requirements of allowability under § 502 are minimal.¹⁰⁸ The low threshold imposed by § 502 results

¹⁰³ *Raleigh v. Illinois Dept. of Revenue*, 530 U.S. 15, 15 (2000).

¹⁰⁴ *See generally id.* (construing a state law that shifted the burden of proof from the government to the person responsible for the tax evasion).

¹⁰⁵ *Id.* In *Raleigh*, the Illinois law at issue was not contravened by any provision in the Code. By addressing issues of burden of proof arising from other situations, the Code's silence on this issue is particularly telling. As a result, the court found that the state law should prevail. *Id.* at 26.

¹⁰⁶ *Butner v. United States*, 440 U.S. 48, 55 (1979).

¹⁰⁷ *See* 11 U.S.C. § 105(a) (2006) (granting bankruptcy courts with the equitable authority necessary to carry out the provisions of the Code, including the priority scheme set forth in § 726).

¹⁰⁸ *See, e.g., In re Dornier Aviation, Inc.*, 453 F.3d 225, 225 (4th Cir. 2006); *In re AutoStyle Plastics, Inc.*, 269 F.3d 726, 748–49 (6th Cir. 2001); *In re Hedged-Invs. Assocs.*, 380 F.3d 1292, 1292 (10th Cir. 2004).

in an increasing number of claims being allowed by bankruptcy courts.¹⁰⁹ If debt recharacterization requires nothing more than surviving § 502(b) allowability, then the requirements for debt recharacterization will be similarly minimal. Ending the inquiry at § 502(b) would mean that bankruptcy courts would have to allow every claim for which an exception did not apply, unless the applicable state law would not characterize that claim as an equity interest.¹¹⁰ Adopting the *Lothian* approach could lead to serious repercussions. Those repercussions will most likely stem from the two most obvious aspects of the holding in *Lothian*: the increased reliance on state law and the minimal requirements imposed by § 502.

One foreseeable ramification of adopting the *Lothian* approach involves the elevation of state law to a status that could render Code provisions redundant. Except for a fairly significant caveat relating to state law, the *Lothian* court found that § 502(b) gives bankruptcy courts the authority to recharacterize debt claims as interests in equity.¹¹¹ The caveat to that rule comes from the *Butner* decision.¹¹² According to *Lothian* court, *Butner* instructs that bankruptcy courts can only recharacterize debt claims if the applicable state law would also classify them as equity interests.¹¹³ In practice, this means allowing those claims that state law would allow and disallowing those claims that state law would prohibit. That understanding of the *Butner* opinion propels state law to such an elevation that it takes precedent over provisions in the Code. The Code was enacted, in part, to generate uniformity in bankruptcy law.¹¹⁴ By instructing bankruptcy courts to look for solutions in state law rather than Code provisions, the *Lothian* approach contravenes the fundamental purpose of the Code. Rather than solving debt-versus-equity inquiry, the *Lothian* approach relegates that task to the states.

The second troublesome aspect of the *Lothian* holding involves the potential ramifications of grounding courts' authority for recharacterization in a Code provision whose requirements are so

¹⁰⁹ See, e.g., *In re Dornier Aviation, Inc.*, 453 F.3d at 225; *In re AutoStyle Plastics, Inc.*, 269 F.3d at 748–49; *In re Hedged-Invs. Assocs.*, 380 F.3d at 1292; *In re First NLC Fin. Servs., LLC*, 396 B.R. 562, 570–71 (Bankr. S.D. Fla. 2008); *In re Commonwealth Biotechnologies, Inc.*, Bankruptcy No. 11-30381-KRH, 2012 WL 5385632, *6 (Bankr. E.D. Va. Nov. 1, 2012).

¹¹⁰ 11 U.S.C. § 502(b) (2006); see *Butner*, 440 U.S. at 54.

¹¹¹ *In re Lothian Oil, Inc.*, 650 F.3d 539, 543 (5th Cir. 2011).

¹¹² *Id.*

¹¹³ *Id.*

¹¹⁴ See Bankruptcy Reform Act of 1978, 11 U.S.C. §§ 101-1330 (1978).

negligible. This could play out in a number of ways. While its effects would most likely prove injurious, favorable consequences could also ensue. For instance, the imposition of a minimal threshold requirement could lead to a reduction in the amount of time that courts spend on recharacterization claims. By ending the recharacterization inquiry in § 502(b), bankruptcy courts could avoid the potentially time consuming analysis in § 105(a).¹¹⁵ If every analysis under § 105(a) requires a determination of whether the proposed recharacterization furthers the purpose of the Code, one can imagine courts expending a lot of resources here.¹¹⁶ Alleviating the time pressures faced by bankruptcy courts is an admirable goal. However, if courts agree that implementing the priority scheme of § 726 is an objective of the Code,¹¹⁷ the time spent analyzing recharacterization under § 105(a) would be negligible. Furthermore, § 502(b) calls for the evaluation of recharacterization as part of the allowability determination. The time spent considering recharacterization under § 105(a), while relegated to an earlier stage in the process, does not cease to exist.

In practice, it seems much more likely that any positive ramifications resulting from the circumvention of an analysis under § 105(a) would pale in comparison to the concomitant results of this approach—namely, the profusion of recharacterization claims. If the threshold requirements of § 502(b) are as minimal as most courts have assumed,¹¹⁸ then recharacterization cannot serve as a factor that limits allowability. That means that the number of claims allowed under § 502(b) will not significantly diminish as a result of adopting the *Lothian* approach. Because the *Lothian* approach compels recharacterization for any claim allowed to proceed under § 502(b), recharacterization would become more commonplace. That, in turn, would have a negative effect on business, shareholders, and the public at large.

¹¹⁵ See *In re Dornier Aviation, Inc.*, 453 F.3d at 231.

¹¹⁶ See *id.* Bankruptcy courts' equitable authority under § 105(a) is limited to actions that further the purpose of the Code. Accordingly, exercise of such authority requires a consideration of the Code's overall objectives.

¹¹⁷ Because the *Lothian* court did not analyze recharacterization under § 105(a), it never explicitly acknowledged that furthering the priority scheme was an objective of the Code. That omission does not impel the conclusion that the Fifth Circuit disagrees.

¹¹⁸ See, e.g., *In re SubMicron Sys. Corp.*, 432 F.3d 448, 454 n.6 (3d Cir. 2006); *In re Dornier Aviation, Inc.*, 453 F.3d at 225; *In re AutoStyle Plastics, Inc.*, 269 F.3d 726, 748–49 (6th Cir. 2001); *In re Hedged Invs. Assocs.*, 380 F.3d 1292, 1292 (10th Cir. 2004).

In *Lothian*, the Fifth Circuit offered an inadequate explanation for its dismissal of § 105(a), but merely explained, “[b]ased on the above analysis, resort to § 105(a) is unnecessary.”¹¹⁹ In defending its decision not to use § 105(a), The Fifth Circuit opined that:

[T]his court’s precedent reflects a cautious view of § 105(a). For example, this court held that § 105 does not authorize bankruptcy courts to punish criminal contempt committed outside the court’s presence, in spite of the fact that other courts had approved using that section to authorize bankruptcy courts to punish civil contempt.¹²⁰

This explanation does not particularly advance the Fifth Circuit’s holding. Referencing unrelated situations in which the court took caution in its use § 105(a) does not mean that the court can throw § 105(a) to the wayside in favor of § 502(b). Furthermore, the Fifth Circuit’s cautious take on § 105(a) in criminal situations has little bearing on the provision’s relevance to debt recharacterization.

Perhaps most importantly, ending the inquiry at § 502(b) would negatively impact equity holders which, in turn, would prove deleterious not only for them, but also for businesses and the bankruptcy system at large.¹²¹ Undoubtedly, this approach would cause an unjust diminution of rights for at least some equity holders.¹²² If courts decide whether or not to allow a claim under § 502(b) based on the appropriateness of debt recharacterization, then those whom the court classifies as holders of equity will find themselves unable to bring any other rights they might have vis-à-vis the debtor.¹²³ In *Dornier*, the Fourth Circuit took measures to avoid such an undesirable outcome.¹²⁴ It insisted that if a claimant does have other rights against the debtor, the bankruptcy court must allow the claim to proceed under § 502(b), irrespective of whether the court would classify that claim as debt or as equity.¹²⁵ Accordingly, even if the circuits were to agree that analysis under § 105(a) is unnecessary, bankruptcy courts could only end the inquiry at § 502(b) in

¹¹⁹ *In re Lothian Oil, Inc.*, 650 F.3d 539, 543 (5th Cir. 2011).

¹²⁰ *Id.*

¹²¹ See Matthew Nozemack, *Making Sense Out of Bankruptcy Courts’ Recharacterization of Claims: Why Not Use § 510(c) Equitable Subordination?*, 56 WASH. & LEE L. REV. 689, 705 (1999) (discussing how recharacterization negatively effects businesses, their potential funders, and the bankruptcy court system).

¹²² See *In re Dornier Aviation, Inc.*, 453 F.3d at 232–36.

¹²³ *Id.*

¹²⁴ *Id.*

¹²⁵ *Id.*

situations in which the claim's characterization is the only issue for the claimant.

If nothing else, the *Dornier* opinion undoubtedly limits the disallowance power of bankruptcy courts to claimants who have no other rights vis-à-vis the debtor.¹²⁶ Nonetheless, it seems unusual that the determination of the origin of bankruptcy courts' authority for debt recharacterization should turn on whether a claimant has other rights against the debtor. Under such a system, the recharacterization issue ceases to play a central role in the inquiry. Moreover, if allowance under § 502(b) hinges on the claimant's other rights against the debtor—and not on whether the claimant is a holder of debt or of equity—then a recharacterization analysis serves no useful purpose at this stage in the process.

Under the equitable subordination doctrine, one's status as a corporate insider lowers the threshold requirement for the degree of misconduct necessary for the court to subordinate the claim.¹²⁷ In *AutoStyle Plastics*, the Sixth Circuit considered the effects of insider status as it relates to the equitable subordination doctrine.¹²⁸ The Sixth Circuit expressed concern with the ramifications of a reduced threshold requirement for insiders.¹²⁹ The court opined that the excessive severity of equitable subordination is evidenced by the fact that it generates enough fear to induce investors to stop investing.¹³⁰ Because recharacterization has the same financial consequences as equitable subordination,¹³¹ the Sixth Circuit's analysis and concern applies equally to recharacterization. That is, the harsh effects of recharacterization have a similar effect on corporate non-insiders as do the harsh effects of equitable subordination on a company's insiders.

In times of need, failing businesses often look first to their shareholders.¹³² The shareholders, or insiders, have a vested interest in the success of the business and are eager to see it succeed.¹³³ Aware of that reality, businesses understand that the current shareholders are the most likely candidates to continue pouring money into the business.¹³⁴ Much to the chagrin of the businesses, the threat of debt

¹²⁶ *Id.*

¹²⁷ *In re AutoStyle Plastics, Inc.*, 269 F.3d 726, 745 (6th Cir. 2001).

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ *Id.*

¹³¹ *In re Hoffinger Indus., Inc.*, 327 B.R. 389, 408 (Bankr. E.D. Ark. 2005).

¹³² *See, e.g., In re Octagon Roofing*, 157 B.R. 852, 858 (N.D. Ill. 1993).

¹³³ *In re AutoStyle Plastics, Inc.*, 269 F.3d at 745.

¹³⁴ *Id.*

recharacterization instills fear in their creditors.¹³⁵ Creditors want assurance the debtors will repay their loans, and if a bankruptcy court recharacterizes the creditor's loan as an equity contribution, the chances of repayment all but disappear.¹³⁶ In turn, creditors become less likely to make loans to businesses in need.¹³⁷ If creditors become less willing to lend their support to flailing businesses, then those businesses are less likely to stay afloat.¹³⁸ For the business, this often means bankruptcy or dissolution. For the employees, it means job loss. For the shareholders, it means the loss of an investment. In other words, the business's failure benefits no one. Accordingly, courts should endeavor to avoid that undesirable outcome.

In practice, many businesses rely on insider loans.¹³⁹ From a policy perspective, therefore, courts should encourage insider loans—not discourage them by threatening to subordinate the claims of those whose loan agreements result in litigation.¹⁴⁰ Oftentimes, insiders are the only ones willing to provide loans to a struggling business. As one court articulately explained, “[a]ny other analysis would discourage loans from insiders to companies facing financial difficulty and that would be unfortunate because it is the shareholders who are most likely to have the motivation to salvage a floundering company.”¹⁴¹ If, in fear of having their claims subordinated, insiders cease making such loans, then businesses that otherwise might have benefited from those loans will struggle to survive.¹⁴² Accordingly, courts should be loath to make

¹³⁵ *Id.* at 747.

¹³⁶ *See In re Octagon Roofing*, 157 B.R. at 858.

¹³⁷ *See In re AutoStyle Plastics, Inc.*, 269 F.3d at 747 (describing the shareholders of a business involved in an equitable subordination claim).

¹³⁸ *See id.*

¹³⁹ *Id.*

¹⁴⁰ *In re Hyperion*, 158 B.R. 555, 563 (Bankr. D.R.I. 1993). *See* Patricia A. Redmond & Jessica D. Gabel, *Not All Loans Are Created Equal: Equitable Subordination and Prepetition Insider Lending After Si Restructuring*, AM. BANKR. INST. J., Nov. 2008, at 22 (averring that “recharacterization disincentivizes eleventh-hour restoration financing” and noting the irony that “many of the outside claims are paid from the insider advances in the wake of successful recharacterization and equitable estoppel claims”); *see also* Michael R. Tucker, *Debt Recharacterization During an Economic Trough: Trashing Historical Tests to Avoid Discouraging Insider Lending*, 71 OHIO ST. L.J. 187, 228 (2010) (“However, inconsistent and ambiguous treatment of debt recharacterization discourages ‘owners and insiders of struggling [firms from undertaking legitimate] efforts to keep a flagging business afloat.’”) (quoting *Sender v. Bronze Group, Ltd. (In re Hedged-Invs. Assocs.)*, 380 F.3d 1292, 1298 n.1 (10th Cir. 2004)).

¹⁴¹ *In re Octagon Roofing*, 157 B.R. at 858.

¹⁴² *See In re Hyperion*, 158 B.R. at 563.

insider status the most significant factor in determining the permissibility of equitable subordination.

Courts impose a higher standard on insiders because insiders, owing to their relationship with the debtor, are more likely to engage in inequitable conduct than non-insiders, who lack any sort of special relationship with the debtor.¹⁴³ The Fifth Circuit noted that insiders typically had “greater opportunities for . . . inequitable conduct.”¹⁴⁴ If the importance of insider status stems only from its propensity to foster inequitable conduct, and inequitable conduct is a factor in § 510, but not in § 105 or § 502,¹⁴⁵ then insider status does not seem applicable to an analysis of § 105 or § 502. The court in *Lothian* recognized that “[e]quitable subordination and recharacterization, although sometimes based on the same facts, are directed at different conduct and have different remedies.”¹⁴⁶ Even within the confines of equitable subordination, insider status is only one of many factors impacting a court’s decision to equitably subordinate a claim.¹⁴⁷ Indeed, “the mere fact of an insider relationship is insufficient to warrant subordination.”¹⁴⁸

The consequences of equitable subordination and debt recharacterization differ in one significant way. “When reviewing equitable subordination claims, courts impose a higher standard of conduct upon insiders.”¹⁴⁹ This stems from the reality that equitable subordination requires a showing of inequity, and corporate insiders are more likely than corporate non-insiders to conduct themselves in such a manner.¹⁵⁰ As a result, courts examine the conduct of insiders with a greater degree of scrutiny.¹⁵¹ In determining debt recharacterization under § 105(a), however, a bankruptcy court should not necessarily consider one’s status as an insider. Debt recharacterization, unlike equitable subordination, does not require a showing of misconduct.¹⁵² That brings into question the significance of insider status in a debt recharacterization case.

¹⁴³ See *In re Fabricators*, 926 F.2d 1458, 1465 (5th Cir. 1991).

¹⁴⁴ *Id.*

¹⁴⁵ See, e.g., *In re Lothian Oil, Inc.*, 650 F.3d 539, 544 (5th Cir. 2011).

¹⁴⁶ *Id.* at 543; see also *In re AutoStyle Plastics, Inc.*, 269 F.3d 726, 745 (6th Cir. 2001).

¹⁴⁷ See *In re AutoStyle Plastics, Inc.*, 269 F.3d at 745.

¹⁴⁸ *In re Hyperion*, 158 B.R. 555, 563 (Bankr. D.R.I. 1993).

¹⁴⁹ *In re AutoStyle Plastics, Inc.*, 269 F.3d at 744.

¹⁵⁰ *Id.*

¹⁵¹ *Id.*

¹⁵² *In re Dornier Aviation, Inc.*, 453 F.3d 225, 232 (4th Cir. 2006).

IV. CONCLUSION

If the Supreme Court addresses this issue, it should disregard the *Lothian* approach.¹⁵³ The Court recently denied Grossman's petition for certiorari, thereby forfeiting the chance to halt this divisive issue in its incipency.¹⁵⁴ By introducing a new means of analyzing debt recharacterization, the Fifth Circuit, perhaps unwittingly, has laid the foundation for a polarizing circuit split. The choice of approach could lead to a different outcome for recharacterization. Because the circuits now disagree on the source of authority for debt recharacterization, it seems likely that bankruptcy courts will reach different conclusions when evaluating this issue. Some courts will stop the inquiry at § 502(b) and others will continue to an analysis under § 105(a). Inevitably, inconsistency will result. Such inconsistency will generate a slew of negative consequences, including forum shopping. In recharacterization cases, creditors and equity holders consistently want courts to characterize their claims as debt. Accordingly, if the characterization of a claim depends on which court hears the claim, then claimants will seek out courts likely to characterize the claim as a debt instead of as equity. Such forum shopping dilutes the purpose of the Code and leads to excessive uncertainty regarding the outcome of a case.

The inconsistency problem becomes especially apparent in view of the *Lothian* court's promotion of the use of state law. Using a Supreme Court decision that was issued before the creation of the Code, the *Lothian* court found that the relevance of insider status hinged on its relevance according to applicable state law. Two obvious issues flow from the Fifth Circuit's reliance on *Butner*. First, the Supreme Court decided *Butner* before the promulgation of the Code, thereby lessening its value as a source of precedent. Second, *Butner* encourages reliance on state law. Not only does such an approach generate inconsistency, but it also offsets one of the main tenets of the Code—uniformity. Congress did not codify bankruptcy law so that bankruptcy courts would make their decisions based on the state law that applied in that case.

¹⁵³ Grossman's attorney filed a petition for certiorari on December 20, 2011, which the Supreme Court denied on February 21, 2012. The Court's denial of Grossman's petition means that the circuits will remain divided as to the correct approach for handling recharacterization. When undecided courts are faced with this issue and forced to choose between the two approaches, the circuit split is likely to grow increasingly divisive. Perhaps a more substantial divide will persuade the Court to resolve the issue.

¹⁵⁴ See *supra* notes 87 and 153 and accompanying text.

Regardless of why the Court decides to address this issue, it should rule in favor of those who oppose the *Lothian* approach.¹⁵⁵ The shortcomings of the *Lothian* approach render it an inappropriate stopping point in the evaluation of the debt-versus-equity inquiry. Ironically, the *Lothian* court acknowledged the fact that debt recharacterization required a two-step inquiry.¹⁵⁶ The court even criticized the district court for failing to consider the second step.¹⁵⁷ Despite that acknowledgement, the *Lothian* court conflated two steps into one by suggesting that a recharacterization inquiry should occur simultaneously with the allowability determination under § 502(b).

Grounding courts' recharacterization authority in § 502 will result in an overabundance of recharacterization claims. According to § 502(b), a bankruptcy court must allow any claim to which no one has filed an objection.¹⁵⁸ If bankruptcy courts must allow every such recharacterization claim, they will have no discretion with regard to determining the appropriateness of recharacterization. By grounding the authority in § 105, however, the Court will ensure that bankruptcy courts make their decisions based on the equitable authority with which the Code has granted them—not because they must.

Requiring bankruptcy courts to look beyond § 502(b) will promote the financing of troubled businesses and dispel fears of potential contributors. To circumvent the problems that arise from the *Lothian* approach, the Court can adopt either of two other approaches. The first such approach entails an analysis under § 105(a) following any determination of allowability under § 502(b). This approach mirrors that used by the majority of circuit courts in the pre-*Lothian* era.¹⁵⁹ More than that, however, this approach aligns with the overall purpose of the Code and follows naturally from a reading from § 105(a). As courts of equity, bankruptcy courts have the authority to take actions that further the purpose of the Code.¹⁶⁰ It seems clear that such equitable authority would include the power to promote the priority scheme established in § 726. If a bankruptcy court finds that debt recharacterization is necessary to implement that priority scheme, then according to § 105(a), the bankruptcy court should have the authority to do so.

¹⁵⁵ See, e.g., *In re AutoStyle Plastics, Inc.*, 269 F.3d at 749.

¹⁵⁶ *In re Lothian Oil, Inc.*, 650 F.3d 539, 543 (5th Cir. 2011).

¹⁵⁷ *Id.*

¹⁵⁸ 11 U.S.C. § 502 (2006).

¹⁵⁹ See, e.g., *In re AutoStyle Plastics, Inc.*, 269 F.3d at 749; *In re Dornier Aviation, Inc.*, 453 F.3d at 231; *In re SubMicron Sys. Corp.*, 432 F.3d 448, 454 n.6 (3d Cir. 2006).

¹⁶⁰ See 11 U.S.C. § 105(a) (2006).

The second approach would require a § 105(a) analysis for only those claimants who have other rights vis-à-vis the debtor. The Fourth Circuit discussed this concept at length in *Dornier*.¹⁶¹ Ending the analysis at § 502(b) is problematic because that section provides for the total allowance or disallowance of a claim. Accordingly, if bankruptcy courts refuse to consider equity as a claim, then the claimant cannot proceed in any capacity. In other words, the characterization under § 502(b) ends the matter entirely. By requiring courts to continue the evaluation for those claimants having further rights, the Court will dispel at least some of the concerns about disallowance under § 502(b).

¹⁶¹ See generally *In re Dornier Aviation, Inc.*, 453 F.3d at 232–36.