By Susan E. Trent

No Final Word

Debt-Recharacterization Issue on Cert Dismissed as Improvidently Granted

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Outside of bankruptcy, accounting and tax laws give parties significant latitude in characterizing contributions as either debt or equity. In bankruptcy, however, whether a contribution is deemed debt or equity impacts the debtor's creditors as a result of the absolute priority rule — namely, that debt must be paid prior to equity receiving anything. Even when a future bankruptcy is merely contemplated as a possibility, a party might need to consider the ramifications of a loan extension versus an equity contribution.

In bankruptcy, equity contributions of capital have a lower priority than debt. From time to time, bankruptcy courts must determine whether certain obligations are debt or equity in order to determine the priority of payment of the bankruptcy estate to creditors and equityholders and, in consequence, what each might receive in distributions from the estate.

Even if provided in good faith in order to rescue a struggling business, insider loans tend to draw scrutiny and are ripe to be recharacterized with significant ramifications in a liquidation context. There are circumstances where federal common law factors are different from the various state law factors and might inject uncertainty into the bankruptcy estate depending on which body of law is deemed determinative by the court. Moreover, debt buyers might also need to weigh risks associated with recharacterization as they consider discounts, purchase-agreement terms and a price in acquiring loans from insiders.

The issue for the U.S. Supreme Court in *PEM Entities LLC v. Levin* (formerly on appeal from the Fourth Circuit) was whether bankruptcy courts should use federal or state law rules of decision in determining whether to recharacterize a debt claim into an equity contribution. However, on Aug. 10, 2017, the petition for *writ of certiorari* was dismissed as "improvidently granted." Nevertheless, an examination of the facts and the briefs to the Court are instructive on the issues debated.

A Complex Factual Background Leading to the Fourth Circuit Case

The case arose from certain real estate investments involving Howard Jacobsen.[1] He managed Lakebound Fixed Return Fund LLC, which invested in real estate and provided significant returns to investors.[2] Eric Levin and Howard Shareff (the "appellees") invested $500,000 each in Lakebound.[3] Province Grand Old Liberty LLC (PGOL) was formed by Jacobsen to acquire a golf and real estate development in North Carolina. PGOL's members included Jacobsen, his parents and Robert Conaty.[4]

To finance the acquisition of the property, PGOL obtained $188,000 from Lakebound and borrowed $6,465,000 from Paragon Commercial Bank by virtue of an arm's-length transaction papered with a promissory note and deed of trust encumbering the property (the "Paragon loan").[5] PGOL ultimately defaulted on the Paragon loan, and Paragon initiated a foreclosure suit.[6]

Ultimately, the parties entered into a settlement agreement to resolve the loans to PGOL and other entities.[7] The terms of the settlement included a sale of the Paragon loan to a new company, PEM LLC, owned by Jacobsen, Conaty and Jacobsen's father, and an entity owned by trusts established by Jacobsen for the benefit of his grandchildren (the "trust") for the discounted price of $1,242,000 (the "loan-purchase amount").[8] PEM's members did not negotiate or execute the settlement agreement — PGOL's principals did.[9]

To fund the loan-purchase amount, PEM used equity contributions from members and outside financing. Jacobsen contributed $130,000, Conaty contributed $100,000 and the Trust contributed $70,000,[10] totaling $300,000.[11] PEM also received $650,000 toward the loan-purchase amount from Joseph Deglomini and Joseph Simone (the "D&S loan").[12] Paragon agreed to loan PEM the final $292,000 interest-free to complete settlement (the "Paragon settlement loan").[13] The Paragon settlement loan and the D&S loan were secured by the property, with PEM subordinating its interest by

1 *PEM Entities LLC v. Levin (In re Province Grande Olde Liberty LLC)*, 655 Fed. App'x. 971, 972 (4th Cir. Aug. 12, 2016).

2 *Id.* at 972.
3 *Id.*
4 *Id.*
5 *Id.* at 973.
6 *Id.*
7 *Id.*
8 *Id.*
9 *Id.*
10 *Id.*
11 *Id.*
12 *Id.*
13 *Id.* "Interest-free" is an interesting example of a factor that may or may not be considered by state law in characterizing an obligation as debt or equity.

virtue of the acquisition of the Paragon loan in the property to both.[14]

Over time and subsequent to the settlement, PGOL sold some assets, made some payments to Paragon and D&S, and also made certain advances to PEM and Jacobsen; however, it failed to maintain any ledger or account of the Paragon settlement loan. On March 11, 2013, PGOL filed for bankruptcy. PEM filed a claim in the amount of $7 million, relative to its acquisition of the Paragon loan. The appellees filed claims against PGOL in the amount of $500,000 each, and they made claims for equitable subordination and recharacterization.[15] The bankruptcy court held in favor of the appellees on the issue of recharacterization and determined that the Paragon loan purchase was really a settlement and satisfaction — not an acquisition of debt — under the circumstances.[16] The bankruptcy court further found that the $300,000 paid toward the Paragon loan purchase price was an equity investment in PGOL rather than a debt owed. The $7 million PEM claim was rendered void.[17] The district court affirmed.[18]

The Fourth Circuit noted in its opening remarks that "recharacterization is well within the broad powers afforded a bankruptcy court" and applied the following 11 federal court-created factors to determine whether to recharacterize the PEM debt claim into equity:[19]

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 interest rate;
4. the source of repayments;
5. the adequacy or inadequacy of capitalization;
6. the identity of interests between the creditor and 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.[20]

None of these factors were deemed "dispositive" by the Fourth Circuit, and their "significance varies depending on the circumstances."[21] The rub on appeal to the Supreme Court was, which body of decisions (state or federal) should apply to recharacterization controversies? The choice could be outcome-determinative given the different tests developed by federal courts and state courts in analyzing the debt or equity question in the differing contexts (*e.g.*, bankruptcy/insolvency versus solvency/tax and accounting).

14 *Id.*
15 *Id.* As the reader might recall, the appellees loaned PGOL $188,000 in the original purchase of the property.
16 *Id.* at 974.
17 *Id.*
18 *Id.*
19 *Id.* (citing *In re Dornier Aviation (N. Am.) Inc.*, 453 F.3d 225 (4th Cir. June 27, 2006)). Broad powers presumably encompass § 105 powers.
20 *Id.*
21 *Id.*

PEM Entities LLC Petition for a *Writ of Certiorari*: Argument Summary

PEM made several interesting arguments in its petition filed on Oct. 11, 2016. First, PEM noted that a "well-developed circuit conflict" existed, offering that the Sixth, Tenth, Third, Fourth and Eleventh Circuits held that a federal rule of decision governs debt recharacterization in bankruptcy.[22] However, PEM argued that more recent decisions had adopted a state law rule of decision, including holdings from the Fifth and Ninth Circuits.[23] These latter circuits reached their conclusion by reviewing § 502(b), which states that all claims are deemed allowed unless a claim is unenforceable under state law.

> **[L]oans from insiders ... have long been an important source of financial rescue for a struggling debtor.**

PEM argued that this § 502(b) focus eliminated the need to resort to vague § 105(a) powers, which should be construed narrowly in any event.[24] PEM also contended that "Congress knows how to draft federal rules for claims dismissals" based on the remaining eight clauses in § 502(b)(2)-(9).[25] These clauses provided "no support for a separate federal common law of debt recharacterization."[26]

PEM also raised a practical point concerning the matter of certainty and its impact on small business.[27] Maintaining that debt recharacterization is not some "obscure and rare bankruptcy doctrine," PEM noted that many businesses struggle at some point.[28] When seeking a rescue cash influx, uncertainty on the issue of recharacterization might make business turnarounds before bankruptcy (or the purchase of distressed debt) more difficult.[29] PEM also discussed that in some cases, and irrespective of the "tension" that it creates, it is only an insider who is willing to make a loan to the struggling business.[30]

Appellees' Brief in Opposition to the *Writ of Certiorari*: Argument Summary

Filed on Feb. 28, 2017, the appellees/respondents led their opposition argument by stating that a bankruptcy court's "equitable powers have long included the ability to look beyond form to substance" while referring to the majority of circuits that have recognized a bankruptcy court's ability to recharacterize debt as equity.[31] The recitation of facts

22 Petition for *Writ of Certiorari* at 11-13, 137 S. Ct. 2326 (June 27, 2017).
23 *Id.* at 14 (referring to *In re Lothian Oil Inc.*, 650 F.3d 539 (5th Cir. 2011), and *In re Fitness Holdings Int'l Inc.*, 714 F.3d 1141 (9th Cir. 2013)).
24 *Id.*
25 *Id.* at 18.
26 *Id.*
27 *Id.* at 25.
28 *Id.*
29 *Id.*
30 *Id.* at 26-27.
31 Appellee's Brief in Opp. to Pet. for *Writ of Cert.* at 1, 137 S. Ct. 2326 (June 27, 2017) (referring to *Pepper v. Litton*, 308 U.S. 295, 305 (1939)).

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between PEM and the appellees is markedly different in terms of tone concerning Jacobsen's insider role.[32]

In this author's opinion, the real gist of the appellees' argument was that the circuit split really does not exist in a meaningful way; thus, a decision from the Supreme Court would be both premature at best and potentially upend established bankruptcy doctrine vetted by numerous lower courts.[33] The appellees/respondents also addressed recent decisions from lower courts in the Second and Seventh Circuits, which have "tended to recognize the majority position" and the application of federal law.[34]

Joint Motion to Confirm Party Status

As is fairly common in a complex, commercial matter, there were other disputes that existed among the parties that did not present a basis for appeal to the Supreme Court. On July 21, 2017, a motion to confirm party status was filed by PEM and PGOL with the Supreme Court, which described an April 2017 settlement that eliminated the interests of Levin and Shareff (the appellees/respondents).[35]

As part of the April 2017 settlement, Levin and Shareff assigned their interest in opposing the relief sought by PEM.[36] Thus, if the bankruptcy court's order was affirmed by the Supreme Court, PEM's note would remain extinguished, and PGOL (the debtor) would likely continue as a viable entity and develop the property. If the Supreme Court reversed, PEM's secured claim of nearly $7 million would be senior to more junior creditors and the equity interests of PGOL. According to the motion, "nearly half of PGOL's equity investors were wholly unrelated to and had no interest in PEM or its members," which was the basis for the motion and continuing interest in the case.[37]

Improvident Dismissal and Conclusion

On Aug. 10, 2017, the Supreme Court dismissed the *writ of certiorari* as "improvidently granted." While the dismissal order does not set forth the Court's reasoning, the assignment of the appeal to PGOL and the complex ownership interests of PEM and PGOL might have played a significant role in the Court's reasoning. Dismissals on the basis that *certiorari* was improvidently granted are relatively rare, although they appear to happen for many reasons. Consequently, the issue of whether state or federal rule of decisions should control the determination of whether a debt might be recharacterized as equity remains a question left for another day.

In bankruptcy, there is little question that a debtor's insiders are incentivized to characterize contributions as debt, in order to have more advantageous priority in a liquidation. While the *Dornier* factors do not specifically note the "good faith" or "bad faith" of an insider in their dealings as a factor, it seems unlikely that it is not considered at least with respect to the credibility of witnesses who might be providing testimony on the nature of the debt. However, loans from insiders vested in the success of companies have long been an important source of financial rescue for a struggling debtor.

Many companies struggle — and insider dealings must not be assumed to always indicate the existence of bad faith, particularly in small businesses. Whether state or federal law should control — at least for the time being — the majority view seems to favor the application of federal law in decisions. abi

32 *Id.* at 2-5.
33 *Id.* at 5.
34 *Id.* at 10 (referring to *In re Emerald Casino Inc.*, 2015 WL 1843271 (N.D. Ill. April 21, 2015), and *In re Eternal Enter. Inc.*, 557 B.R. 277, 286 (Bankr. D. Conn. 2016)).
35 Joint Motion to PEM Entities LLC and Province Grande Old Liberty LLC to Confirm Party Status, 137 S. Ct. 2326 (June 27, 2017).
36 *Id.* at 9-10.
37 *Id.* at 11.