

## U.S. Supreme Court Grants Certiorari to Decide Circuit Split on Applicable Law for the Recharacterization of Debt

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The United States Supreme Court will soon decide whether state or federal law will apply to the recharacterization of debt. On June 27, 2017, the Court granted certiorari in *In re Province Grande Olde Liberty, LLC*, a decision out of the Fourth Circuit.

In *Province Grande*, the Fourth Circuit affirmed the judgment of the bankruptcy court and district court, both of which had relied on the Bankruptcy Code to recharacterize a debt from a secured claim to a capital investment. The underlying transaction involved multiple investments tied to three companies, all of which had a common member. The common member obtained a loan from company A, as well as a loan from an outside lender, in order to acquire real property in the name of company B. In exchange for the loan from the outside lender, company B executed a promissory note and deed of trust for the real property. After Company B could not pay the loan, company C was created. Company C ultimately purchased the secured debt from the outside lender. Soon thereafter, Company B defaulted on the loan and subsequently filed for bankruptcy. Company C then filed a claim.

In the bankruptcy court, investors of company A sought to have the secured debt, owned by company C, recharacterized as a capital investment, effectively eliminating company C's claim in the bankruptcy. In determining whether to recharacterize the debt, the bankruptcy court relied on federal law and applied eleven factors, which included:

- (1) the names given to the instruments, if any, evidencing the indebtedness;
- (2) the presence or absence of a fixed maturity date and schedule or payments;
- (3) the presence or absence of a fixed rate or 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.

The Fourth Circuit agreed that all eleven factors weighed in favor of recharacterization. In reaching its conclusion, the Fourth Circuit reiterated the importance of recharacterization in implementing the priority scheme of the Bankruptcy Code.

In their petition for writ of certiorari, company C pointed to the split that currently exists amongst the circuits. While five of the circuits that have addressed the recharacterization of debt have applied federal law, two circuits, including the Fifth Circuit, have applied state law. It is likely that a decision to apply federal law would more often lead to the recharacterization of debt to equity. A decision to apply state law, on the other hand, could lead to inconsistent and varied results.

While it remains to be seen how the U.S. Supreme Court will rule on the issue, given the impacts of recharacterization, you can certainly be sure that lenders will anxiously be awaiting the decision's debut. We will keep you informed as the

case proceeds.