

Client Alert

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The Tenth Circuit BAP Affirms a Bankruptcy Court's Ability to Recharacterize Debt to Equity

Despite the absence of any provision in the Bankruptcy Code expressly authorizing the recharacterization of a debt claim to an equity interest, it generally is well-established that recharacterization is within the broad powers afforded a bankruptcy court under section 105(a) of the Bankruptcy Code and is necessary for the proper application of the Bankruptcy Code's priority scheme.¹ In a recharacterization analysis, a bankruptcy court ignores the labels of a transaction, examines the facts, and determines whether a particular obligation represents debt or equity. If the court concludes that the advance embodies an equity infusion rather than a debt that the parties intended to be repaid, the claim will be recharacterized and effectively subordinated because the Bankruptcy Code requires that a debtor satisfy all other obligations before providing a return to equity interests.²

On March 18, 2014, the Bankruptcy Appellate Panel for the Tenth Circuit Court of Appeals ("BAP") in *Redmond v. Cimarron Energy Co. (In re Alternate Fuels, Inc.)*, 2014 Bankr. LEXIS 1041 (B.A.P. 10th Cir. Mar. 18, 2014), affirmed a bankruptcy court's authority to recharacterize claims and rejected the claimant's arguments that two recent Supreme Court decisions, *Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co.*, 549 U.S. 443 (2007), and *Law v. Siegel*, 2014 U.S. LEXIS 1784 (Mar. 4, 2013); prohibit bankruptcy courts from granting relief not expressly authorized under the Bankruptcy Code, such as recharacterization.

Case Background

The Claim

The case focused on an alleged secured claim in the principal amount of \$4,336,813.10 (the "Claim") held by William Jenkins and his wife, M. Earlene Jenkins (together, the "Claimants"), against debtor Alternate Fuels, Inc. ("AFI").³

The origins of the case, however, lie in the Claimants acquisition of the outstanding shares of AFI, which was engaged in coal mining operations, and certain related assets. Specifically, in December 1999, after mining operations had ceased but when AFI was obligated to reclaim mining properties in the State of Missouri, the Claimants purchased from John Warmack ("Warmack"): (i) all of the outstanding shares of

¹ See 11 U.S.C. § 105(a) (authorizing bankruptcy courts to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]"); see, e.g., *Braun v. Official Comm. of Unsecured Creditors (In re Dornier Aviation)*, 453 F.3d 225, 231 (4th Cir. 2006) (holding that a bankruptcy court's power to recharacterize under section 105(a) is essential to the proper and consistent application of the Bankruptcy Code's priority scheme).

² See 11 U.S.C. § 1129(b).

³ *Redmond v. Jenkins (In re Alternate Fuels, Inc.)*, 2012 Bankr. LEXIS 5682, at *3-11 (Bankr. D. Kan. Dec. 10, 2012).

AFI and 99% of the stock in Cimarron Energy Co. ("Cimarron"), which was the operating company for AFI; (ii) certain equipment owned by Cimarron; and (iii) twenty-four certificates of deposit, which were pledged to secure bonds in favor of the State of Missouri to guarantee AFI's reclamation obligations. The Claimants paid \$549,250 directly to Warmack for this transaction. However, because William Jenkins was listed in the Federal Office of Surface Mining's Applicant Violator System, he was prohibited from owning the stock of a surface coal mining company. To get around this obstacle, the Claimants arranged for the ownership of the AFI stock to be placed in the name of Michael Christie, who acted as a mere straw man for the Claimants.

At the time of the transaction, AFI had no assets and no ongoing business. AFI did not recognize or follow corporate formalities or hold annual shareholder and board of director meetings. William Jenkins controlled all of AFI's operations, which were limited to reclamation efforts through Cimarron, and delegated the day-to-day operation of AFI and Cimarron to AFI's field engineer and financial cost analyst, Larry Pommier ("Pommier"). Cimarron held all of the assets.

The Claimants also financed the reclamation efforts. The Claimants provided checks payable to AFI that were drawn on accounts of Green Acres Farms, a fictitious name for the Claimants that was registered with the Missouri Secretary of State. The funds were delivered to Pommier, who then endorsed them for payment to Cimarron. AFI, through Cimarron, using the funds provided by the Claimants, then undertook reclamation.

In exchange for such funds, AFI issued three promissory notes to Green Acres Farms (collectively, the "Promissory Notes") with similar payment terms, including a five-year due date; but repayment was expressly conditioned on the release of the reclamation bond from the State of Missouri at an uncertain time in the future. When the Promissory Notes were executed, AFI was engaged in reclamation, not mining, and had no expected source of income for payment of such notes. Before obtaining the funds from the Claimants, AFI attempted unsuccessfully to get loans from at least six banks. No payments on the Promissory Notes were ever made to the Claimants.

In 2002, when Pommier and William Jenkins believed that reclamation was nearly complete and that the State of Missouri had unreasonably blocked and interfered with such efforts, AFI filed a lawsuit against officers and employees of the Missouri Department of Natural Resources for tortious interference, seeking approximately \$5 million in damages. In 2006, AFI obtained a judgment on the lawsuit, which the State of Missouri satisfied in September 2008.

The judgment prompted many entities to assert claims against AFI. As a result, on January 28, 2009, AFI filed a voluntary petition under chapter 11 in the Bankruptcy Court for the District of Kansas (the "Bankruptcy Court") for assistance in determining the priority of the payment of creditors. Christopher J. Redmond subsequently was appointed as chapter 11 trustee for AFI (the "Trustee"). The \$5 million judgment was AFI's primary asset.

On July 11, 2009, the Claimants filed a proof of claim in the bankruptcy case for the Claim, alleging that it arose from, among other things, the Promissory Notes.

The Adversary Proceeding and Bankruptcy Court Decision

The Trustee, on January 27, 2011, filed an adversary proceeding in the Bankruptcy Court against the Claimants, asserting that the Claim should be recharacterized to an equity interest because the moneys advanced to AFI and evidenced by the Promissory Notes were equity infusions and not true loans.⁴

⁴ *Id.* at *4.

The Bankruptcy Court agreed with the Trustee and recharacterized the Claim as an equity interest in AFI. In reaching its conclusion, the Bankruptcy Court held that its authority to recharacterize is found in section 105 of the Bankruptcy Code.⁵

To complete the recharacterization analysis, the Bankruptcy Court applied the following thirteen-factor test adopted by the Tenth Circuit Court of Appeals in *Sender v. Bronze Group, Ltd. (In re Hedged-Investments Assocs., Inc.)*, 380 F.3d 1292, 1297-98 (10th Cir. 2004):

- i. the names given to the certificates evidencing the indebtedness;
- ii. the presence or absence of a fixed maturity date;
- iii. the source of payments;
- iv. the right to enforce payment of principal and interest;
- v. participation in management flowing as a result;
- vi. the status of contribution in relation to regular corporate creditors;
- vii. the intent of the parties;
- viii. “thin” or adequate capitalization;
- ix. identity of interest between the creditor and stockholder;
- x. source of interest payments;
- xi. the ability of the corporation to obtain loans from outside lending institutions;
- xii. the extent to which the advance was used to acquire capital assets; and
- xiii. the failure of the debtor to repay on the due date or to seek a postponement.⁶

The Bankruptcy Court determined that two of the factors were inapplicable (factors (vi) and (x)); three of the factors “superficially” supported treatment of the advances as loans (factors (i), (v) and (xii)); and the remaining seven factors “strongly” supported recharacterization. In particular, the Court held that “[t]here was no fixed maturity date, AFI had no present or expected source of funds to repay the advances, the parties did not intend a true loan, AFI was thinly capitalized, AFI had no ability to obtain loans from lending institutions, and AFI failed to pay the [Promissory] Notes or seek an extension after the passage of the five-year due dates stated in the [Promissory] Notes.”⁷ Despite the fact that the Promissory Notes provided that they were payable in five years, the Bankruptcy Court noted that such payments also were expressly conditioned on the release of the reclamation bond at an unspecified time. The Bankruptcy Court, therefore, found that the Promissory Notes in fact did not have a fixed maturity date. Given that the factors overwhelmingly supported recharacterization, the Bankruptcy Court concluded that the parties treated the Claim as an equity infusion rather than a true loan, and recharacterized the Claim as an equity interest.

⁵ *Id.* at *30 (citation omitted).

⁶ *Id.* at *31-32 (quoting *Hedged-Investments*, 380 F.3d 1292 at 1298) (noting that “[n]one of these factors is dispositive and their significance may vary depending upon the circumstances”). The Circuits have employed various multi-factor tests to define the recharacterization inquiry. See, e.g., *Grossman v. Lothian Oil, Inc. (In re Lothian Oil, Inc.)*, 650 F.3d 539, 544 (5th Cir. 2011) (endorsing sixteen factor test used under Texas state law); *Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Sys.)*, 432 F.3d 448, 455-56 (3d Cir. 2006) (affirming the district court’s application of a seven factor test, but cautioning that the overarching inquiry is “intent” rather than a factored-test); *Dornier*, 453 F.3d at 223 (endorsing an eleven factor test); *Bayer Corp. v. Masco Tech, Inc. (In re AutoStyle Plastics, Inc.)*, 269 F.3d 726, 747-48 (6th Cir. 2001) (endorsing an eleven factor test).

⁷ *Id.* at *38.

The Appeal and Tenth Circuit BAP's Opinion

On appeal to the Tenth Circuit BAP, the Claimants argued that a bankruptcy court's power to recharacterize claims and the use of multi-factor tests for recharacterization was prohibited by the Supreme Court's recent decisions in *Travelers* and *Law*.⁸

Specifically, the Claimants argued that *Travelers* precludes recharacterization unless recharacterization is allowed by applicable state law. In *Travelers*, the Supreme Court analyzed a bankruptcy court's decision to disallow a claim by a debtor's bonding company for attorneys' fees it incurred litigating issues in the bankruptcy case. The Supreme Court held that, in the absence of support for a claim in the Bankruptcy Code, "we generally presume that claims enforceable under applicable state law will be allowed in bankruptcy unless they are expressly disallowed [by the Bankruptcy Code]."⁹ Accordingly, the Supreme Court disagreed with the bankruptcy court's decision because nothing in the Bankruptcy Code outlawed the debtor's state law obligation to pay attorneys' fees. As a result, the Claimants argued that *Travelers* prohibits recharacterization of their Claim because (i) there is no provision in the Bankruptcy Code that disallows their Claim; and (ii) Kansas law, which governs the transactions underlying the Claim, allegedly does not recognize recharacterization.¹⁰

The Claimants also asserted that *Law* prohibits recharacterization. In *Law*, the Supreme Court held that the bankruptcy court's powers under section 105(a) of the Bankruptcy Code "can only be exercised within the confines of the Bankruptcy Code."¹¹ The Supreme Court disagreed with a decision by a bankruptcy court to grant, pursuant to section 105(a) of the Bankruptcy Code, a chapter 7 trustee's motion to "surcharge" a debtor's \$75,000 homestead exemption and make such funds available to defray the trustee's attorneys' fees. In particular, the Supreme Court held that the bankruptcy court exceeded the limits of its authority because its decision violated the express terms of the Bankruptcy Code – namely section 522(k) of the Bankruptcy Code, which states that exempt assets are not liable for administrative expenses, including the reasonable attorney's fees incurred by a trustee. The Court noted that the Bankruptcy Code's "meticulous...enumeration of exemptions and exceptions to those exemptions confirms that courts are not authorized to create additional exceptions."¹² "[F]ederal law provides no authority for bankruptcy courts to deny an exemption on a ground not specified in the Code."¹³

Relying on the holding in *Law*, the Claimants contended that the Bankruptcy Court erred because the Bankruptcy Code does not give bankruptcy courts discretion to recharacterize claims under section 105(a) of the Bankruptcy Code based on whatever considerations they deem appropriate.¹⁴

The Tenth Circuit BAP rejected the Claimants' arguments and affirmed the Bankruptcy Court's decision. The BAP first noted that neither *Travelers* nor *Law* abrogated a bankruptcy court's ability to recharacterize claims. "Significantly, the *Travelers* and *Law* decisions do not deal with recharacterization at all, or even mention the *Hedged-Investments* decision."¹⁵ *Law* dealt with a bankruptcy court order that

⁸ See *Redmond v. Cimarron Energy Co.*, 2014 Bankr. LEXIS 1041, at *17-18.

⁹ 549 U.S. at 452 (citation omitted).

¹⁰ *Redmond v. Cimarron Energy Co.*, 2014 Bankr. LEXIS 1041, at *18.

¹¹ 2014 Bankr. LEXIS 1784, at *11.

¹² *Id.* at *17.

¹³ *Id.* at *18 (emphasis included in the decision).

¹⁴ *Redmond v. Cimarron Energy Co.*, 2014 Bankr. LEXIS 1041, at *18.

¹⁵ *Id.* at *21.

directly contravened a Bankruptcy Code provision, while *Travelers* addressed the allowance of claims enforceable under state law that are not expressly prohibited by the Bankruptcy Code.¹⁶ The BAP held that recharacterization is not based on the enforceability of a claim nor does it violate a provision of the Bankruptcy Code. Instead, it is based on establishing the true substance of a transaction. “It is not a determination of whether a claim should be allowed or disallowed; it is a determination of whether a claim should be treated as a claim or as an equity interest.”¹⁷ If a claim is recharacterized, it still is recognized in the bankruptcy case, but simply is treated as an equity interest.

Moreover, the BAP recognized that implementation of the Bankruptcy Code’s priority scheme requires a determination of whether a particular obligation is debt or equity.¹⁸ Where the question is in dispute, the bankruptcy court must have the authority to make this determination in order to preserve the Bankruptcy Code’s priority scheme.¹⁹ According to the BAP, denying a bankruptcy court the ability to recharacterize would have the effect of subverting the Bankruptcy Code’s critical priority scheme by allowing equity investors to jump the line and reduce the recovery of true creditors. Thus, “[i]n light of the broad language of § 105(a) and the larger purpose of the Bankruptcy Code,” the BAP held that “a bankruptcy court’s power to recharacterize is essential to the proper and consistent application of the Code.”²⁰

After affirming that the Bankruptcy Court has the authority to recharacterize debt to equity, the BAP then held that the Bankruptcy Court’s recharacterization of the Claim was appropriate. The BAP agreed that the Bankruptcy Court properly applied the thirteen-factor test adopted in *Hedged-Investments* to analyze the true substance of the Claim. “The purpose of the *Hedged-Investments* factors is to ‘distinguish true debt from camouflaged equity’ by determining whether certain facts are more supportive of a loan or an equity transaction.”²¹ The BAP agreed with the Bankruptcy Court that application of the factors to the facts concerning the Claim clearly support recharacterization. The BAP noted that if anything the Bankruptcy Court was generous to the Claimants in its findings, noting that more than seven of the factors weighed heavily in favor of recharacterization.

Conclusion

In sum, the BAP’s decision in *Redmond v. Cimarron Energy Co.* affirmed that a bankruptcy court’s equitable power to recharacterize claims is well within the broad powers afforded bankruptcy courts under section 105 of the Bankruptcy Code. The BAP was unwilling to expand the holdings in *Travelers* and *Law* to abolish such authority, despite the fact that recharacterization is not expressly prescribed by the Bankruptcy Code. In essence, the BAP appeared to be particularly focused on the fact that recharacterization is necessary for bankruptcy courts to preserve the Bankruptcy Code’s priority scheme and prevent abuse by equity holders trying to disguise their true interests.

¹⁶ *Id.*

¹⁷ *Id.* at *20-21.

¹⁸ *Id.* at 18 (citing *Dornier*, 453 F.3d at 225).

¹⁹ *Id.*

²⁰ *Id.* (quoting *Dornier Aviation*, 453 F.3d at 231).

²¹ *Id.* at *22.

Contacts

Benjamin C. Ackerly
backerly@hunton.com

Tyler P. Brown
tpbrown@hunton.com

Tara L. Elgie
telgie@hunton.com

Jarrett L. Hale
jhale@hunton.com

Jason W. Harbour
jharbour@hunton.com

Gregory G. Hesse
ghesse@hunton.com

Andrew Kamensky
akamensky@hunton.com

Henry P. Long, III
hlong@hunton.com

Richard Norton
rnorton@hunton.com

Peter S. Partee, Sr.
ppartee@hunton.com

Michael Richman
mrichman@hunton.com

Ronald L. Rubin
rrubin@hunton.com

J. R. Smith
jrsmith@hunton.com

Michael G. Wilson
mwilson@hunton.com

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