

# Financial Restructuring Group Client Alert

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## FIFTH CIRCUIT COURT OF APPEALS HOLDS THAT NON-INSIDER CLAIMS MAY BE RECHARACTERIZED BY BANKRUPTCY COURT PURSUANT TO STATE LAW

On August 9, 2011, the Court of Appeals for the Fifth Circuit (the “Fifth Circuit”) published an important decision regarding the recharacterization of non-insider debt claims as equity under the Bankruptcy Code, *in Grossman v. Lothian Oil Inc.* (*In re Lothian Oil Inc.*), --- F.3d ---, No. 10-50683, 2011 WL 3473354 (5th Cir. Aug. 9, 2011). The Fifth Circuit (1) held that a bankruptcy court may recharacterize non-insider claims as equity pursuant to applicable state law; and (2) reversed the District Court’s holding that contributions from non-corporate insiders could never be recharacterized as equity.

### Background

In April 2005, Israel Grossman (“Grossman”) and the secretary of Lothian Oil Inc. (“Lothian”) executed two documents. The first (the “First Loan”), which was handwritten, stated that “Grossman loans \$200,000 US to Lothian Oil Inc . . .”<sup>1</sup> As consideration for the First Loan, Grossman was to receive a one (1) percent royalty on the gross production Lothian received from the Webb Properties of New Mexico (i.e., oil and gas) (the “Webb Properties”).<sup>2</sup> The First Loan was to be repaid from the proceeds of a \$0.75 (per share) equity placement made in Lothian or any other equity placements in Lothian.<sup>3</sup> In May 2005, Grossman and the secretary of Lothian signed a document called a “Loan Agreement” (the “Second Loan” and, together with the First Loan, the “Alleged Loans”), pursuant to which Grossman loaned \$150,000 to Lothian. In consideration for the Second Loan, Grossman was to receive a one (1) percent royalty on the gross production Lothian received from the Webb Properties (i.e., oil and gas), and the Second Loan was to be repaid from the proceeds of the \$0.75 per share equity placement made in Lothian or from the proceeds of any other equity placement.<sup>4</sup> After Lothian filed for chapter 11, the Bankruptcy Court recharacterized the Alleged Loans and held that they

<sup>1</sup> *Grossman v. Lothian Oil Inc. (In re Lothian Oil Inc.)*, --- F.3d ---, No. 10-50683, 2011 WL 3473354, at \*1 (5th Cir. Aug. 9, 2011) (emphasis added).

<sup>2</sup> *Id.*

<sup>3</sup> *Id.*

<sup>4</sup> *Id.* at \*2..

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“assert common equity interests at best . . .”<sup>5</sup> because, while the Alleged Loans contained elements of debt and equity, the one percent overriding royalty interest on the Webb Properties constituted equity and should be characterized as such.<sup>6</sup>

## District Court Decision

The District Court affirmed the Bankruptcy Court’s decision in part, but reversed the recharacterization of the claims based on the Alleged Loans. Specifically, the District Court “decline[d] to extend the concept of debt recharacterization to a non-insider creditor.”<sup>7</sup> Thus, the District Court applied a *per se* rule prohibiting bankruptcy courts from recharacterizing contributions from non-corporate insiders as equity. Since Grossman was not an insider of the debtors,<sup>8</sup> his advances to Lothian Oil constituted *bona fide* loans and were characterized as debt. While the District Court cited the 11-factor test for determining whether to recharacterize debt as equity (from *Jones v. United States*, 659 F.2d 618, 622 n.12 (5th Cir. 1981)), it did not apply the factors because Grossman was not an insider.<sup>9</sup> Lothian appealed, challenging the District Court’s recharacterization decision.

## Fifth Circuit Reversal

The Fifth Circuit reversed the District Court’s decision on recharacterization and held that “recharacterization exists beyond insiders and is part of the bankruptcy court’s authority to allow and disallow claims under 11 U.S.C. § 502.”<sup>10</sup>

Significantly, the Fifth Circuit recognized 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).”<sup>11</sup> However, the Fifth Circuit stated that “resort[ing] to § 105(a) is unnecessary” because section 502(b) provides that, where a creditor timely files a claim, “the court, after notice and a hearing, shall determine the amount of such claim . . . and shall allow such claim in such amount, except to the extent that -- (1) such claim is unenforceable against the debtor and property of the debtor, *under any agreement or applicable law*.”<sup>12</sup> Furthermore, the Supreme Court has held that “applicable law” means state law. *See Butner v. United States*, 440 U.S. 48, 54, 99 S. Ct. 914, 918 (1979) (“Congress has generally left the determination of property rights in the assets of a bankrupt’s estate to state law”). Therefore, the Fifth Circuit held that, “[t]aken together, *Butner* and § 502(b) support the bankruptcy courts’ authority to recharacterize claims” under state law (and, presumably, under other applicable non-bankruptcy law as well).<sup>13</sup>

Thus, unless state law – or some other applicable non-bankruptcy law – establishes that insider status is relevant to a recharacterization determination, insider status cannot affect whether federal bankruptcy courts

<sup>5</sup> *In re Lothian Oil, Inc.*, No. 07-70121, Order Sustaining the Sixth Omnibus Objection to Claims, Docket No. 1832 at 2 (Bankr. W.D. Tex. Dec. 17, 2008). In addition, the Bankruptcy Court held that Grossman’s other proofs of claim asserted claims against non-debtor entities for which the reorganized debtors were not liable.

<sup>6</sup> *In re Lothian Oil, Inc.*, No. 07-70121, Transcript of 12/17/2008 Hearing, Docket No. 1846 at 105 (Bankr. W.D. Tex. Dec. 17, 2008).

<sup>7</sup> *In re Lothian Oil*, 2011 WL 3473354, at \*2.

<sup>8</sup> Section 101(31) of the Bankruptcy Code defines “insiders,” if the debtor is a corporation, as including a: “(i) director of the debtor; (ii) officer of the debtor; (iii) person in control of the debtor; (iv) partnership in which the debtor is a general partner; (v) general partner of the debtor; or (vi) relative of a general partner, director, officer, or person in control of the debtor.” 11 U.S.C. § 101(31).

<sup>9</sup> *In re Lothian Oil*, 2011 WL 3473354, at \*2.

<sup>10</sup> *Id.* at \*3.

<sup>11</sup> *Id.* Section 105(a) of the Bankruptcy Code provides, in relevant part, that: “[t]he court may issue any order, process or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code].”

<sup>12</sup> 11 U.S.C. § 502(b) (emphasis added).

<sup>13</sup> *In re Lothian Oil*, 2011 WL 3473354, at \*3.

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recharacterize claims.<sup>14</sup> Since the Alleged Loans were governed by Texas law, the Fifth Circuit applied Texas' multi-factor recharacterization test<sup>15</sup> and concluded that, since Grossman's advances to Lothian constituted equity under Texas law, the Bankruptcy Court correctly recharacterized Grossman's claims. In reaching this conclusion, the Fifth Circuit specifically noted that, despite language referring to "loans" in the underlying documents, (i) Texas law does not factor insider status into recharacterization analyses; (ii) Grossman would be paid from royalties and "equity placements"; and (iii) the documents lacked a specified interest rate, term of repayment and maturity date.<sup>16</sup> The most important factor in favor of recharacterizing Grossman's claims was "the inclusion of a royalty payment, which depended on the success of Lothian's business, instead of a prescribed interest rate."<sup>17</sup>

Finally, the Fifth Circuit rejected the notion that there was a *per se* rule against recharacterizing the claims of non-insiders, and explicitly stated that "because insiders and non-insiders alike can mischaracterize their claims in contravention of state law, we decline to limit recharacterization to insider claims."<sup>18</sup>

### Implications of Fifth Circuit's Holding

The Fifth Circuit's decision has two potential important implications. First, bankruptcy courts – which have generally looked to section 105 of the Bankruptcy Code in connection with recharacterizing claims – may look to state law, and other applicable non-bankruptcy law, when performing a recharacterization analysis (and this could have a more far reaching impact). This increases the importance and relevance of state law decisions as precedent for federal bankruptcy courts, at least in the Fifth Circuit.

Second, the Fifth Circuit explicitly overruled the District Court's rule prohibiting bankruptcy courts from recharacterizing the claims of non-insiders, which means that – as long as the relevant recharacterization factors are met – non-insiders and non-affiliates can have their claims recharacterized as equity contributions. While the "paradigmatic" situation for recharacterization remains "where the same individuals or entities (or affiliates of such) control both the transferor and the transferee, and inferences can be drawn that funds were put into an enterprise with little or no expectation that they would be paid back along with other creditor claims,"<sup>19</sup> recharacterization is explicitly not limited to insiders' or affiliates' claims. Thus, lenders – both insiders and non-insiders – must continue to be cognizant of the recharacterization factors and ensure that their loans are negotiated at arms length and have the relevant indicia of *bona fide* loans.

<sup>14</sup> *Id.*

<sup>15</sup> See *Estate of Mixon v. United States*, 464 F.3d 394, 402 (5th Cir. 1972) (applying a 13-factor test to determine whether to recharacterize a claim as equity).

<sup>16</sup> *In re Lothian Oil*, 2011 WL 3473354, at \*4.

<sup>17</sup> *Id.*

<sup>18</sup> *Id.*

<sup>19</sup> *In re Adelpia Commc'ns Corp.*, 365 B.R. 24, 74 (Bankr. S.D.N.Y. 2007).

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**New York**

One Chase Manhattan Plaza  
New York, NY 10005

Dennis F. Dunne	+1-212-530-5770	ddunne@milbank.com
Matthew S. Barr	+1-212-530-5194	mbarr@milbank.com
Evan R. Fleck	+1-212-530-5567	efleck@milbank.com
Wilbur F. Foster, Jr.	+1-212-530-5058	wfoster@milbank.com
Tyson Lomazow	+1-212-530-5367	tlomazow@milbank.com
Abhilash M. Raval	+1-212-530-5123	araval@milbank.com

**Los Angeles**

601 South Figueroa Street  
Los Angeles, CA 90017

Paul S. Aronzon	+1-213-892-4377	paronzon@milbank.com
Gregory Bray	+1-213-892-4470	gbray@milbank.com
Thomas R. Kreller	+1-213-892-4463	tkreller@milbank.com
Robert J. Moore	+1-213-892-4501	rmoore@milbank.com
Mark Shinderman	+1-213-892-4411	mshinderman@milbank.com

**London**

10 Gresham Street  
London EC2V 7JD England

Nick Angel	+44-20-7615-3008	nangel@milbank.com
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