BECKER LLC
ATTORNEYS AT LAW

Looking Back, We Had A Great 2017!

- We negotiated stay relief for the single largest secured creditor, vendor and logistics provider of an energy company in Chapter 7. We subsequently defended against preference, fraudulent conveyance, fraud, insider, good faith and fair dealing, and subordination claims by the Trustee. In a defense aided by pre-action discovery under *Rule* 2004, we obtained partial dismissal of the complaint on motion, then successfully resolved all remaining claims, and recovered collateral.
- We represented a commercial lender secured creditor of a Chapter 11 debtor in negotiations, *Section* 363 motion and successful auction sale of a large Staten Island commercial facility, recovering principal, interest and legal fees.
- Represented a land owner in successfully obtaining dismissal of a bankruptcy initiated by a developer who was seeking to preserve a failed development project on the owner's farmland.
- Represented the Chapter 11 trustee of an individual debtor in obtaining bankruptcy court approval of a $12 million sale of a former gas station and car wash property in New York City. This matter included substantial negotiations with the real estate developer – purchaser. It also require application of Bankruptcy Code §363(h) to sell the interest of a co-owner of the property.
- Settled for *de minimis* value complex preference and unauthorized post-petition transfer litigation brought by a litigation trustee, involving a pre and post-petition emergency service provider to a national Chapter 11 debtor. The provider had been retained on the eve of bankruptcy, and had functioned both pre and post-petition under a contract, advance deposit, advance payment and an amended post-petition contract, which debtor refused to assume.

"Good Money after Bad" - Equitable Subordination and the Associated Doctrine of Recharacterization of Debt to Equity

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Mr. Underwood is Chairperson of the firm's Bankruptcy, Restructuring and Creditor's Rights Group. He also maintains an active commercial and corporate practice focusing on the representation of principals and closely held manufacturers, logistics and service providers, and lenders.

Equity holders (including parents and subsidiaries) in all businesses (but in particular closely held businesses) must be particularly concerned with the equitable subordination of advances, loans and investments, and the recharacterization of debt as equity, in bankruptcy. Lenders to, and investors in such entities, and the professionals who represent them, also must be cautious as to same.

When bankruptcy follows significant investment, equitable subordination and recharacterization can transform well-meaning loans and investments into lost "good money after bad." Even worse, equitable subordination or recharacterization can lay the groundwork for trustee avoidance actions for funds repaid on loans prior to bankruptcy, either as preferences pursuant to 11 U.S.C. § 547, or fraudulent conveyances under 11 U.S.C. § 548.

Whether by unforeseen tempest, the forewarned tsunami, or a slow death spiral, the period leading to insolvency and bankruptcy is generally composed of a series of predictable events. Though the actual circumstances will be industry specific, inevitably, the day of reckoning occurs. The cause, be it a looming loan default, an inability to meet a claim or judgment, lack of funds to meet an insurance premium or payroll, or even the desperate need to re-tool or fund critical growth, are similar and pressing. Previously successful business owners and investors - being what they are – hard-working, entrepreneurial and hopeful, often find irresistible the lure of pouring personal funds

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"Good Money After Bad" - Equitable Subordination and the Doctrine… *Cont'd…/*

into a failing company to rebuild on hard work and investment. The sentiment cannot be faulted, but the acts and consequences often are, in hindsight.

The federal statutory framework for equitable subordination, and the separate judge made doctrine of recharacterization, are similar, often confused, and frequently pled in tandem – despite important distinctions between the two. In simple terms, equitable subordination of a claim can occur after a bankruptcy, where a shareholder or insider, (and sometimes even an angel investor, trade creditor or lender), has advanced or loaned funds to the company prior to bankruptcy. If all creditors are not to be paid in full, a bankruptcy court may subsequently determine that the advances or loans were an equity contribution, and therefore subordinate to all unsecured creditors. Equitable subordination claims arise under 11 *U.S.C.* § 510(c) of the Bankruptcy Code. Recharacterization, on the other hand, is an equitable, judge made doctrine that does not arise under a specific provision of the Bankruptcy Code other than the Code's equity "catch all" provision. Recharacterization is based on either federal common law, or the law of the applicable state. Equitable subordination is applied when a creditor's pre-petition acts are in question – but there is little question about the documentary foundation of the claim. Debt recharacterization focuses on whether or not a debt actually exists – as opposed to whether the debt is a disguised equity contribution.

In 2016, the U.S. Supreme Court granted Certiorari in the case of *PEM Entities LLC v. Levin*, *et als*. to resolve a split of the circuits as to whether bankruptcy courts should employ state or federal common law in recharacterizing debt as equity. Ultimately, the grant of Certiorari was dismissed as improvidently granted, thus the Supreme Court has not ruled on the issue. The Third Circuit is in the majority in holding that recharacterization is governed by federal common law. Interestingly, there is almost no body of common law from the state courts of New Jersey with reference to corporations and the recharacterization of shareholder loans or advances. Parallels arise, for instance, the doctrine of merger as to judgments. Nevertheless, New Jersey state courts have avoided equitable recharacterization, resorting most frequently instead to the fraudulent conveyance statue in the case of claw backs on payments by insolvent entities to equity, ahead of general creditors.

All circuits agree that bankruptcy courts as courts of equity have the power to recharacterize debt as equity. Despite varying tests, the Third, Fourth, Sixth, Tenth and Eleventh Circuits employ federal common law in reliance upon the Bankruptcy Court's equitable powers pursuant to 11 *U.S.C* § 105(a). The Fifth and Ninth Circuits defer to state law and *Section* 502 of the Bankruptcy Code, under *Butner vs. United States.* Presently, within the Third Circuit, New Jersey Bankruptcy Courts must follow *In re Submicron Systems Corporation et als*. Were the Supreme Court to decide to visit the split, and were it to rule in favor of the minority position, recharacterization claims in the Third Circuit, and in particular in New Jersey, might be much more difficult to pursue given the paucity of New Jersey state court decisions directly addressing recharacterization of debt.

Equitable subordination and recharacterization often pose "all or nothing" stakes. The cost of successfully defending these fact sensitive claims can be very high. Extreme care in the drafting and execution of transactions, and extreme caution in the parties' behavior regarding transactions in the danger zone, is absolutely critical to avoid later bankruptcy litigation, and to maintain solid defenses. A loss on either, and you might as well have tossed the money invested into the wind

About Becker LLC

Becker LLC is a premier mid-market firm serving the New York, New Jersey, Philadelphia and California corridor. The firm provides the complete spectrum of legal services from litigation, transactional, labor and employment, and bankruptcy law counseling, to intellectual property, real estate and construction law-related advice. Our size and regional footprint allows us to provide sophisticated services in a manner not only focused on results, but also on our client's return on their investment. For more information, call (973) 422-1100, or visit www.becker.legal