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RESCUE LOANS AND THE RISK OF RECHARACTERIZATION

Recharacterization is a doctrine that allows bankruptcy courts to look behind the label assigned to a particular investment and determine whether it should be treated as debt or equity. The authors discuss the doctrine with a particular focus on rescue loans and then turn to recent cases in which recharacterization was granted or denied.

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As a company begins its slide into distress, it is common for management to look for sources of capital to address liquidity constraints to weather the storm impacting the company's business. As a result, existing creditors or the company's equity sponsor will often agree to provide rescue financing. The doctrine of recharacterization allows bankruptcy courts to look behind the label assigned to a particular investment and determine whether it should be treated as debt or equity. In many instances, recharacterization of debt to equity means that the putative creditor will not receive any distribution in those cases where equity is out of the money. Moreover, prepetition payments of interest, fees, or principal on account of a recharacterized debt can also give rise to a fraudulent transfer claim. Thus, in the worst case scenario, the putative creditor may not get any distribution and be forced to disgorge prepetition payments. This article discusses recent developments in the doctrine of recharacterization with a particular focus on rescue loans.[1]

LEGAL STANDARD

The Bankruptcy Code does not expressly authorize recharacterization. As a result, bankruptcy courts have adopted two views on the source of their power to recharacterize debt as equity. The Third, Fourth, Sixth, and Tenth Circuits follow the "equitable power" theory of recharacterization, which holds that the recharacterization power stems from the broad, equitable powers granted to bankruptcy courts under section

[1] Recharacterization is often confused with equitable subordination. Recharacterization allows a court to reclassify a debt instrument as equity. By contrast, equitable subordination is a remedial doctrine that alters the relative priority of a debt instrument due to the creditor's inequitable conduct that harms other creditors. Thus, an equitably subordinated debt will be subordinated to the claims of all other injured creditors, but will remain senior to equity. While subordination is not the same thing as disallowance, subordination may have practical consequence of non-payment if a claim is subordinated below the fulcrum security.

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