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Making Sense Out of Bankruptcy Courts' Recharacterization of Claims: Why Not Use § 510(c) Equitable Subordination?

Matthew Nozemack*

I. Introduction

In order to remedy creditor misconduct that harms the debtor or other creditors,¹ bankruptcy courts have the authority to subordinate claims in bankruptcy on equitable grounds.² The courts remedy creditor misconduct by moving otherwise valid, superior claims behind inferior claims.³ The subordinated claims receive a distribution from the bankruptcy estate only after the

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1. See *Heiser v. Woodruff*, 327 U.S. 726, 733 (1946) (stating that equitable principles allow subordination of creditor's claims to prevent consummation of course of conduct that would prove fraudulent or inequitable to other claimants).

2. See *Pepper v. Litton*, 308 U.S. 295, 308 (1939) (stating that bankruptcy courts examine circumstances surrounding claims to "see that injustice or unfairness is not done in administration of the bankrupt estate"); 4 LAWRENCE P. KING ET AL., *COLLIER ON BANKRUPTCY* ¶ 510.05, at 510-12 (15th ed. 1997) (discussing bankruptcy courts' authority to subordinate claims under principles of equitable subordination); Andrew DeNatale & Prudence B. Abram, *The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors*, 40 *BUS. LAW.* 417, 421 (1985) (discussing bankruptcy courts' review of claims).

3. See *Pepper*, 308 U.S. at 306 (discussing authority to subordinate otherwise valid claim behind other claims under principles of equity); see also ROBERT L. JORDAN & WILLIAM D. WARREN, *BANKRUPTCY* 30 (4th ed. 1995) (discussing distribution of assets in bankruptcy). The harsh effect of subordinating claims below other unsecured creditors results from the general order of distribution in bankruptcy proceedings. *Id.* Secured creditors have claims to specific property of the bankrupt debtor. *Id.* The trustee first distributes estate property to satisfy secured claims. *Id.* The trustee distributes the remaining property among various claimants according to § 726 of the Bankruptcy Code (Code). *Id.* Under § 726, the first disbursement of property is to expenses and claims with priority under § 507. *Id.* Administrative expenses described in § 503 are given first priority. *Id.* Next, the trustee pays the additional priority claimants listed in order under § 507. *Id.* After the estate pays all priority claims, it distributes property to the remaining unsecured creditors pursuant to § 726. *Id.* These unsecured claims are ordinarily paid on a pro-rata basis because the estate normally distributes all available property before being able to satisfy the unsecured claims fully. *Id.* In the extremely rare situation in which the estate fully satisfies claims of all unsecured creditors, any remaining property would be distributed back to equity holders. *Id.*

estate satisfies all the superior claims.⁴ Although bankruptcy courts had exercised equitable jurisdiction for years,⁵ in 1978, Congress finally codified the bankruptcy courts' use of equitable subordination in § 510(c) of the Bankruptcy Code (Code).⁶

Despite the availability of § 510(c) equitable subordination, some bankruptcy courts have achieved the same remedial result by recharacterizing purported debt transactions as equity contributions by using the bankruptcy courts' general equitable powers.⁷ Bankruptcy courts have based these recharacterizations on § 105 of the Code, which grants bankruptcy judges the authority to "issue any order, process or judgment that is necessary or appropriate to carry out the provisions" of the Code.⁸ Bankruptcy courts have pointed to their authority to disregard the form of a transaction and to determine its true substance to support their recharacterization of claims.⁹ The lack of a specific code provision governing recharacterization of claims, however, has left the courts with a large number of factors to sort through when considering whether to recharacterize a transaction.¹⁰

4. 4 KING ET AL., *supra* note 2, ¶ 510.01, at 510-13.

5. See *infra* notes 33-45 and accompanying text (discussing Supreme Court's exercise of equitable jurisdiction to subordinate claims in two 1939 decisions).

6. 11 U.S.C. § 510(c) (1994). Equitable subordination allows a bankruptcy court to reorder existing priorities among creditors. The subordination provision of the Code provides:

Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may —

(1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or

(2) order that any lien securing such a subordinated claim be transferred to the estate.

Id.

7. See generally *Unsecured Creditors' Comms. of Pac. Express, Inc. v. Pioneer Commercial Funding Corp.* (*In re Pacific Express, Inc.*), 69 B.R. 112 (B.A.P. 9th Cir. 1986) (noting that bankruptcy court cannot allow recharacterization of purported loans into equity transactions because § 510(c) of Bankruptcy Code governs result of subordination that recharacterization achieves); *Pinetree Partners, Ltd. v. State Teachers Retirement Sys.* (*In re Pinetree Partners, Ltd.*), 87 B.R. 481 (Bankr. N.D. Ohio 1988) (same). Recharacterizing a claimant's transaction from debt to equity moves the claimant further down the line in bankruptcy proceedings. If the court considers the transaction to be a debt or loan, the bankruptcy trustee pays the claimant with the other unsecured creditors. Once the court recharacterizes the claim as an equity transaction, the claimant must wait and see if the bankruptcy estate has enough capital to satisfy the unsecured claims in their entirety because only then will the trustee begin to pay the equity holders.

8. 11 U.S.C. § 105(a).

9. See *Pepper v. Litton*, 308 U.S. 295, 304-05 (1939) (stating that bankruptcy court's equitable powers enable it to look past form of transaction to its substance in determining whether to treat transaction as debt or equity).

10. See *infra* note 143 (listing factors courts consider in determining whether to subordinate transaction).

According to the United States Court of Appeals for the Ninth Circuit Bankruptcy Appellate Panel's (B.A.P.)¹¹ decision in *Unsecured Creditors' Committees of Pacific Express, Inc. v. Pioneer Commercial Funding Corp. (In re Pacific Express, Inc.)*,¹² bankruptcy courts do not have the authority to recharacterize debt into equity.¹³ The *Pacific Express* panel determined that the Code does not provide for the characterization of claims as debt or equity.¹⁴ The B.A.P. refused to adopt the tax court's analysis to determine whether an advance is a loan or capital contribution.¹⁵ The panel rejected this

11. See *JORDAN & WARREN, supra* note 3, at 940-43 (discussing formation and jurisdiction of Bankruptcy Appellate Panels). In 1994, Congress amended 28 U.S.C. § 158(b) to require the establishment of Bankruptcy Appellate Panels (B.A.P.) in each circuit unless the circuit's judicial council determines that insufficient judicial resources prevent establishing B.A.P.s or that the B.A.P. would create undue delay or increased cost to parties. *Id.* at 941. A majority of district judges must vote to authorize a B.A.P. to hear an appeal. *Id.* Any party to the case may elect for the district court, instead of a B.A.P., to hear the appeal. *Id.* The Ninth Circuit B.A.P. has operated since the Code went into effect in 1978. *Id.* The Ninth Circuit B.A.P. consists of rotating panels of three ordinary bankruptcy judges from within the circuit, but outside the district from which the appeal arises. *Id.* Appeals from bankruptcy courts initially go to either the district court or to a B.A.P. *Id.* After the district court or the B.A.P. hears the case, the case can go to a United States Court of Appeals and perhaps to the Supreme Court. *Id.* at 942. The Supreme Court normally hears between five to seven bankruptcy appeals per year. *Id.*

12. 69 B.R. 112 (B.A.P. 9th Cir. 1986).

13. See *Unsecured Creditors' Comms. of Pac. Express, Inc. v. Pioneer Commercial Funding Corp. (In re Pacific Express, Inc.)*, 69 B.R. 112, 115 (B.A.P. 9th Cir. 1986) (concluding that Code provisions do not provide for characterization of claims in bankruptcy as equity or debt). In *Pacific Express*, the Ninth Circuit B.A.P. considered whether the Bankruptcy Code provided a basis for the characterization of claims as debt or equity. *Id.* An unsecured creditors committee filed a complaint to determine the status of creditors' claims against a collection agency and the participants in a loan participation agreement. *Id.* at 114. The bankruptcy court found that the transactions should be classified as a stock transfer rather than as a secured loan. *Id.* The court found that the participation agreement was not an arm's length transaction and was an equity investment rather than a loan. *Id.* at 115. The court stated that its power to recharacterize the claims was consistent with the Code. *Id.* The B.A.P. reversed the lower court, stating that the result achieved by recharacterizing the claims — subordination — is governed by § 510(c) of the Code. *Id.* The B.A.P. vacated the bankruptcy court's characterization of the transaction as an equity contribution rather than as a loan. *Id.* The B.A.P. also considered whether the claims should be subordinated under § 510(c), and it determined that no inequitable conduct was present. *Id.* at 118. Consequently, the B.A.P. reversed the lower court and held that the claims should neither be reclassified nor subordinated. *Id.*; see *In re Lewiston Steam & Power Assocs.*, No. B86-00477-Y, 1989 Bankr. LEXIS 1382, at *12 (Bankr. N.D. Ohio Aug. 24, 1989) (holding recharacterization of loans as equity contributions outside power of bankruptcy court); *Pinetree Partners, Ltd. v. State Teachers Retirement Sys. (In re Pinetree Partners, Ltd.)*, 87 B.R. 481, 491 (Bankr. N.D. Ohio 1988) (holding that bankruptcy courts cannot recharacterize claims because Code provisions do not support such action).

14. See *Pacific Express*, 69 B.R. at 115 (stating that Code supports court's ability to determine amount and allowance of claim but not its character).

15. See *id.* (claiming factors tax court utilized to determine classification of transaction

analysis as irrelevant, but never stated how it reached that conclusion.¹⁶ The B.A.P. ruled that § 510(c) equitable subordination governs all actions resulting in the subordination of claims in bankruptcy proceedings.¹⁷

This Note examines the practice of recharacterizing claims in bankruptcy proceedings and considers whether recharacterization differs materially from § 510(c) equitable subordination. To answer this question, this Note evaluates why the *Pacific Express* B.A.P. prohibited bankruptcy judges from going beyond traditional § 510(c) equitable subordination concepts to subordinate claims. Part II discusses the evolution of equitable subordination and how bankruptcy courts apply § 510(c) to equitably subordinate claims.¹⁸ Part III examines when and why some courts choose to recharacterize transactions from debt to equity instead of using § 510(c) to subordinate claims in bankruptcy.¹⁹ Part IV takes a closer look at *Pacific Express* and the Ninth Circuit's prohibition of the recharacterization of claims in bankruptcy proceedings.²⁰ Part V analyzes the reasons why bankruptcy courts choose to recharacterize certain transactions in bankruptcy.²¹ This Note ultimately concludes that bankruptcy courts should have the authority to recharacterize claims using the tax court factors. However, the bankruptcy courts should examine these factors as a group and avoid subordinating or recharacterizing claims based solely on the debtor's undercapitalization or inability to procure outside financing from disinterested lenders.

II. *The Doctrine of Equitable Subordination*

Bankruptcy courts are traditionally regarded as courts of equity.²² The doctrine of equitable subordination derives from this equitable jurisdic-

are irrelevant for bankruptcy purposes); *see also infra* note 143 and accompanying text (discussing factors normally used by tax court to determine classification of transaction).

16. *Pacific Express*, 69 B.R. at 115.

17. *Id.* at 115-16 (noting appropriate test to use in considering whether to subordinate claim is equitable subordination under § 510(c)).

18. *See infra* Part II (discussing evolution and application of doctrine of equitable subordination).

19. *See infra* Part III (discussing bankruptcy courts' practice of recharacterizing debt to equity).

20. *See infra* Part IV (discussing *Pacific Express* and reasons for not allowing bankruptcy courts to recharacterize claims).

21. *See infra* Part V (discussing need for bankruptcy courts to disregard form of some transactions in bankruptcy and determine true substance).

22. *See* *Sampsel v. Imperial Paper & Color Corp.*, 313 U.S. 215, 219 (1941) (stating that "the theme of the Bankruptcy Act is equality of distribution"); *Local Loan Co. v. Hunt*, 292 U.S. 234, 240 (1934) (examining equity jurisdiction of bankruptcy courts); *Clarke v. Rogers*, 228 U.S. 534, 548 (1913) (stating that equality among creditors is aim of bankruptcy law); Corley

tion.²³ Although the substantive laws of bankruptcy normally achieve fair results for all interested parties, occasionally a narrow interpretation of the laws produces an unjust result.²⁴ The bankruptcy courts avoid unjust results by exercising their equitable powers to subordinate claims of wrongdoing creditors.²⁵ The courts examine a claimant's conduct in relation to other creditors to determine whether it is unfair to allow the claimant to share in a pro rata distribution in bankruptcy with other creditors of equal status.²⁶ The bankruptcy trustee pays a subordinated claim only after the estate pays all other creditors ahead of that claim in full.²⁷

The Supreme Court first recognized the bankruptcy courts' power to equitably subordinate claims in two cases in 1939.²⁸ Although the Court failed to provide a framework for applying equitable subordination, most courts have exercised their equitable powers only after finding inequitable conduct by the creditor.²⁹ In 1977, the United States Court of Appeals for

v. Cozart, 115 F.2d 119, 121 (5th Cir. 1940) (describing bankruptcy courts as courts of equity with power to subordinate claims based on equities of case).

23. See *Bank of Marin v. England*, 385 U.S. 99, 103 (1966) (stating that "there is an overriding consideration that equitable principles govern the exercise of bankruptcy jurisdiction"); *DeNatale & Abram*, *supra* note 2, at 421 (discussing origins of doctrine of equitable subordination).

24. See *DeNatale & Abram*, *supra* note 2, at 419 (discussing bankruptcy court's review of claims).

25. See *Prudence Realization Corp. v. Geist*, 316 U.S. 89, 93 (1942) (explaining that courts use equitable powers to subordinate claim of one claimant to those in same class if conduct in asserting claim was inequitable); *Pepper v. Litton*, 308 U.S. 295, 306 (1939) (stating that bankruptcy court may subordinate creditor's claims below other equal claimants by using principles of equity).

26. See *DeNatale & Abram*, *supra* note 2, at 419 (discussing bankruptcy court's review of claims).

27. See 4 KING ET AL., *supra* note 2, ¶ 510.01, at 510-13 (discussing general purpose of equitable subordination).

28. See *Pepper*, 308 U.S. at 308 (stating that "bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate"); *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307, 323-24 (1939) (subordinating creditor's claims because of inequitable conduct of creditor through mismanagement and undercapitalization of bankrupt debtor); see also *Comstock v. Group of Institutional Investors*, 335 U.S. 211, 229 (1948) (holding that parent's domination of subsidiary did not justify subordination of claim when parent did not use control to its advantage or to detriment of subsidiary). *Comstock* narrowed the application of equitable subordination to situations in which the courts found bad faith by the claimant. *Id.*

29. See, e.g., *Wood v. Richmond (In re Branding Iron Steak House)*, 536 F.2d 299, 302 (9th Cir. 1976) (stating that subordination requires some showing of inequitable conduct beyond mere initial undercapitalization); *Stebbins v. Crocker Citizens Nat'l Bank (In re Ahlsweide)*, 516 F.2d 784, 788 (9th Cir. 1975) (requiring inequitable conduct in asserting or acquiring claim to justify equitable subordination); *Gould v. Levin (In re Credit Indus. Corp.)*,

the Fifth Circuit parsed the existing case law on equitable subordination to develop workable criteria for implementing the doctrine.³⁰ Although bankruptcy courts have used their equitable jurisdiction to subordinate claims for years, Congress finally codified the judicially created doctrine of equitable subordination in § 510(c) of the Bankruptcy Act of 1978.³¹ Congress intended for the principles of equitable subordination to follow existing case law, while leaving bankruptcy courts the ability to further develop the principles.³²

A. The Early Decisions

In 1939, two Supreme Court cases laid the foundation for the development of equitable subordination.³³ The Supreme Court initially recognized the bankruptcy courts' equitable authority in *Taylor v. Standard Gas & Electric Co.*,³⁴ generally referred to as the *Deep Rock* decision.³⁵ In *Deep Rock*, the

366 F.2d 402, 408-09 (2d Cir. 1966) (noting that courts invoke equitable subordination to deny equal treatment for creditors engaging in unconscionable or inequitable conduct); *Luther v. United States (In re Garden Grain & Seed Co.)*, 225 F.2d 495, 499 (10th Cir. 1954) (same); *In re Elkins-Dell Mfg. Co.*, 253 F. Supp. 864, 870 (E.D. Pa. 1966) (requiring "convincing proof" of inequitable conduct of claimant to warrant subordination).

30. See *Benjamin v. Diamond (In re Mobile Steel Co.)*, 563 F.2d 692, 700-01 (5th Cir. 1977) (proposing three conditions derived from prior case law that must be satisfied before exercising power of equitable subordination); *infra* notes 46-95 and accompanying text (discussing *Mobile Steel*).

31. See *supra* note 6 (reproducing 11 U.S.C. § 510(c) (1994)).

32. 124 CONG. REC. H11,095 (daily ed. Sept. 28, 1978) (statement of Rep. Edwards); *id.* at S17,412 (daily ed. Oct. 6, 1978) (statement of Sen. DeConcini); see *supra* note 6 (reproducing 11 U.S.C. § 510(c)). Congress did not offer any guidance on the criteria for equitable subordination in § 510(c), leaving common law principles to control application of the doctrine. *Id.*

33. *Pepper v. Litton*, 308 U.S. 295, 303-04 (1939); *Taylor*, 306 U.S. at 307.

34. 306 U.S. 307 (1939).

35. *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307, 323 (1939) (holding that parent company's mismanagement and undercapitalization of subsidiary constituted inequitable conduct sufficient to subordinate parent's claim in subsidiary's bankruptcy). In *Taylor*, the Supreme Court considered the claim of Standard Gas & Electric (Standard), a parent corporation, against Deep Rock Oil Corporation (Deep Rock), its bankrupt subsidiary. *Id.* at 309. Standard controlled all of Deep Rock's finances and served as the subsidiary's lone source of financial aid. *Id.* at 311. Deep Rock faced constant financial troubles and was clearly undercapitalized from its inception. *Id.* at 315. The Court reasoned that Deep Rock would not be regarded as a separate corporate entity when doing so would promote fraud or injustice. *Id.* at 322. The Court found that Standard caused Deep Rock to enter into several transactions for the benefit of Standard and to the detriment of Deep Rock and its shareholders. *Id.* at 320. The Court concluded that Deep Rock went bankrupt because of the enormous sums it owed Standard and the abuses in management resulting from Standard's dual role as proprietor and creditor of Deep Rock. *Id.* at 323. The Court decided that equity required that the preferred stockholders of Deep Rock get a superior position in the reorganized company over Standard. *Id.* Conse-

Supreme Court considered the bankruptcy claims of a parent corporation against its subsidiary.³⁶ The parent company's claims arose from loans it made to the subsidiary.³⁷ The Court determined that the parent company mismanaged and undercapitalized the subsidiary to the detriment of the subsidiary's preferred stockholders.³⁸ The Court ultimately subordinated the parent's bankruptcy claims to the preferred stockholders' claims because of the parent's inequitable conduct.³⁹

Later that year, the Supreme Court expanded *Deep Rock in Pepper v. Litton*,⁴⁰ the seminal equitable subordination case.⁴¹ In *Pepper*, the Court gave bankruptcy courts more latitude in applying their equitable powers by suggesting that bankruptcy courts could equitably subordinate claims even without finding fraud, domination by a shareholder, or undercapitalization of the corporation.⁴² The Court indicated that a breach of fiduciary duty by acting for oneself to the detriment of other shareholders and creditors was

quently, the *Taylor* Court held that Standard's claims in the reorganized company would be subordinated to the claims of those preferred stockholders who were injured by Standard's inequitable conduct. *Id.* at 324.

36. *Id.* at 308-09.

37. *Id.* at 311-12.

38. *Id.* at 323.

39. *Id.*

40. 308 U.S. 295 (1939).

41. *Pepper v. Litton*, 308 U.S. 295, 307-08 (1939) (holding that bankruptcy courts have power to sift circumstances surrounding claim to prevent injustice). In *Pepper*, the Supreme Court considered whether a fiduciary's claim should be equitably subordinated if the fiduciary acted for its own benefit to the detriment of the bankrupt corporation and its creditors and shareholders. *Id.* at 311. *Pepper* brought suit against the debtor, Dixie Splint Coal Company (Dixie Splint), and its dominant stockholder, Litton, for an accounting of royalties due to *Pepper* under a lease. *Id.* at 297. While the suit was pending, Litton caused Dixie Splint to confess to a judgment for Litton of over \$33,000 for alleged accumulated salary claims dating back five years. *Id.* Litton then formed a new company, Dixie Beaver Coal Company, by transferring over all the property of Dixie Splint to the new company. *Id.* at 298. After the transfer of property, Dixie Splint filed a voluntary petition in bankruptcy. *Id.* The Court found that this entire scheme was "plainly for the sole purpose of avoiding payment of the *Pepper* debt." *Id.* The Court reasoned that the fact that a dominant stockholder had reduced a claim to judgment did not guarantee that the bankruptcy court had to treat the claims equally to the claims of other creditors. *Id.* at 306. The Court stated that bankruptcy courts have the power to sift through the circumstances of a claim to ensure the fair administration of the bankrupt estate. *Id.* at 308. The Court concluded that Litton used his position as an insider to gain an advantage for himself and to the detriment of *Pepper*. *Id.* at 311. Consequently, the *Pepper* Court disallowed Litton's claim. *Id.* at 312.

42. See *id.* at 308-12 (suggesting that courts do not necessarily need to find fraud, domination by shareholder, or undercapitalization of company to equitably subordinate claim); Jeremy W. Dickens, Note, *Equitable Subordination and Analogous Theories of Lender Liability: Toward a New Model of "Control,"* 65 TEX. L. REV. 801, 812 (1987) (discussing *Pepper* as it relates to origins of equitable subordination).

sufficient to justify equitable subordination.⁴³ Less than ten years later, the Supreme Court narrowed the use of equitable subordination by imposing a requirement that bankruptcy courts find inequitable creditor conduct accompanied by bad faith before applying the doctrine.⁴⁴ Although courts struggled for years without clear guidelines for how to apply equitable subordination, virtually every court required a finding of inequitable creditor conduct before ordering the subordination of a claim.⁴⁵

B. *The Mobile Steel Decision*

In 1977, the Fifth Circuit in *Benjamin v. Diamond (In re Mobile Steel Co.)*⁴⁶ finally organized the requirements for equitable subordination of claims into a workable three-part test.⁴⁷ In *Mobile Steel*, the court concluded that a

43. *Pepper*, 308 U.S. at 311.

44. *See Comstock v. Group of Institutional Investors*, 335 U.S. 211, 229 (1948) (distinguishing claim from *Pepper* based on creditor acting in good faith so that court should not subordinate claim); *see also DeNatale & Abram, supra* note 2, at 428 (commenting that *Comstock* is reminder to bankruptcy court that although it is court of equity, it cannot reclassify valid claim that innocent party asserted in good faith just because court perceives result to be inequitable).

45. *See supra* note 29 (listing decisions requiring inequitable conduct by creditor to subordinate claim). *But see Jezarian v. Raichle (In re Stirling Homex Corp.)*, 579 F.2d 206, 214-15 (2d Cir. 1978) (stating that court permitted subordination without explicit finding of inequitable conduct), *cert. denied*, 439 U.S. 1074 (1979). *But see also Burden v. United States (In re Burden)*, 917 F.2d 115, 122 (3d Cir. 1990) (noting that opinions written in 1990 found *Stirling Homex* to be only pre-1978 case allowing equitable subordination without finding inequitable conduct by creditor).

46. 563 F.2d 692 (5th Cir. 1977).

47. *Benjamin v. Diamond (In re Mobile Steel Co.)*, 563 F.2d 692, 700 (5th Cir. 1977) (holding that equitable considerations justify only subordination of claims, not their disallowance, and that three conditions must be satisfied before equitable subordination is appropriate). In *Mobile Steel*, the Fifth Circuit considered whether the bankruptcy court should subordinate claims of some organizers, officers, and directors of the debtor because of mismanagement of corporate affairs and unfair dealings between the corporation and its creditors. *Id.* at 695. The trustee contended that debentures and promissory notes given to the claimants were actually preferred stock and were not entitled to debt treatment. *Id.* at 702. The court observed that \$250,000 of capital was initially contributed to Mobile Steel, and it concluded that the corporation was never undercapitalized. *Id.* at 703. The court also determined that the fiduciaries of the company did not mismanage or breach their duties in connection with certain property purchases. *Id.* at 704. The court found that the purchases of property were tax-driven and actually benefitted the bankrupt. *Id.* at 705. Moreover, the court found that the purchases proved detrimental to the financial interests of the fiduciaries themselves. *Id.* The court also emphasized that the fiduciaries did not use Mobile Steel as a shell company and that it was clearly a legitimate business, selling approximately \$3.8 million worth of steel a year. *Id.* at 706. The *Mobile Steel* court stated that for equitable subordination of claims to be appropriate, the trustee must satisfy three criteria. *Id.* at 699-700. First, the claimant must have engaged in some type of inequitable conduct. *Id.* Second, the misconduct must have resulted in injuries

claimant must satisfy the following three criteria to warrant the exercise of equitable subordination: (1) the claimant must have engaged in some type of inequitable conduct, (2) the misconduct must have caused injury to creditors of the bankrupt or conferred an unfair advantage on the claimant, and (3) equitable subordination of the claim must not be inconsistent with the Bankruptcy Act provisions.⁴⁸ A majority of courts adopted the *Mobile Steel* test as a solution to the confusion of when to equitably subordinate claims in bankruptcy.⁴⁹ The Supreme Court recognized and endorsed the *Mobile Steel* three-part test for equitable subordination in 1996.⁵⁰

The *Mobile Steel* court also noted that courts must consider three additional principles to implement equitable subordination properly.⁵¹ First, the inequitable conduct and the claim at issue do not need to be related to warrant subordination.⁵² The inequitable conduct may arise out of any unfair act by the creditor so long as the conduct affects the bankruptcy results of the other creditors.⁵³ Second, courts should limit subordination of claims to the extent required to offset the harm caused to the bankrupt and to the other creditors.⁵⁴ This principle is a reminder to bankruptcy courts that their subordination power derives from equitable principles and is remedial rather than penal.⁵⁵

to other creditors or must have conferred an unfair advantage on the claimant. *Id.* Finally, equitable subordination must not have been inconsistent with the Bankruptcy Act. *Id.* The court held that the first requirement of the test was not met because the fiduciaries did not engage in inequitable conduct sufficient to subordinate the fiduciaries' claims. *Id.* at 706.

48. *Id.* at 699-700.

49. *See, e.g.,* Stoumbus v. Kilimnik, 988 F.2d 949, 958 (9th Cir. 1993) (requiring evidence of inequitable conduct by lender to equitably subordinate claim); Smith v. Associated Commercial Corp. (*In re* Clark Pipe & Supply Co.), 893 F.2d 693, 699 (5th Cir. 1990) (same); Estes v. N & D Properties, Inc. (*In re* N & D Properties, Inc.), 799 F.2d 726, 731 (11th Cir. 1986) (adopting *Mobile Steel* three-prong test); Unsecured Creditors' Comms. of Pac. Express, Inc. v. Pioneer Commercial Funding Corp. (*In re* Pacific Express, Inc.), 69 B.R. 112, 116 (9th Cir. B.A.P. 1986) (applying *Mobile Steel* three-part test); *In re* Bell & Beckwith, 44 B.R. 664, 666 (Bankr. N.D. Ohio 1984) (same); Anaconda-Ericsson, Inc. v. Hessen (*In re* Teltronics Servs., Inc.), 29 B.R. 139, 168 (Bankr. E.D.N.Y. 1983) (same).

50. *See* United States v. Noland, 116 S. Ct. 1524, 1526 (1996) (noting that district courts and courts of appeals generally follow *Mobile Steel* three-part test in applying § 510(c) to equitably subordinate claims in bankruptcy proceedings).

51. *See Mobile Steel*, 563 F.2d at 700 (listing three principles trustee must consider before using equitable subordination); *see also* Wilson v. Huffman (*In re* Missionary Baptist Found. of Am.), 818 F.2d 1135, 1143-44 (5th Cir. 1987) (citing *Mobile Steel* for proposition that court must consider three additional principles when determining whether bankruptcy trustee satisfies three criteria for equitable subordination).

52. *Mobile Steel*, 563 F.2d at 700.

53. *See id.* (citing Bostian v. Schapiro (*In re* Kansas City Journal-Post Co.), 144 F.2d 791, 803-04 (8th Cir. 1944)).

54. *Id.* at 701.

55. *Id.*

The third principal courts must consider is the allocation of the burden of proof in equitable subordination cases and the notion that transactions involving fiduciaries or insiders of the bankrupt are subject to rigorous scrutiny.⁵⁶ The party seeking the remedy of equitable subordination has the burden of proof.⁵⁷ The objection to the claim must include a factual basis to support the allegations of unfair conduct.⁵⁸ If the trustee demonstrates a sufficient basis for the objection, the burden shifts to the challenged creditor to show good faith and fairness.⁵⁹ If the claimant engaging in inequitable conduct is an insider⁶⁰ or a fiduciary, the claim is subject to rigorous scrutiny, and the court may subordinate the claim for less severe misconduct.⁶¹

Scholars generally regard the first part of the three-prong *Mobile Steel* test, identifying inequitable conduct, as the most difficult to apply.⁶² The *Mobile Steel* court enumerated the following three separate allegations of inequitable conduct that justify equitable subordination: (1) undercapitalization; (2) fraud, mismanagement, or breach of fiduciary duty; and (3) the claimant's use of the debtor as a mere instrumentality or alter ego.⁶³ These

56. *Id.*

57. *Id.*

58. *Id.*

59. *See* *Pepper v. Litton*, 308 U.S. 295, 306 (1939) (stating that fiduciaries have burden to demonstrate good faith and fairness from viewpoint of corporation and other interested parties).

60. 11 U.S.C. § 101(31)(B) (1998). The Code defines an insider if debtor is a corporation as follows:

(31) "insider" includes-

(B) if the debtor is a corporation-

- (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.

Id.

61. *See* *Pepper*, 308 U.S. at 306 (noting that fiduciaries' dealings with corporation are subject to rigorous scrutiny); *Benjamin v. Diamond (In re Mobile Steel Co.)*, 563 F.2d 692, 701-02 (5th Cir. 1977) (observing that fiduciaries' claims demand close scrutiny); *Anaconda-Ericsson, Inc. v. Hessen (In re Teltronics Servs., Inc.)*, 29 B.R. 139, 169 (Bankr. E.D.N.Y. 1983) (stating that when claimant is insider, dealings with debtor "will be subjected to more exacting scrutiny").

62. *See* *DeNatale & Abram*, *supra* note 2, at 423 (stating that no precise definition is possible for type of conduct necessary to be considered fraudulent or inequitable).

63. *See* *Mobile Steel*, 563 F.2d at 702 (noting that for purpose of court's analysis, alleged misconduct could be divided into three classes).

three examples of inequitable conduct are the grounds that debtors or creditors' committees most often assert for equitable subordination.⁶⁴

The first ground of alleged misconduct that the *Mobile Steel* court examined was undercapitalization.⁶⁵ When capital contributions are insufficient, courts consider a debtor undercapitalized.⁶⁶ Courts subordinate claims based on undercapitalization when a claimant who exercises control over the debtor funds the corporation through loans rather than through capital investment, resulting in harm to the corporation and other creditors.⁶⁷ Although courts have never clearly defined the concept of undercapitalization, they often cite two guidelines from *Mobile Steel*.⁶⁸ First, the *Mobile Steel* court determined that the moving party can establish inadequate capitalization if, in the opinion of a financial analyst, the shareholders contributed an insufficient amount of capital at the debtor's inception to support a debtor of that size and that nature.⁶⁹ Second, the court stated that capitalization is inadequate if, at the time of the advances, the debtor could not borrow similar funds from an informed outside source.⁷⁰ A majority of courts support the proposition that

64. See *Fabricators, Inc. v. Technical Fabricators, Inc. (In re Fabricators, Inc.)*, 926 F.2d 1458, 1467 (5th Cir. 1991) (stating that it is difficult to define boundaries of inequitable conduct under first prong of *Mobile Steel*, but that three general categories of conduct constitute inequitable conduct); *Smith v. Associates Commercial Corp. (In re Clark Pipe & Supply Co.)*, 893 F.2d 693, 699 (5th Cir. 1990) (stating that courts recognize three general categories of conduct sufficient to satisfy first prong of *Mobile Steel* test); *Wilson v. Huffman (In re Missionary Baptist Found. of Am.)*, 712 F.2d 206, 212 (5th Cir. 1983) (listing three categories of conduct sufficient to warrant equitable subordination); *In re Beverages Int'l Ltd.*, 50 B.R. 273, 281 (Bankr. D. Mass. 1985) (same); *Waslow v. MNC Commercial Corp. (In re M. Paoella & Sons, Inc.)*, 161 B.R. 107, 117-18 (Bankr. E.D. Pa. 1993) (listing three situations in which courts normally apply equitable subordination). But see *United States Abatement Corp. v. Mobil Exploration & Producing U.S., Inc. (In re United States Abatement Corp.)*, 39 F.3d 556, 561 (5th Cir. 1994) (confining equitable subordination to three alternative paradigms: (1) when fiduciary of debtor misuses position to disadvantage of other creditors; (2) when third party controls debtor to disadvantage of other creditors; and (3) when third party actually defrauds other creditors); *Holt v. Federal Deposit Ins. Corp. (In re CTS Truss, Inc.)*, 868 F.2d 146, 148-49 (5th Cir. 1989) (same).

65. *Mobile Steel*, 563 F.2d at 702.

66. See *Summit Coffee Co. v. Herby's Foods, Inc. (In re Herby's Foods, Inc.)*, 2 F.3d 128, 131 (5th Cir. 1993) (considering when corporation should be deemed undercapitalized).

67. See 4 KING ET AL., *supra* note 2, ¶ 510.05, at 510-23 (discussing undercapitalization as example of inequitable conduct occurring when debt funding is substituted for risk capital).

68. See *Herby's*, 2 F.3d at 131-32 (citing *Mobile Steel* for guidelines to establish if debtor corporation is undercapitalized); *Machinery Rental, Inc. v. Herpel (In re Multiplonics, Inc.)*, 622 F.2d 709, 717 (5th Cir. 1980) (same).

69. See *Benjamin v. Diamond (In re Mobile Steel Co.)*, 563 F.2d 692, 703 (5th Cir. 1977) (discussing questions to ask in determining whether debtor corporation is inadequately capitalized).

70. *Id.*

initial undercapitalization alone is not enough to subordinate claims, and they require some type of misconduct accompanying the undercapitalization.⁷¹ If courts subordinated claims solely based on the debtor's undercapitalization, insiders would be reluctant to lend money to a struggling debtor.⁷² This would be devastating for debtors because insiders are normally the only persons interested enough in a company to lend it money in troubled times.⁷³

A second ground for equitable subordination of claims that the *Mobile Steel* court examined was fraud, mismanagement, or breach of fiduciary duties.⁷⁴ In order to equitably subordinate a claim based on fraud or breach of fiduciary duties, the bankruptcy court need not find actual fraud.⁷⁵ Because fraudulent conduct cases often include elements of undercapitalization or self-dealing, it is difficult to place subordination cases in precise categories.⁷⁶ Examples of fraudulent conduct demanding subordination of claims include when a creditor knowingly makes false statements regarding the bankrupt's financial condition and when a creditor colludes with the bankrupt, using its claim to defraud other creditors.⁷⁷ Although no clear line exists as to what

71. See *Wood v. Richmond (In re Branding Iron Steak House)*, 536 F.2d 299, 302 (9th Cir. 1976) (requiring proof of inequitable conduct beyond mere initial undercapitalization); *Costello v. Fazio*, 256 F.2d 903, 910 (9th Cir. 1958) (subordinating claim because trustee showed more than mere undercapitalization); *Rego Crescent Corp. v. Tymon (In re Rego Crescent Corp.)*, 23 B.R. 958, 962-65 (Bankr. E.D.N.Y. 1982) (stating that conduct of insider or lender must be inequitable in addition to undercapitalization at time of loan).

72. See *Braas Sys., Inc. v. WMR Partners (In re Octagon Roofing)*, 157 B.R. 852, 858 (N.D. Ill. 1993) (noting that absent inequitable conduct requirement, subordination of claims would discourage loans from insiders to companies in financial difficulty).

73. See *Allied E. States Maintenance Corp. v. Miller (In re Lemco Gypsum, Inc.)*, 911 F.2d 1553, 1557 (11th Cir. 1990) (noting that insiders' strong interest in company and not desire to protect themselves in bankruptcy-motivated attempts to salvage struggling company); *Octagon Roofing*, 157 B.R. at 858 (noting that shareholders are most likely party to be motivated to attempt to save struggling corporation on verge of bankruptcy).

74. See *Mobile Steel*, 563 F.2d at 704 (determining whether claimants' breach of fiduciary duties was sufficient to warrant equitable subordination of their claims).

75. See *Heiser v. Woodruff*, 327 U.S. 726, 732-33 (1946) (establishing that application of equitable subordination does not require showing of actual fraud); *Machinery Rental, Inc. v. Herpel (In re Multiplonics, Inc.)*, 622 F.2d 709, 720 (5th Cir. 1980) (rejecting claimant's argument that he may have been foolish but not fraudulent); *Costello*, 256 F.2d at 910 (establishing that application of equitable subordination does not require showing of actual fraud).

76. See *Asa S. Herzog & Joel B. Zweibel, The Equitable Subordination of Claims in Bankruptcy*, 15 VAND. L. REV. 83, 99 (1961) (discussing what constitutes fraudulent inequitable conduct sufficient to warrant equitable subordination of claim); *Dickens, supra* note 42, at 812 (discussing requirement of inequitable conduct for subordination and how courts interpret it).

77. See *Bank of New Richmond v. Production Credit Assoc. (In re Osborne)*, 42 B.R. 988, 1000 (Bankr. W.D. Wis. 1984) (concluding that claimant's misrepresentations deceived and injured other creditors); *First Nat'l Bank v. Charles Blalock & Sons, Inc. (In re Just For the Fun of It Tenn., Inc.)*, 7 B.R. 166, 181 (Bankr. E.D. Tenn. 1980) (holding that claimant's conduct in filing notice of completion and later repudiating that notice materially damaged other

courts consider fraudulent conduct worthy of equitable subordination, sufficient warning flags notify claimants that their conduct may result in subordination of their claims.⁷⁸

The final ground of inequitable conduct that *Mobile Steel* acknowledged was the claimant's use of the debtor corporation as a mere instrumentality or alter ego.⁷⁹ It is clear that domination and control accompanied by fraud will lead courts to disregard the corporate entity and equitably subordinate a claim.⁸⁰ Alter ego cases typically involve a debtor that is an affiliate of a parent creditor.⁸¹ If the debtor corporation is a mere instrumentality of the creditor and the creditor's conduct prejudices other claimants, courts can subordinate the creditor's claim to the injured claimants.⁸² Courts will not subordinate claims solely because of a parent or insider relationship; additional contributing factors must be present.⁸³

The second prong of the *Mobile Steel* three-part test for exercising subordination is whether the claimant's conduct injured other creditors of the bankrupt or conferred an unfair advantage on the claimant.⁸⁴ Inequitable conduct alone does not justify equitable subordination unless the conduct

creditors and permitted subordination of claim); Herzog & Zweibel, *supra* note 76, at 98-100 (discussing fraud classification of cases calling for equitable subordination).

78. See Herzog & Zweibel, *supra* note 76, at 100 (noting warning flags including misrepresentation of credit status, misuse of judgment claims, concealment, and overt misrepresentation).

79. See Benjamin v. Diamond (*In re Mobile Steel Co.*), 563 F.2d 692, 706 (5th Cir. 1977) (discussing whether Mobile Steel was legitimate business instrumentality or shell corporation); see also 4 KING ET AL., *supra* note 2, ¶ 510.05, at 510-19 (discussing cases of equitable subordination in which claimant is insider or alter ego of bankrupt debtor).

80. See Taylor v. Standard Gas & Elec. Co., 306 U.S. 307, 323 (1939) (deciding to subordinate parent company's claim because parent's abuses in management and control led to debtor's bankruptcy); Herzog & Zweibel, *supra* note 76, at 104 (discussing alter ego and instrumentality category of cases in which courts have implemented equitable subordination).

81. See Comstock v. Group of Institutional Investors, 335 U.S. 211, 229 (1948) (noting that courts will not allow fiduciary that dominates subsidiary to benefit by breaching its trust); Taylor, 306 U.S. at 323 (observing that abuses in management because of interest of Standard as proprietor and creditor of subsidiary led to bankruptcy of Deep Rock corporation); 4 KING ET AL., *supra* note 2, ¶ 510.05, at 510-19.

82. See Comstock, 335 U.S. at 229 (noting that creditors' use of opportunity to do wrong that injures other creditors will result in subordination of claim); *In re Process-Manz Press, Inc.*, 236 F. Supp. 333 (N.D. Ill. 1964) (subordinating claim to other unsecured creditors because claimant voted debtor's stock to detriment of other creditors).

83. See *Mobile Steel*, 563 F.2d at 701 (noting that nature of relation between bankrupt debtor and claimant does not invalidate claims advanced by fiduciary claimants); Wood v. Richmond (*In re Branding Iron Steak House*), 536 F.2d 299, 302 (9th Cir. 1976) (stating that for court to subordinate claim, some type of inequitable conduct must accompany close relationship).

84. See *Mobile Steel*, 563 F.2d at 700 (discussing second prong of test to exercise equitable subordination).

results in harm to other creditors.⁸⁵ The court must contemplate the harm done to future creditors as well as to present creditors of the bankrupt party.⁸⁶ The court's primary consideration is whether the inequitable conduct affected the bankruptcy proceedings.⁸⁷ The misconduct affects the proceedings when creditors lose something they had an equitable or legal right to receive in bankruptcy.⁸⁸ Demonstrating that the inequitable conduct reduced the chances of general creditors to collect their debts is adequate to satisfy the second prong of the *Mobile Steel* test.⁸⁹ The bankruptcy courts can remedy creditor misconduct by subordinating the offending creditor's claim below those creditors harmed by the inequitable conduct.⁹⁰

The third prong of the *Mobile Steel* test is that equitable subordination of the claim must not be inconsistent with provisions of bankruptcy law.⁹¹ This element of the test is a reminder to bankruptcy courts that they cannot adjust valid claims by good faith creditors simply because the courts sense an inequitable result.⁹² One court stated that the enactment of § 510(c) rendered this prong of the test useless because now the Code clearly recognizes the

85. See *Comstock*, 335 U.S. at 229 (discussing requirement that creditor benefit itself at detriment of subsidiary for court to subordinate claim); *Branding Iron Steak House*, 536 F.2d at 302 (refusing to subordinate claim because no exercise of control to detriment of creditors).

86. See *Costello v. Fazio*, 256 F.2d 903, 911 (9th Cir. 1958) (finding inequitable conduct to detriment of present or future creditors sufficient to subordinate claim); *DeNatale & Abram*, *supra* note 2, at 426 (discussing requirements for satisfying second prong of *Mobile Steel* test for subordination of claims).

87. See *DeNatale & Abram*, *supra* note 2, at 426 (noting court's considerations in determining whether claimant's behavior warrants equitable subordination).

88. See *Bostian v. Schapiro (In re Kansas City Journal-Post Co.)*, 144 F.2d 791, 800-01 (8th Cir. 1944) (noting that subordination should not punitively take away one creditor's justified claim and give it to someone with no fair right to claim); *DeNatale & Abram*, *supra* note 2, at 426 (observing that particular facts of individual case are important to determine extent of harm to creditors resulting from inequitable conduct).

89. See *Creditor's Comm. of Trantex Corp. v. Baybank Valley Trust Co. (In re Trantex Corp.)*, 10 B.R. 235, 238 (Bankr. D. Mass. 1981) (characterizing harm as reasonable likelihood of creditors collecting debt and whether wrongdoing claimant's actions reduced chances of collecting from debtor).

90. See *L & M Realty Corp. v. Leo*, 249 F.2d 668, 671-72 (4th Cir. 1957) (noting that claim is subordinated only to claims of creditors who were injured by inequitable dealings); *First Nat'l Bank v. Charles Blalock & Sons, Inc. (In re Just For the Fun of It Tenn., Inc.)*, 7 B.R. 166, 181 (Bankr. E.D. Tenn. 1980) (subordinating claim below creditors harmed by inequitable conduct, but not below those creditors whose claims inequitable dealings did not affect); *DeNatale & Abram*, *supra* note 2, at 426 (noting that court can subordinate claims to creditors actually injured by inequitable conduct).

91. See *Benjamin v. Diamond (In re Mobile Steel Co.)*, 563 F.2d 692, 700 (5th Cir. 1977) (noting third prong of test for equitably subordinating claims).

92. See *Stebbins v. Crocker Citizens Nat'l Bank (In re Ashwede)*, 516 F.2d 784, 787 (9th Cir. 1975) (noting that bankruptcy court's power to impose result different from one intended by law is not unlimited simply because court perceives result unjust).

court's authority to equitably subordinate claims in bankruptcy.⁹³ Another court interpreted the third prong to mean that bankruptcy courts cannot recharacterize debt transactions as equity.⁹⁴ This difference of opinion has led some bankruptcy courts to recharacterize claims that other courts refuse to equitably subordinate.⁹⁵

C. Congress Codifies Equitable Subordination

In 1978, Congress codified the judicially created doctrine of equitable subordination in § 510(c) of the current Code.⁹⁶ This section grants bankruptcy courts the authority to subordinate normally allowable claims to other claims with equal standing according to principles of equity.⁹⁷ Congress purposely drafted § 510(c) very broadly to allow bankruptcy courts to follow existing case law such as *Mobile Steel*.⁹⁸ Furthermore, Congress noted that bankruptcy courts should subordinate claims only if the claimant engaged in some type of inequitable conduct.⁹⁹ The bankruptcy courts ordinarily consider whether creditor misconduct harmed other creditors of the debtor.¹⁰⁰ If the misconduct harmed other creditors, the creditor at fault must wait until the estate first satisfies the claims of those that the creditor harmed.¹⁰¹

Bankruptcy courts still generally apply the three-part test from *Mobile Steel* to determine whether to equitably subordinate a claim.¹⁰² If the claim-

93. See *Diasonics, Inc. v. Ingalls*, 121 B.R. 626, 628 (Bankr. N.D. Fla. 1990) (citing three-part test from *Mobile Steel* for requirements to subordinate claim and noting that implementation of Code § 510(c) makes third part of test irrelevant).

94. See *Unsecured Creditors' Comms. of Pac. Express, Inc. v. Pioneer Commercial Funding Corp. (In re Pacific Express, Inc.)*, 69 B.R. 112, 115 (B.A.P. 9th Cir. 1986) (holding that bankruptcy court is not authorized to recharacterize transactions because it results in subordination of claims that § 510(c) governs).

95. See *infra* Part IV (comparing different circuit opinions regarding ability of bankruptcy courts to recharacterize creditors' claims even though circumstances do not warrant equitable subordination of claims).

96. See *supra* note 6 (reproducing text of 11 U.S.C. § 510(c) (1994)).

97. See 4 KING ET AL., *supra* note 2, ¶ 510.02, at 510-14 (discussing subordination of claims).

98. 124 CONG. REC. 32,398 (statement of Rep. Edwards), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6542; 124 CONG. REC. 33,998 (statement of Sen. DeConcini), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6521.

99. 124 CONG. REC. 32,398 (statement of Rep. Edwards), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6542. Congress also noted that claims of a status susceptible to subordination, such as penalties and damage claims involving securities, can be subordinated without finding inequitable conduct. *Id.* This Note addresses ordinary debt transactions and does not analyze claims of a status susceptible to subordination.

100. 4 KING ET AL., *supra* note 2, ¶ 510.02, at 510-15.

101. *Id.*

102. See *Benjamin v. Diamond (In re Mobile Steel Co.)*, 563 F.2d 692, 699-700 (5th Cir.

ant engaging in inequitable conduct is an insider or a fiduciary, a court may subordinate the claim for less severe misconduct.¹⁰³ The objecting party bears the burden of presenting material evidence of unfair conduct by the insider creditor.¹⁰⁴ Once the objecting party meets this burden, the claimant must prove both the fairness and the arm's length nature of the questioned transactions or the court will subordinate the insider's claims.¹⁰⁵

Equitable subordination generally requires some type of inequitable conduct on the part of a creditor.¹⁰⁶ A few recent decisions have departed from this requirement and have subordinated claims without finding inequitable conduct.¹⁰⁷ These decisions seem to indicate a desire by at least some courts to establish an increased level of lender liability.¹⁰⁸ Although the Supreme Court has not decided whether inequitable conduct is an absolute prerequisite to subordination under § 510(c),¹⁰⁹ the majority of courts continue to require inequitable conduct by creditors before subordinating claims.¹¹⁰

The burden of proving the existence of all the elements required for equitable subordination is on the objecting party.¹¹¹ The objecting party must

1977) (stating that equitable subordination is extraordinary remedy that requires satisfaction of certain conditions before court can exercise power); *supra* notes 46-95 and accompanying text (discussing *Mobile Steel*).

103. See *Anaconda-Ericsson, Inc. v. Hessen (In re Teltronics Servs., Inc.)*, 29 B.R. 139, 169 (Bankr. E.D.N.Y. 1983) (stating that when claimant is insider, dealings with debtor "will be subjected to more exacting scrutiny").

104. See *Estes v. N & D Properties, Inc. (In re N & D Properties, Inc.)*, 799 F.2d 726, 731 (11th Cir. 1986) (discussing burden of proof in equitable subordination cases); *Teltronics*, 29 B.R. at 169 (discussing burden on objecting party to come forward with sufficient evidence of misconduct by insider claimant).

105. See *Teltronics*, 29 B.R. at 169 (discussing equitable subordination of insider's claims).

106. See *Machinery Rental, Inc. v. Herpel (In re Multiplonics, Inc.)*, 622 F.2d 709, 713 (5th Cir. 1980) (adopting *Mobile Steel* three-part test to implement equitable subordination, including first part that requires that claimant have engaged in inequitable conduct); *supra* note 61 (listing cases relying on inequitable conduct to equitably subordinate claims in bankruptcy proceedings).

107. See generally *Schultz Broadway Inn v. United States*, 912 F.2d 230 (8th Cir. 1990); *In re Virtual Network Servs. Corp.*, 902 F.2d 1246 (7th Cir. 1990).

108. See Scott M. Browning, Note, *No Fault Equitable Subordination: Reassuring Investors That Only Government Penalty Claims Are At Risk*, 34 WM. & MARY L. REV. 487, 522-23 (1993) (discussing courts' motivations for applying equitable subordination to claims absent any inequitable conduct).

109. See generally *United States v. Noland*, 116 S. Ct. 1524 (1996) (declining to address whether inequitable conduct is prerequisite to implementing § 510(c) of Bankruptcy Code to equitably subordinate claims in bankruptcy proceedings).

110. See *supra* note 49 (listing decisions adopting *Mobile Steel* three-part test requiring inequitable conduct).

111. See *Anaconda-Ericsson, Inc. v. Hessen (In re Teltronics Servs., Inc.)*, 29 B.R. 139,

demonstrate by a preponderance of the evidence that the claimant engaged in inequitable conduct which hurt other creditors and that warrants subordination.¹¹² The goal of equitable subordination is to put creditors in the places in the payment line that they would have occupied if not for the inequitable conduct.¹¹³ As a result, the remedy of subordination only rectifies injury that the claimant's inequitable conduct created.¹¹⁴ Therefore, the moving party must be able to show the extent of the damage that the inequitable conduct caused for the creditor.¹¹⁵ Although equitable subordination is still a broad doctrine in its application, the *Mobile Steel* framework and its codification in § 510(c) enable bankruptcy courts to implement the doctrine with some sense of uniformity and predictability.¹¹⁶

III. Recharacterization of Claims

One exceptionally confusing device currently employed by a majority of bankruptcy courts is the recharacterization of debt transactions into equity contributions.¹¹⁷ Courts ordinarily consider whether to recharacterize a transaction after the trustee in bankruptcy first objects to the creditor's claim.¹¹⁸ This situation most often occurs when shareholders advance money to a corporation.¹¹⁹ Specifically, after the owners initially organize the corporation

168 (Bankr. E.D.N.Y. 1983) (noting that burden of proving all elements of equitable subordination is on objecting party).

112. *Id.* at 103-04.

113. *Id.* at 103.

114. *Id.*

115. *Id.*

116. *See* Browning, *supra* note 108, at 522-23 (noting that courts have sufficient options under *Mobile Steel* framework without resorting to inconsistent, unpredictable jurisprudence).

117. *See* Summit Coffee Co. v. Herby's Foods, Inc. (*In re* Herby's Foods, Inc.), 2 F.3d 128, 133 (5th Cir. 1993) (stating that court is authorized to recharacterize loans as equity contributions even when circumstances do not warrant equitable subordination); G.J. Sinclair v. Barr (*In re* Mid-Town Produce Terminal, Inc.), 599 F.2d 389, 393 (10th Cir. 1979) (noting that usual procedure in bankruptcy proceeding is to first determine whether transaction is loan or capital contribution); United States v. Colorado Invesco, Inc., 902 F. Supp. 1339, 1342 (D. Colo. 1995) (discussing bankruptcy court's power to recharacterize purported loans as contributions to capital); Blasbalg v. Tarro (*In re* Hyperion Enters., Inc.), 158 B.R. 555, 561-62 (Bankr. D.R.I. 1993) (considering recharacterization of alleged loans as equity capital); Disonics, Inc. v. Ingalls, 121 B.R. 626, 630 (Bankr. N.D. Fla. 1990) (stating that court should determine whether transaction is loan or capital contribution before determining equitable subordination issue). *But see* *In re* Lewiston Steam & Power Assocs., No. B86-00477-Y, 1989 Bankr. LEXIS 1382, at *12 (Bankr. N.D. Ohio Aug. 24, 1989) (referring to recharacterization of advances as capital contributions as minority concept).

118. *See* Jules S. Cohen, *Shareholder Advances: Capital or Loans*, 52 AM. BANKR. L.J. 259, 259 (1978) (discussing results of recharacterizing debt transactions into capital contributions).

119. *Id.*

with capital contributions, the shareholders occasionally advance additional funds to the corporation in the form of loans.¹²⁰ The trustee sometimes argues that these additional advances are actually capital contributions.¹²¹ The trustee contends that no actual debt exists and, therefore, the court should disallow the claim.¹²² The result achieved by recharacterizing the transaction is essentially subordination of the claim.¹²³ The court's action subordinates the recharacterized claim in bankruptcy below the debtor's unsecured creditors to the level of equity holders.¹²⁴ A claim recharacterized as an equity transaction is not satisfied until the estate pays all other creditors in full.¹²⁵ The bankruptcy trustee rarely pays equity holders because the estate normally has insufficient property to satisfy the unsecured creditors' claims.¹²⁶

Many courts base their authority to recharacterize a transaction in bankruptcy on *Pepper v. Litton*,¹²⁷ which scholars generally regard as an equitable subordination case.¹²⁸ The Supreme Court did not recharacterize the share-

120. *Id.*

121. *Id.*

122. *Id.*

123. See *Summit Coffee Co. v. Herby's Foods, Inc. (In re Herby's Foods, Inc.)*, 2 F.3d 128, 133 (5th Cir. 1993) (stating that in *Herby's Foods*, practical effects of recharacterization and equitable subordination were identical); *Central Coops., Inc. v. Irwin (In re Colonial Poultry Farms)*, 177 B.R. 291, 299 (Bankr. W.D. Mo. 1995) (explaining that end result of equitable subordination and recharacterization are similar); *Diasonics, Inc. v. Ingalls*, 121 B.R. 626, 630 (Bankr. N.D. Fla. 1990) (stating that effects of recharacterizing and equitably subordinating claim are same).

124. See *Cohen*, *supra* note 118, at 259 (citing dictum from *Pepper v. Litton*, 308 U.S. 295, 309-10 (1939)) (stating that court can subordinate advances by controlling stockholders to other claims, and court can treat them as capital contributions in certain cases); see also *Diasonics*, 121 B.R., at 630 (stating that trustee pays recharacterized claims and equitably subordinated claims after trustee pays all other creditors).

125. *Diasonics*, 121 B.R. at 630.

126. See *JORDAN & WARREN*, *supra* note 3, at 30 (discussing distribution of assets to unsecured creditors).

127. 308 U.S. 295 (1939).

128. See *Cohen*, *supra* note 118, at 259-60 (citing dictum from *Pepper v. Litton* that court may treat shareholder's loan claim as equity investment and disallow it); see also *supra* notes 40-43 and accompanying text (discussing *Pepper v. Litton* as equitable subordination case, not example of recharacterization). In *Pepper*, the Court subordinated the stockholder's claim on equitable principles to prevent injustice. *Pepper v. Litton*, 308 U.S. 295, 312 (1939). The Supreme Court narrowed the grounds for applying equitable subordination after *Pepper* in *Comstock v. Group of Institutional Investors*. See *Comstock v. Group of Institutional Investors*, 335 U.S. 211, 229 (1948) (stating that courts need more than just mere existence of opportunity to do wrong for equitable subordination). In *Comstock*, the Court required that bankruptcy courts find bad faith by the creditor in order to apply equitable subordination. See *supra* notes 28, 44 and accompanying text (discussing *Comstock*); see also *Diasonics*, 121 B.R. at 631 (citing *Pepper* as first bankruptcy case examining substance of transaction rather than just form of transaction).

holder's claim in *Pepper* as a capital investment.¹²⁹ Rather, the Court disallowed the shareholder's claim on equitable grounds to prevent injustice.¹³⁰ The Court only mentioned the concept of recharacterizing loans as capital contributions as dicta in the opinion.¹³¹ In 1948, the Court took a step back from *Pepper* by requiring bad faith of the creditor to subordinate a claim.¹³² Courts continue to recharacterize debt claims to equity even without satisfying the criteria for equitable subordination.¹³³ Courts justify recharacterizing claims by pointing to the authority vested in the bankruptcy court to use its equitable powers to test the validity of debts.¹³⁴

No clear test exists for determining whether a court should recharacterize a transaction.¹³⁵ The Code does not provide any specific authorization for courts to recharacterize debt into equity transactions.¹³⁶ Courts often rely on § 105 of the Code, which refers to the general equitable powers of the court.¹³⁷ Courts point to the authority of bankruptcy courts to disregard the form of a transaction to determine its true substance.¹³⁸ The lack of a specific code

129. See *Pepper*, 308 U.S. at 307-08 (explaining court's authority to exercise equitable jurisdiction when allowing claim would unfairly benefit stockholder to detriment of other creditors).

130. *Id.*

131. See *id.* at 309-10 (listing situations in which disallowance or subordination of claims is warranted).

132. See *supra* note 128 (discussing narrower application of equitable subordination given by Court in *Comstock*, which required bad faith by creditor to warrant subordination of claim).

133. See *Summit Coffee Co. v. Herby's Foods, Inc. (In re Herby's Foods, Inc.)*, 2 F.3d 128, 133 (5th Cir. 1993) (stating that court is authorized to recharacterize loans as equity contributions even when circumstances do not warrant equitable subordination); *In re Blevins Concession Supply Co.*, 213 B.R. 185, 187 (Bankr. M.D. Fla. 1997) (stating that when shareholder substitutes debt for adequate risk capital, courts should recharacterize claim as equity even if trustee cannot meet other requirements of equitable subordination); *Diasonics, Inc. v. Ingalls*, 121 B.R. 626, 630 (Bankr. N.D. Fla. 1990) (stating that substitution of debt for adequate risk capital alone warrants reclassification of alleged loan to equity). *But see Blasbalg v. Tarro (In re Hyperion Enters., Inc.)*, 158 B.R. 555, 561-62 (Bankr. D.R.I. 1993) (rejecting trustee's contention that mere undercapitalization justifies recharacterization of transaction).

134. See *In re Cold Harbor Assoc., L.P.*, 204 B.R. 904, 915 (Bankr. E.D. Va. 1997) (discussing court's ability to inquire into nature of transaction and recharacterize it using equitable powers if necessary); *Fett v. Moore (In re Fett Roofing & Sheet Metal Co., Inc.)*, 438 F. Supp. 726, 729-30 (Bankr. E.D. Va. 1977) (stating that bankruptcy court, as court of equity, can disregard appearance of transaction and determine its actual character).

135. See *infra* note 143 (discussing various factors courts examine to determine if court should recharacterize claim from debt to equity).

136. See *supra* note 6 (reproducing § 510(c), which authorizes equitable subordination of claims). No Code section explicitly authorizes bankruptcy courts to recharacterize debt transactions into equity.

137. See *supra* note 8 and accompanying text (discussing bankruptcy court's reliance on § 105 for general equitable powers).

138. See *Pepper v. Litton*, 308 U.S. 295, 306-07 (1939) (stating that bankruptcy court's

provision governing recharacterization of claims leaves courts with a large number of factors to consider when determining whether to recharacterize a transaction.¹³⁹

Courts generally focus on several different criteria to determine if they should characterize a claim as a loan or equity transaction.¹⁴⁰ The courts' primary consideration appears to be whether the transaction reflects the characteristics of an arm's length negotiation.¹⁴¹ Courts are more likely to characterize a transaction made at arm's length as a loan.¹⁴² They use a variety of factors to determine whether a claimant made a transaction at arm's length.¹⁴³ The factors for courts to consider encompass the following three

equitable powers enable it to look past form of transaction to its substance in determining whether to treat transaction as debt or equity).

139. See *infra* note 143 (listing factors courts consider in determining whether to subordinate transactions).

140. See *Central Coops., Inc. v. Irwin (In re Colonial Poultry Farms)*, 177 B.R. 291, 299 (Bankr. W.D. Mo. 1995) (discussing multitude of factors courts use to determine characterization of claim); *Blasbalg v. Tarro (In re Hyperion Enters., Inc.)*, 158 B.R. 555, 561 (Bankr. D.R.I. 1993) (listing several factors considered for recharacterization including adequacy of contributed capital, ratio of shareholder loans to capital, amount of shareholder control, and availability of loans from outside lenders); *Diasonics, Inc. v. Ingalls*, 121 B.R. 626, 631 (Bankr. N.D. Fla. 1990) (stating that trustee must show that corporation was initially undercapitalized or that no disinterested creditor would loan it money at time of transaction); Cohen, *supra* note 118, at 264 (discussing criteria for recharacterization of transaction from debt to equity).

141. See *Pepper*, 308 U.S. at 306-07 (noting that test to scrutinize dealings between director or stockholder and debtor corporation is whether transaction is arm's length bargain); *In re Cold Harbor Assocs., L.P.*, 204 B.R. 904, 915 (Bankr. E.D. Va. 1997) (stating primary factor to consider in determining whether advances were loans or capital contributions is whether transaction bore earmarks of arm's length bargain); Cohen, *supra* note 118, at 264 (noting that most criteria in determining whether to recharacterize transactions focus on whether transaction resembles arm's length bargain).

142. *Cold Harbor*, 204 B.R. at 915.

143. See *Celotex Corp. v. Hillsborough Holdings Corp. (In re Hillsborough Holdings Corp.)*, 176 B.R. 223, 248 (Bankr. M.D. Fla. 1994) (listing 13 factors courts should examine when determining whether to recharacterize debt as equity). In *Celotex*, the court considered the following list of factors: (1) the names given the instruments that evidence the indebtedness, (2) the presence or absence of a fixed maturity date, (3) the source of the payments, (4) the right to enforce payment of the principal and interest, (5) participation in management flowing as a result of the transaction, (6) the status of the contribution in relation to regular corporate creditors, (7) the intent of the parties, (8) "thin" or inadequate capitalization, (9) identity of interest between creditor and stockholder, (10) the source of interest payments, (11) the ability of the corporation to obtain loans from outside lending institutions, (12) the extent to which the corporation used the advance to acquire capital assets, and (13) the failure of the debtor to repay on the due date or to seek postponement. *Id.*; see *Roth Steel Tube Co. v. Commissioner*, 800 F.2d 625, 630-32 (6th Cir. 1986) (considering 11 similar factors to determine if advances were loans or capital contributions); *Lane v. United States (In re Lane)*, 742 F.2d 1311, 1314-15 (11th Cir. 1984) (using same list of factors as *Celotex* court); *Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972) (same); *Cold Harbor*, 204 B.R. at 915 (same); Cohen, *supra* note 118, at 264 (discussing factors similar to those listed in *Celotex*).

critical groups: (1) the formality of the alleged loan agreement, (2) the financial situation of the company when the creditor made the purported loan, and (3) the relationship between the creditor and the debtor.¹⁴⁴

Courts measure the formality of the alleged loan by how specific and complete the parties make the agreement.¹⁴⁵ The transaction appears more like a loan when the parties clearly identify and codify the terms of the agreement.¹⁴⁶ Courts will often label the transaction a capital investment if the terms of the agreement are vague and unspecific.¹⁴⁷ They examine the formality of the agreement by looking to the intent of the parties and at the names given to the agreement documents.¹⁴⁸ The parties' labeling of the documents normally demonstrates their intentions concerning the agreement.¹⁴⁹ Courts also consider whether the creditor has the right to enforce payment of principal or interest.¹⁵⁰ Debt holders have the right to enforce payment by the debtor under the terms of the agreement, while equity holders have no similar right.¹⁵¹ The absence of a fixed maturity date, a schedule of interest payments, and a sinking fund indicate that the agreement is actually a capital contribution.¹⁵² Lenders do not normally engage in debt transactions without clearly establishing the maturity date and the schedule of payments for the loan.¹⁵³

144. See *Cold Harbor*, 204 B.R. at 916-18 (highlighting three main themes that mark distinction between loans and capital contributions).

145. *Id.* at 916.

146. *Id.*

147. *Id.*

148. See *United States v. Colorado Invesco, Inc.*, 902 F. Supp. 1339, 1342 (D. Colo. 1995) (noting that one relevant factor used to determine whether court should recharacterize loan is how parties treated transaction when made); *Blasbalg v. Tarro (In re Hyperion Enters., Inc.)*, 158 B.R. 555, 561 (Bankr. D.R.I. 1993) (including analysis of how business records treat debt to determine treatment of disputed transaction).

149. See *Estate of Mixon v. United States*, 464 F.2d 394, 403 (5th Cir. 1972) (noting issuance of stock certificate indicates equity contribution while issuance of bond, debenture, or note indicates true indebtedness); *Celotex Corp. v. Hillsborough Holdings Corp. (In re Hillsborough Holdings Corp.)*, 176 B.R. 223, 248 (Bankr. M.D. Fla. 1994) (noting that labeling of obligations as loans indicates intent to treat advances as debt). The parties' labeling of the transaction serves as evidence of how to classify the deal, but the labels are not dispositive of whether the transaction should be recharacterized. *Id.*

150. *Roth Steel Tube Co. v. Commissioner*, 800 F.2d 625, 631 (6th Cir. 1986). If the debtor's repayment of a claimant's advances depends on the financial success of the debtor, the transaction appears to be a capital contribution. *Id.*; *Lane v. United States (In re Lane)*, 742 F.2d 1311, 1314 (11th Cir. 1984); *In re Cold Harbor Assocs., L.P.*, 204 B.R. 904, 917 (Bankr. E.D. Va. 1997).

151. *Cold Harbor*, 204 B.R. at 917.

152. *Id.* at 917-18.

153. *Roth Steel*, 800 F.2d at 631; *Lane*, 742 F.2d at 1317. The creditor in *Lane* took none of the common precautions to ensure payment in the event that the business went bankrupt

Additionally, debtors often establish sinking funds to provide for repayment of the loans.¹⁵⁴ Another factor indicating an equity transaction is the corporation's use of the advances to purchase capital equipment.¹⁵⁵ Corporations normally use loan proceeds to meet the everyday expenses of the operation.¹⁵⁶ A final consideration in examining the formality of the alleged loan agreement is the presence or absence of security.¹⁵⁷ Lack of security for the creditor indicates that the transaction was not made at arm's length and that it is more likely a capital contribution than a loan.¹⁵⁸

The second group of factors that courts consider involves the financial situation of the company at the time of the transaction.¹⁵⁹ Inadequate capitalization indicates that courts should consider shareholders' initial loans as capital contributions to the corporation.¹⁶⁰ A related issue to undercapitalization is whether the corporation could obtain outside financing at the time of the transaction.¹⁶¹ Courts generally analyze the undercapitalization question just as they would in the equitable subordination context.¹⁶² Courts look to either the initial amount of capital in a corporation or the corporation's capital at the time of the transaction.¹⁶³ Courts also look to the amount of

indicating that he intended advances to constitute contributions of capital rather than debt. *Id.*; *Cold Harbor*, 204 B.R. at 917.

154. *See Roth Steel*, 800 F.2d at 631 (stating that absence of security for advances is strong indication of capital contribution).

155. *See Celotex Corp. v. Hillsborough Holdings Corp.* (*In re Hillsborough Holdings Corp.*), 176 B.R. 223, 249 (Bankr. M.D. Fla. 1994) (stating that corporation's use of advances to purchase capital equipment may indicate advances were in fact capital contributions).

156. *See Roth Steel Tube Co. v. Commissioner*, 800 F.2d 625, 632 (6th Cir. 1986) (stating that use of advances to meet daily operating expenses of corporation indicates that advances were indeed loans).

157. *Id.*

158. *Id.*; *see In re Cold Harbor Assocs., L.P.*, 204 B.R. 904, 918 (Bankr. E.D. Va. 1997) (noting that absence of security indicates advance is not loan, and complete lack of security is evidence that parties did not transact business at arm's length).

159. *Cold Harbor*, 204 B.R. at 916.

160. *Id.* at 917; *see Braddy v. Randolph*, 352 F.2d 80, 82 (4th Cir. 1965) (finding inadequate capitalization because bankrupt debtor began borrowing from officers and bank from outset of operations); *Fett v. Moore* (*In re Fett Roofing & Sheet Metal Co., Inc.*), 438 F. Supp. 726, 730-31 (Bankr. E.D. Va. 1977) (noting that corporation's debt-to-equity ratio of over eighty to one cast serious doubts on advances truly being loans).

161. *See Roth Steel*, 800 F.2d at 631 (stating that question to ask is whether reasonable outside creditor would loan debtor money in this situation on similar terms).

162. *See supra* notes 68-70 and accompanying text (discussing *Mobile Steel's* two questions to determine if debtor corporation is undercapitalized in equitable subordination case); *see also United States v. Colorado Invesco, Inc.*, 902 F. Supp. 1339, 1343 (D. Colo. 1995) (adopting two-part test for undercapitalization from *Mobile Steel* and applying it in context of recharacterization).

163. *Colorado Invesco*, 902 F. Supp. at 1342.

control shareholders exercise and to whether the undercapitalization ultimately caused the debtor's bankruptcy.¹⁶⁴ Although undercapitalization alone is insufficient to justify equitable subordination,¹⁶⁵ it is enough to recharacterize an alleged loan into a capital contribution.¹⁶⁶

The final group of factors that courts examine in determining whether to recharacterize a transaction involves the relationship between the parties to the agreement.¹⁶⁷ One factor evidencing a capital contribution is the right to participate in management for the creditor as a result of the transaction.¹⁶⁸ Any time a lender obtains the right to control the company's operations, the court considers the transaction an equity contribution.¹⁶⁹ A final factor to consider is the relationship between the creditor and the shareholder.¹⁷⁰ If all the shareholders of a corporation advance money in proportion to their stock ownership, the court will probably find that the contribution is an equity transaction.¹⁷¹ The transaction appears to be more like a loan, however, if one shareholder advances money in disproportion to his interest in the corporation.¹⁷²

The courts should weigh the relevant factors as a group so that no single factor will result in recharacterization of an advance.¹⁷³ The many different

164. See *Blasbalg v. Tarro (In re Hyperion Enters., Inc.)*, 158 B.R. 555, 561 (Bankr. D.R.I. 1993) (noting that in considering whether to recharacterize transaction, court considers whether debtor's ultimate financial failure resulted from undercapitalization).

165. See *Fabricators, Inc. v. Technical Fabricators, Inc. (In re Fabricators, Inc.)*, 926 F.2d 1458, 1469 (5th Cir. 1991) (stating that "undercapitalization alone is an insufficient reason to use equitable subordination" (quoting *Wood v. Richmond (In re Branding Iron Steak House)*, 536 F.2d 299, 302 (9th Cir. 1976))); *Braas Sys., Inc. v. WMR Partners (In re Octagon Roofing)*, 141 B.R. 968, 984 (N.D. Ill. 1992) (stating that only when undercapitalization is combined with inequitable conduct will courts subordinate insiders' claims).

166. See *In re Blevins Concession Supply Co.*, 213 B.R. 185, 187 (Bankr. M.D. Fla. 1997) (stating that when shareholder substitutes debt for adequate risk capital, court should recharacterize claim as equity even if trustee cannot meet other requirements of equitable subordination). *But see Hyperion*, 158 B.R. at 561-62 (rejecting trustee's contention that mere undercapitalization justifies recharacterization of transaction).

167. *In re Cold Harbor Assocs., L.P.*, 204 B.R. 904, 916 (Bankr. E.D. Va. 1997).

168. See *Estate of Mixon v. United States*, 464 F.2d 394, 406 (5th Cir. 1972) (noting that when debtor grants creditor participation in management as result of advances, management participation is evidence of capital contribution by creditor); *Cold Harbor*, 204 B.R. at 917 (observing that one characteristic of equity contribution is participation in management).

169. *Cold Harbor*, 204 B.R. at 917.

170. *Id.* at 919.

171. See *Mixon*, 464 F.2d at 409 (observing that one indication of equity contribution is when stockholders advance money to corporation in proportion with their holdings); *Cold Harbor*, 204 B.R. at 918-19 (noting that shareholders' loan to partnership on pro-rata basis equal to interest in partnership indicated that shareholders made equity contribution).

172. See *Mixon*, 464 F.2d at 409 (noting that sharply disproportionate ratio between interest in company and advance indicate true debt transaction).

173. See *Central Coops., Inc. v. Irwin (In re Colonial Poultry Farms)*, 177 B.R. 291, 300 (Bankr. W.D. Mo. 1995) ("[N]o one fact will result in the determination that putative loans are

factors employed to determine if courts should treat an alleged loan as a capital contribution make it difficult for both lenders and corporate borrowers to predict how the court will view individual transactions.¹⁷⁴

IV. Pacific Express: *The Ninth Circuit's Reason for Disallowing the Recharacterization of Claims in Bankruptcy*

Although courts apply different tests to determine when they can recharacterize a debt transaction into equity or equitably subordinate a claim, the two procedures produce the same basic result.¹⁷⁵ The court moves the recharacterized or equitably subordinated claim behind other unsecured creditors, and the estate pays the claimant only after the estate satisfies all other obligations.¹⁷⁶ In *Pacific Express*, the B.A.P. held that the bankruptcy court construed its authority too broadly by recharacterizing claims from debt to equity.¹⁷⁷ The panel rejected the adoption of tax court standards to determine the true character of a disputed claim.¹⁷⁸ In effect, the B.A.P. ruled that a court can subordinate a claim behind other claims only by using § 510(c) equitable subordination.¹⁷⁹

Did the *Pacific Express* B.A.P. really intend for bankruptcy courts to apply § 510(c) equitable subordination to subordinate advances that were

actually contributions to capital." (quoting *Fett v. Moore (In re Fett Roofing & Sheet Metal Co., Inc.)*, 436 F. Supp. 726, 731 (Bankr. E.D. Va. 1977)).

174. See Cohen, *supra* note 118, at 274 (discussing court criteria for determining whether to treat loans as capital contributions).

175. See *Summit Coffee Co. v. Herby's Foods, Inc. (In re Herby's Foods, Inc.)*, 2 F.3d 128, 133 (5th Cir. 1993) (stating that practical effects of recharacterization and equitable subordination are identical); *Colonial Poultry Farms*, 177 B.R. at 299 (explaining that end result of equitable subordination and recharacterization are similar).

176. See *Colonial Poultry Farms*, 177 B.R. at 299 (discussing result of recharacterizing debt transaction into equity contribution); *Diasonics, Inc. v. Ingalls*, 121 B.R. 626, 630 (Bankr. N.D. Fla. 1990) (stating that trustee pays recharacterized claims after paying other unsecured creditors).

177. *Unsecured Creditors' Comms. of Pac. Express, Inc. v. Pioneer Commercial Funding Corp. (In re Pacific Express, Inc.)*, 69 B.R. 112, 115 (B.A.P. 9th Cir. 1986) (holding that Code does not support courts' ability to characterize claims as debt or equity).

178. See *id.* (claiming that although some sources approve use of tax standards, they should be considered irrelevant to claim determination in bankruptcy proceedings); see also *Long Island Lighting Co. v. Bokum Resources Corp.*, 40 B.R. 274, 296 (Bankr. D.N.M. 1983) (noting that examination of claims in bankruptcy is for different purpose and utilizes different criteria than analysis for tax purposes); *Rego Crescent Corp. v. Tymon (In re Rego Crescent Corp.)*, 23 B.R. 958, 962 (Bankr. E.D.N.Y. 1982) (noting that legal questions and policy considerations for tax determination of claims is removed from determination of whether courts should consider capital contributions or loans for bankruptcy purposes).

179. See *Pacific Express*, 69 B.R. at 115-16 (noting that appropriate test to use in considering whether to subordinate claim is equitable subordination under § 510(c)).

actually capital contributions? The bankruptcy court's decision in *Diasonics, Inc. v. Ingalls*¹⁸⁰ illustrates the result that the *Pacific Express* B.A.P. may have intended to avoid by prohibiting bankruptcy judges from using recharacterization to subordinate claims.¹⁸¹ In *Diasonics*, an unsecured creditor, Diasonics, Inc. (Diasonics) requested that the court either recharacterize the debt claims of National Plastics (Plastics) and Ingalls as capital contributions or equitably subordinate those claims to the other unsecured creditors' claims.¹⁸² Ingalls owned and controlled Diasonics through Plastics, which existed solely to receive funds from Ingalls and to distribute them to Diasonics.¹⁸³ Ingalls structured these advances as long-term debt and listed them as loans on his tax returns.¹⁸⁴ The court denied Diasonics's motion for summary judgment regarding equitable subordination of the claims, but it granted a motion for summary judgment with respect to recharacterizing the claims as capital contributions.¹⁸⁵ The court refused to equitably subordinate Ingalls's claims because it found no evidence of inequitable conduct.¹⁸⁶ The court decided that undercapitalization without additional inequitable conduct did not justify equitable subordination.¹⁸⁷ Furthermore, the court stated that the appropriate issue in determining if courts should subordinate claims because of under-

180. 121 B.R. 626 (Bankr. N.D. Fla. 1990).

181. See *Diasonics, Inc. v. Ingalls*, 121 B.R. 626, 632 (Bankr. N.D. Fla. 1990) (holding funds advanced to debtor by Ingalls to be capital contributions and not loans). In *Diasonics*, the bankruptcy court considered whether advances made by Ingalls to Diasonics, Inc. (Diasonics) should be equitably subordinated or, alternatively, treated as capital contributions instead of as loans. *Id.* at 626-27. Over a period of several years, Ingalls advanced money to Diasonics both personally and through a parent corporation of Diasonics. *Id.* at 627. Ingalls structured the advances to Diasonics in the form of long-term loans. *Id.* The court found no evidence of inequitable conduct by Ingalls sufficient to warrant exercising the power of § 510(c) equitable subordination. *Id.* at 630. The *Diasonics* court held that the initial undercapitalization of a company, without additional inequitable conduct, is not a sufficient basis for equitably subordinating a claim. *Id.* A court should not consider the issue of equitable subordination until it determines whether the advances are loans or capital contributions. *Id.* If the court determines that the advances are actually capital contributions, the equitable subordination issue becomes completely irrelevant. *Id.* Once the court determines that the advances are capital contributions, the court must subordinate the advances to true claims because capital contributions are repaid only after all other obligations are satisfied. *Id.* The *Diasonics* court found no evidence of initial undercapitalization of Diasonics. *Id.* at 631. The court, however, determined that at the time Ingalls advanced funds to the debtor, no disinterested investor would provide similar financing. *Id.* at 632. Consequently, the *Diasonics* court held that the advances were actually capital contributions to *Diasonics* and not loans. *Id.*

182. *Id.* at 626-27.

183. *Id.* at 627.

184. *Id.*

185. *Id.*

186. *Id.* at 629.

187. *Id.*

capitalization is whether the advance is a loan or an equity contribution.¹⁸⁸ The court also stated that when Ingalls advanced funds to the debtor, no other disinterested lender would extend equivalent credit.¹⁸⁹ Based on this determination, the court found the advances to be capital contributions rather than loans.¹⁹⁰

Under the *Pacific Express* analysis, the court would reach a different result in *Diasonics*.¹⁹¹ The *Diasonics* court refused to equitably subordinate the advances, but it accomplished the same result of subordination by recharacterizing the claims as capital contributions.¹⁹² *Pacific Express* holds that bankruptcy courts are not authorized to recharacterize advances, so once a court denies equitable subordination as in *Diasonics*, the claims would remain on a level with other secured creditors.¹⁹³ Although additional factors possibly weighed against the characterization of the advances as loans in *Diasonics*,¹⁹⁴ the court based its decision to recharacterize the advances as capital contributions on its determination that no other disinterested lenders would extend credit.¹⁹⁵ Allowing bankruptcy judges to recharacterize claims based on mere undercapitalization alone or on the inability of a corporation to obtain outside financing is a result that the *Pacific Express* decision clearly prohibits.¹⁹⁶

188. *Id.*

189. *Id.* at 632.

190. *Id.*

191. *See id.* (holding that courts should recharacterize advances in bankruptcy as capital contributions if no disinterested outside lender would provide similar financing to debtor at time of alleged loans); *see also* Unsecured Creditors' Comms. of Pac. Express, Inc. v. Pioneer Commercial Funding Corp. (*In re Pacific Express, Inc.*), 69 B.R. 112, 115 (B.A.P. 9th Cir. 1986) (holding that bankruptcy courts do not have authority to recharacterize claims from debt to equity in bankruptcy proceedings).

192. *See Diasonics, Inc. v. Ingalls*, 121 B.R. 626, 630-32 (Bankr. N.D. Fla. 1990) (determining that absent inequitable conduct, courts should not exercise equitable subordination, but because no disinterested lender would provide similar financing, court could subordinate claim through recharacterization).

193. *Pacific Express*, 69 B.R. at 115-16.

194. *Diasonics*, 121 B.R. at 627-32. None of the notes executed between Ingalls and the debtor contained repayment terms. *Id.* at 627. Although *Diasonics* made some payments on the note, the payments were not made in the ordinary course of business. *Id.* The interest charged on the notes was nominal and computed arbitrarily. *Id.* at 627-28. Some additional evidence indicated in correspondence to another creditor that *Diasonics* considered the transaction an investment. *Id.* at 631-32.

195. *See id.* at 632 (stating that Ingalls presented no evidence that debtor could have obtained financing from disinterested lender, therefore funds Ingalls advanced were capital contributions and not loans).

196. *See Pacific Express*, 69 B.R. at 115-16 (prohibiting bankruptcy courts from recharacterizing claims from debt to equity to accomplish subordination).

The bankruptcy courts' practice of recharacterizing debt transactions even without inequitable conduct by the creditor will discourage insiders from making loans to troubled companies.¹⁹⁷ Often an insider is the only source of funds for a struggling company.¹⁹⁸ If the insider creditor faces a possibility of its claim being recharacterized and subordinated even without any inequitable conduct, it will think twice before lending money to a debtor possibly nearing bankruptcy.¹⁹⁹ This would make it nearly impossible for companies such as Disonics and Pacific Express to borrow money when they need it the most.²⁰⁰

Pacific Express avoids this drastic result by requiring courts to find inequitable creditor conduct through § 510(c) equitable subordination analysis in order to subordinate a claim in bankruptcy.²⁰¹ This ruling provides assurance to lenders in the Ninth Circuit that absent inequitable conduct, courts will not subordinate lenders' claims in bankruptcy proceedings.²⁰² The *Pacific Express* B.A.P. did not want bankruptcy judges to subordinate claims without applying § 510(c) equitable subordination.²⁰³ Although the *Pacific Express* B.A.P. achieved the result it desired, it appears to have gone too far in prohibiting the recharacterization of claims in bankruptcy altogether.

197. See *Herzog v. Leighton Holdings, Ltd. (In re Kids Creek Partners, L.P.)*, 200 B.R. 996, 1020 (Bankr. N.D. Ill. 1996) (noting that advancing funds to undercapitalized debtor is insufficient for finding inequitable conduct because it would discourage insiders from making loans to save troubled companies); *Braas Sys., Inc. v. WMR Partners (In re Octagon Roofing)*, 157 B.R. 852, 858 (N.D. Ill. 1993) (stating that subordinating claim absent inequitable conduct would dissuade shareholders with most motivation to save floundering company from advancing funds).

198. See *Octagon Roofing*, 157 B.R. at 858 (noting that shareholders are ordinarily most interested or motivated to save troubled debtor).

199. *Id.*

200. A hypothetical example illustrates how allowing courts to recharacterize alleged loans from insiders as capital contributions would discourage insiders from lending money to financially troubled companies. Assume *C* is an insider of struggling debtor corporation *D*. *D* seeks financing, but no disinterested outside lender wants to risk advancing money to *D* in fear that *D* may go bankrupt. *C*, as an insider of *D*, has an obvious interest in helping *D* get out of financial trouble. *C* wants to help by loaning money to *D*, but *C* also wants assurance that if *D* declares bankruptcy *C*'s claim will be treated as a debt with the claims of *D*'s other unsecured creditors. *C* is unlikely to advance *D* money if the bankruptcy court can recharacterize the advance as a capital contribution based solely on *D*'s undercapitalization and inability to obtain outside financing.

201. See *Unsecured Creditors' Comms. of Pac. Express, Inc. v. Pioneer Commercial Funding Corp. (In re Pacific Express, Inc.)*, 69 B.R. 112, 115-16 (B.A.P. 9th Cir. 1986) (noting that bankruptcy courts are not authorized to characterize claims and correct analysis is whether court should equitably subordinate claim under § 510(c)).

202. *Id.*

203. *Id.*

V. *Why Bankruptcy Courts Should Be Authorized to Recharacterize Claims Independent of § 510(c) Equitable Subordination*

In *Pacific Express*, the Ninth Circuit B.A.P. cited *Mobile Steel* to suggest that the issue is not whether the advances were actually loans, but whether equity requires that courts treat the advances like something other than loans.²⁰⁴ The majority of courts, however, analyze this situation by addressing the question of whether an advance is in fact a loan or capital contribution before they examine equitable subordination.²⁰⁵ Courts apply equitable subordination only to true creditors.²⁰⁶ If a court considers a claim to actually be an equity contribution, the court will subordinate that claim below other claimants, but not through § 510(c) equitable subordination.²⁰⁷ The court subordinates the equity contribution because the corporation only repays equity contributions after it satisfies all other obligations.²⁰⁸ The *Pacific Express* B.A.P. failed to acknowledge that these cases actually turn on whether a debt actually exists, not on whether the claim should be equitably subordinated.²⁰⁹

Pacific Express rejected the recharacterization of transactions because it determined that § 510(c) governs the result, subordination of claims.²¹⁰

204. See *id.* (stating that "[i]t is important to remember that the issue is not whether the advances 'actually' were loans, but whether equity requires that they be regarded as if they were something else" (quoting *Benjamin v. Diamond (In re Mobile Steel Co.)*, 563 F.2d 692, 702 (5th Cir. 1977))).

205. See *Diasonics, Inc. v. Ingalls*, 121 B.R. 626, 630 (Bankr. N.D. Fla. 1990) (noting that court should decide whether advance is loan or capital contribution before it contemplates equitable subordination of claim in bankruptcy).

206. *Id.*

207. *Id.*

208. *Id.*

209. See *Herzog & Zweibel*, *supra* note 76, at 93 (discussing cases involving whether alleged debts are actually capital contributions). A simple hypothetical illustrates the absurdity of this analysis. Assume that *C* files a proof of claim against debtor *D*'s estate for \$1000 based on *C*'s purchase of *D*'s stock. *D* files for bankruptcy and *C* claims that the transaction created a \$1000 debt because it was a loan. The trustee of *D*'s estate denies the claim because the purchase of stock is clearly an equity investment in the company. All creditors' claims must be satisfied before shareholders can begin to recoup their investment. In this hypothetical, the trustee recharacterized *C*'s claim of debt into equity. No reason exists to address the issue of equitably subordinating the claim because the stock purchase is not even a true claim. Courts must be permitted to recharacterize transactions of this nature or creditors will always try and claim their advances were loans.

210. See *Unsecured Creditors' Comms. of Pac. Express, Inc. v. Pioneer Commercial Funding Corp. (In re Pacific Express, Inc.)*, 69 B.R. 112, 115 (B.A.P. 9th Cir. 1986) (noting that Code does not provide authority for characterization of claims and § 510(c) governs results of determinations); *In re Lewiston Steam & Power Assocs.*, No. B86-00477-Y, 1989 Bankr. LEXIS 1382, at *5 (Bankr. N.D. Ohio Aug. 24, 1989) (stating that recharacterization of claim

Other courts have stated that debt may be recharacterized as equity regardless of whether the trustee has satisfied the other requirements of equitable subordination.²¹¹ These courts argue that § 510(c) does not prevent a court from viewing the substance of a transaction over its form and determining that the claimant took an equity position.²¹² These courts continue to recharacterize claims by relying on the authority vested in the bankruptcy court to use its equitable powers to test the validity of claims.²¹³

One reason the application of these two procedures causes so much confusion is that courts sometimes consider the recharacterization of loans as equity as a subset of the bankruptcy courts' equitable subordination powers.²¹⁴ Undercapitalization cases illustrate this confusion because they lead some courts to equitably subordinate claims that other courts would recharacterize as equity contributions.²¹⁵ Mere undercapitalization without inequitable conduct is generally insufficient to support equitable subordination of a claim.²¹⁶ It is not always clear whether courts will elect to recharacterize a claim based on undercapitalization even when the claimant acted inequitably.²¹⁷ This area

from debt to equity is not allowed absent controlling provisions in Code); *Pinetree Partners, Ltd. v. State Teachers Retirement Sys.* (*In re Pinetree Partners, Ltd.*), 87 B.R. 481, 490 (Bankr. N.D. Ohio 1988) (same).

211. See *Summit Coffee Co. v. Herby's Foods, Inc.* (*In re Herby's Foods, Inc.*), 2 F.3d 128, 133 (5th Cir. 1993) (stating that court is authorized to recharacterize loan as equity contribution even when circumstances do not warrant equitable subordination); *Diasonics, Inc. v. Ingalls*, 121 B.R. 626, 630 (Bankr. N.D. Fla. 1990) (observing that court should first determine whether transaction is loan or capital contribution before determining equitable subordination issue).

212. See *Pepper v. Litton*, 308 U.S. 295, 304-05 (1939) (noting that bankruptcy courts exercise equitable powers to ensure that substance of transaction does not give way to form); *Fabricators, Inc. v. Technical Fabricators, Inc.* (*In re Fabricators, Inc.*), 926 F.2d 1458, 1469 (5th Cir. 1991) (finding claimant's advances more related to equity investment than loan transaction); *United States v. Colorado Invesco, Inc.*, 902 F. Supp. 1339, 1342 (D. Colo. 1995) (discussing merits of recharacterization).

213. See *In re Cold Harbor Assocs., L.P.*, 204 B.R. 904, 915 (Bankr. E.D. Va. 1997) (citing *Pepper v. Litton*, 308 U.S. 295, 305-06 (1939)) (discussing court's ability to inquire into nature of transaction and recharacterize it using equitable powers if necessary); *Fett v. Moore* (*In re Fett Roofing & Sheet Metal Co., Inc.*), 438 F. Supp. 726, 729-30 (Bankr. E.D. Va. 1977) (stating that bankruptcy court, as court of equity, can disregard appearance of transaction and determine actual character of transaction between parties).

214. See *Blasbalg v. Tarro* (*In re Hyperion Enters., Inc.*), 158 B.R. 555, 559 (Bankr. D.R.I. 1993) (comparing two related arguments of recharacterization and equitable subordination).

215. See *Diasonics*, 121 B.R. at 629-30 (discussing issue of whether undercapitalization of corporation should lead courts to equitably subordinate claim or to recharacterize as equity contribution).

216. See *supra* note 71 and accompanying text (noting that mere undercapitalization is not enough to subordinate claim without finding additional inequitable conduct).

217. See *Diasonics, Inc. v. Ingalls*, 121 B.R. 626, 632 (Bankr. N.D. Fla. 1990) (determining that equitable subordination was not justified because of lack of inequitable conduct, but

is one in which it may be easier for courts to recharacterize a claim as an equity contribution than it would be to equitably subordinate the same claim.²¹⁸

One argument for the use of recharacterization of transactions in bankruptcy is that because tax courts use a similar analysis recharacterization of claims promotes uniformity between the bankruptcy and tax courts.²¹⁹ Most bankruptcy courts employ tax court factors to determine whether to recharacterize a claim.²²⁰ Some courts reject this analysis and claim that the tax court's factors concerning recharacterization are irrelevant for a determination for bankruptcy purposes.²²¹

Another argument for allowing the bankruptcy court to recharacterize claims is that it is a court of equity with the power to consider the substance of a transaction regardless of its form.²²² The courts use recharacterization to decide whether a debt exists and not to decide whether to subordinate it.²²³ Under this line of reasoning, if courts consider the advance to be a capital contribution, then equitable subordination would be irrelevant.²²⁴ Equitable subordination applies only to legitimate creditors.²²⁵ If the court determines

that court should recharacterize claim). *But see Hyperion*, 158 B.R. at 561-62 (rejecting trustee's contention that mere undercapitalization justifies recharacterization of transaction).

218. *See generally Disonics*, 121 B.R. 626. *But see* Unsecured Creditors' Comms. of Pac. Express, Inc. v. Pioneer Commercial Funding Corp. (*In re Pacific Express, Inc.*), 69 B.R. 112, 115 (B.A.P. 9th Cir. 1986) (avoiding confusion by prohibiting bankruptcy courts from recharacterizing claims and requiring them to exercise § 510(c) equitable subordination to subordinate bankruptcy claims).

219. *See Pacific Express*, 69 B.R. at 115 (observing that lower court applied factors that tax courts ordinarily used to determine that court should recharacterize claim as equity).

220. *See Herzog & Zweibel*, *supra* note 76, at 94 (noting that appropriate standards to use in considering whether transaction is equity or debt are stated more clearly in tax cases); *see also supra* note 140 (outlining factors adopted from tax court decisions to determine if claim is debt or equity).

221. *See Pacific Express*, 69 B.R. at 115 (rejecting adoption of standards tax courts used to serve in review of claims for bankruptcy proceedings); *Rego Crescent Corp. v. Tymon (In re Rego Crescent Corp.)*, 23 B.R. 958, 962 (Bankr. E.D.N.Y. 1982) (noting that legal questions and policy considerations considered in tax case were far removed from determining whether courts should treat advances as debt or equity for bankruptcy purposes).

222. *See Pepper v. Litton*, 308 U.S. 295, 304-05 (1939) (noting that bankruptcy courts exercise equitable powers to ensure that substance of transaction does not give way to form); *Fabricators, Inc. v. Technical Fabricators, Inc. (In re Fabricators, Inc.)*, 926 F.2d 1458, 1469 (5th Cir. 1991) (finding claimant's advances more related to equity investment than loan transaction).

223. *See Herzog & Zweibel*, *supra* note 76, at 93 (discussing recharacterization of claims as subset of equitable subordination).

224. *See Disonics, Inc. v. Ingalls*, 121 B.R. 626, 630 (Bankr. N.D. Fla. 1990) (noting that courts should consider recharacterization of claim before addressing issue of equitable subordination).

225. *Id.*

that the claimant is not a creditor but an equity holder, then equitable subordination would not apply.²²⁶ The court subordinates the claim as a proprietary interest because the corporation repays capital contributions only after satisfying all other obligations of the corporation.²²⁷

VI. Conclusion

Although different courts incorporate various subtle differences in determining when to equitably subordinate claims, virtually all courts use some form of the three-prong test developed in *Mobile Steel*.²²⁸ The *Mobile Steel* test brings a certain level of predictability for debtors and lenders to consider when structuring a loan. It is important for lenders to be able to advance funds to troubled companies confidently without worrying about the bankruptcy court later deciding that the alleged loan is actually a capital contribution.²²⁹ The bankruptcy courts do not want to discourage inside lenders from attempting to bail out failing corporations with loans. Struggling companies would be unable to procure financing because insiders are normally the only lenders willing to help out companies in trouble. The obvious result if insiders stop loaning money to these troubled corporations would be an increased number of bankruptcy filings.

In *Pacific Express*, the B.A.P. held that bankruptcy judges cannot go beyond the traditional § 510(c) equitable subordination concepts to subordinate claims.²³⁰ This ruling left courts with the requirement of finding inequitable conduct by creditors in order to subordinate claims in bankruptcy. This decision provides assurance to lenders in the Ninth Circuit that courts will not subordinate their claims to other creditors absent inequitable conduct. Unfortunately, the *Pacific Express* decision goes too far by completely prohibiting the courts from recharacterizing claims. Bankruptcy courts should have the authority to recharacterize claims that are clearly capital contributions. Otherwise, every time a party makes an equity contribution to a corporation, they will characterize it as a loan, and the bankruptcy courts will be forced to

226. *Id.*

227. *Id.*; see Herzog & Zweibel, *supra* note 76, at 94 (noting that capital interests are contributed to meet obligations of business and are repaid only after all other claimants are satisfied).

228. See *supra* notes 46-95 and accompanying text (discussing *Mobile Steel* case and how courts apply three-pronged test).

229. See *supra* notes 197-200 and accompanying text (explaining how bankruptcy courts' practice of recharacterizing advances will discourage insiders from lending money to financially troubled corporations on brink of bankruptcy).

230. See Unsecured Creditors' Comms. of Pac. Express, Inc. v. Pioneer Commercial Funding Corp. (*In re Pacific Express, Inc.*), 69 B.R. 112, 115 (B.A.P. 9th Cir. 1986) (noting that § 510(c) equitable subordination governs subordination of claims).

accept their characterization. Bankruptcy courts would have to analyze every disputed transaction regarding possible subordination of alleged claims under § 510(c). This would lead to the ridiculous result of bankruptcy courts trying to determine whether purported loans that are actually capital contributions should be equitably subordinated.

Courts need to find a middle ground in which good faith loans from insiders will be protected from recharacterization, but bankruptcy courts will still be authorized to recharacterize obvious equity transactions. This middle ground would prohibit courts from recharacterizing insider loans simply because the debtor was undercapitalized or was unable to procure outside financing. The factors adopted from the tax court's analysis begin to provide a reasonable criteria for courts to consider when determining whether to recharacterize claims.²³¹ If bankruptcy courts examine these factors as a group to determine the true nature of the transaction, they will normally reach the correct result. It is important for the courts to analyze the factors as a whole instead of relying on undercapitalization alone to justify recharacterization. This type of analysis will provide more comfort to good faith lenders who structure their loans correctly. The *Pacific Express* B.A.P. may have gone too far in limiting any subordination of claims in bankruptcy to § 510(c) equitable subordination. However, bankruptcy courts are well advised to maintain a higher standard for recharacterizing claims than mere undercapitalization or inability of the debtor to obtain financial support elsewhere. Requiring this higher standard for recharacterizing claims will ensure creditors that courts will not treat their legitimate loans as equity contributions once the debtor files in bankruptcy.

231. See *supra* note 143 (listing factors considered in determining whether court should recharacterize claim).