

# Client Alert.

October 19, 2011

## ***Lothian Oil:* Fifth Circuit Recharacterizes Non-Insiders' Debt Claim as Equity**

**By Stefan W. Engelhardt and John A. Pintarelli<sup>1</sup>**

On August 9, 2011, the United States Court of Appeals for the Fifth Circuit held that a non-insider's debt claim can be recharacterized as equity in *Grossman v. Lothian Oil Inc. (In re Lothian Oil, Inc.)*.<sup>2</sup> The Fifth Circuit, in reversing the district court, held that: (i) there is no *per se* rule limiting to insiders the recharacterization of debt claims as equity and (ii) non-insider debt claims may be recharacterized as equity under section 502(b) of the Bankruptcy Code.

With the court's extension of the recharacterization test to non-insiders, lenders must ensure that they properly structure and document a loan transaction. Lenders can no longer rely on the perception of a *per se* rule limiting debt recharacterization to insiders.

### BACKGROUND

Israel Grossman ("Grossman") filed several proofs of claim in the bankruptcy cases of Lothian Oil and its affiliates (collectively, "Lothian Oil"). One of these claims, in the amount of \$250,000, was based on a handwritten agreement dated April 27, 2005 between Grossman and Lothian Oil (the "Initial Loan") that stated "Grossman loans \$200,000 U.S. to Lothian Oil, Inc."<sup>3</sup> In exchange, Grossman was to receive a one percent royalty on the debtors' gross production of oil and gas from its properties in New Mexico, an area known as Webb Properties. The principal was to be repaid from the proceeds of an anticipated \$0.75 equity issuance or any other equity issued by Lothian Oil.<sup>4</sup>

A second claim, also for \$250,000, was based on a "Loan Agreement" between Grossman and Lothian Oil dated May 12, 2005 (the "Additional Loan" and together with the Initial Loan, the "Loans") that stated "Grossman shall loan the sum of \$150,000 to Lothian Oil"<sup>5</sup> and in consideration for the loan, Grossman was to receive a royalty of one percent of Lothian Oil's share of gross production of oil and gas on the Webb Properties in New Mexico, without further investment to be made by Grossman. Principal was to be repaid from the proceeds of an anticipated \$0.75 equity issuance, or from the proceeds – subject always to a certain Sterling Bank credit agreement – of any other equity issued by Lothian Oil.<sup>6</sup>

The United States Bankruptcy Court for the Western District of Texas (the "Bankruptcy Court") held a hearing on these claims and entered an order sustaining Lothian Oil's objections, disallowing each of the disputed claims in their entirety. The Bankruptcy Court found that Grossman asserted common equity interests at best, for which there was insufficient evidence of value.<sup>7</sup> The Bankruptcy Court determined that although the Loans contained elements of debt and equity, the one percent overriding royalty interest in the Webb Properties was equity and should be treated as such.<sup>8</sup>

Grossman filed a motion for reconsideration that was denied by the Bankruptcy Court,<sup>9</sup> and later filed an appeal to the United States District Court for the Western District of Texas (the "District Court").

# Client Alert.

## THE DISTRICT COURT

The District Court affirmed the Bankruptcy Court's decision in part, and reversed it in part. The District Court declined to extend the concept of debt recharacterization to a non-insider.<sup>10</sup> In effect, the District Court applied a *per se* rule wherein a court could not recharacterize debt claims of non-insiders against a debtor as equity. Although referencing the traditional 11-factor test for examining whether an agreement should be classified as an equity investment or a debt instrument,<sup>11</sup> the District Court held many of the factors irrelevant or inapplicable in the case of a non-insider creditor. As a result, the District Court held that the Bankruptcy Court erred in recharacterizing Grossman's claims as equity investments.<sup>12</sup> Lothian Oil appealed the District Court's decision.

## THE FIFTH CIRCUIT

The issue of whether a bankruptcy court may recharacterize the debt claim of a non-insider as equity was one of first impression for the Fifth Circuit. The Fifth Circuit reversed the District Court's decision that the Loans constituted debt claims and held that "recharacterization extends beyond insiders and is part of the Bankruptcy Court's authority to allow and disallow claims under section 502 of the Bankruptcy Code."<sup>13</sup>

While acknowledging that other circuit courts have generally found their power to recharacterize debt as equity to be based on the equitable powers vested in them in section 105(a) of the Bankruptcy Code, the Fifth Circuit concluded that resorting to its equitable power was unnecessary.<sup>14</sup>

The Fifth Circuit's analysis began with the language of section 502(b) of the Bankruptcy Code which requires that, upon objection to a timely filed claim, the court "shall determine the amount of such claim... and shall allow such claim in such amount, except to the extent that - - (1) such claim is unenforceable against the debtor and property of the debtor, under any agreement or applicable law..."<sup>15</sup> The Supreme Court has held that, in determining property rights in a bankruptcy estate, the "applicable law" is state law.<sup>16</sup> The Fifth Circuit therefore conducted its analysis of section 502 of the Bankruptcy Code by applying Texas law to the agreements underlying Grossman's claims.

Preliminarily, the Fifth Circuit determined that, unless state law deems insider status relevant to characterizing equity versus debt, such status was irrelevant in a federal bankruptcy proceeding.<sup>17</sup> Furthermore, the Fifth Circuit specifically declined to limit recharacterization to insider claims; both insiders and non-insiders can mischaracterize their claims in contravention of state law.<sup>18</sup>

Next, the Fifth Circuit determined that Texas courts should apply a multi-factor test to distinguish between debt and equity.<sup>19</sup> These factors include: (i) the intent of the parties; (ii) the identity of interests between the creditor and stockholder; (iii) the extent of participation in management by the holder of the instrument; (iv) the ability of the corporation to obtain funds from outside sources; (v) the "thinness" of the capital structure in relation to the debt; (vi) the risk involved; (vii) the formal indicia of the arrangement; (viii) the relative position of the obligees as to other creditors regarding the payment of interest and principal; (ix) the voting power of the holder of the instrument; (x) the provision of a fixed rate of interest; (xi) a contingency on the obligation to repay; (xii) the source of the interest payments; (xiii) the presence or absence of a fixed maturity date; (xiv) a provision for redemption by the corporation; (xv) a provision for redemption at the option of the holder; and (xvi) the time of the advance with reference to the organization of the corporation.<sup>20</sup> The test is not dissimilar to those cited by the District Court or those employed by circuit courts that use their equitable power under section 105 of the Bankruptcy Code to determine whether recharacterization is appropriate.

## Client Alert.

---

The Fifth Circuit held that the Bankruptcy Court did not commit error in finding that Grossman's claims "assert common equity interests at best" because Texas law would not have recognized the claims as an assertion of a debt interest.<sup>21</sup>

### THE IMMEDIATE IMPLICATIONS OF *LOTHIAN OIL*

Courts that have used their equitable powers under section 105(a) of the Bankruptcy Code have held that a bankruptcy court's use of its equitable powers to recharacterize debt is essential to implement the Bankruptcy Code's mandate that creditors have a higher priority than holders of equity interests.<sup>22</sup> These courts have drawn the distinction between (i) equitable subordination under section 510(c) of the Bankruptcy Code – where a party has a valid debt claim but is being subordinated to other creditors within the class because of some inequitable conduct and (ii) recharacterization – where a party has misclassified its interest as a debt claim.<sup>23</sup>

Other courts have questioned the use of a court's equitable powers to recharacterize a claim because it would vitiate the framework that the Bankruptcy Code and Bankruptcy Rules have established for subordinating claims to one another.<sup>24</sup> For example, the bankruptcy appellate panel for the Ninth Circuit ("B.A.P.") found it inappropriate to use the court's equitable powers to recharacterize a debt claim, holding that section 502 of the Bankruptcy Code only provides for the court to allow and determine the amount of a claim because the section does not provide for recharacterization. The B.A.P. stated that "where there is a specific provision governing these determinations, it is inconsistent with the interpretation of the Bankruptcy Code to allow such determinations to be made under different standards through the use of the court's equitable powers."<sup>25</sup> A later decision by the bankruptcy court for the Northern District of California, however, found that recharacterization of debt was "a distinct cause of action which can be decided in the context of a bankruptcy case."<sup>26</sup>

Decisions supporting recharacterization state that no one factor in their analysis is dispositive. However, the failure to extend recharacterizations to non-insiders in courts outside the Fifth Circuit implies that an entity's status does have a bearing the result. It is unclear whether the *Lothian* decision will prompt these courts to consider applying debt recharacterization to non-insiders. For the moment, it is clear that, in the Fifth Circuit, potential investors must take additional care to properly document a loan transaction.

### Contact:

**Stefan W. Engelhardt**  
(212) 468-8165  
[sengelhardt@mofo.com](mailto:sengelhardt@mofo.com)

**John A. Pintarelli**  
(212) 336-4133  
[jpintarelli@mofo.com](mailto:jpintarelli@mofo.com)

### About Morrison & Foerster:

We are Morrison & Foerster—a global firm of exceptional credentials in many areas. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We've been included on *The American Lawyer's* A-List for eight straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at [www.mofo.com](http://www.mofo.com).

*Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.*

# Client Alert.

<sup>1</sup> Stefan W. Engelhardt is a Partner in the Litigation Group of Morrison & Foerster LLP in its New York office. Mr. Engelhardt's practice focuses on complex commercial litigation and bankruptcy litigation. John A. Pintarelli is an associate in the Bankruptcy and Restructuring Group of Morrison & Foerster LLP in its New York office. John's practice focuses on representing debtors and creditors in complex domestic and international bankruptcy and insolvency matters, including judicial and out-of-court restructurings.

<sup>2</sup> *Grossman v. Lothian Oil Inc. (In re Lothian Oil, Inc.)*, (No. 10-50683) 2011 U.S. App. LEXIS 16404, at \*1 (5th Cir. Aug. 9, 2011).

<sup>3</sup> *Id.* at \*2.

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> *Id.* at \*2-3.

<sup>7</sup> *In re Lothian Oil, Inc.*, No. 07-70121, Order Sustaining the Reorganized Debtors' Sixth Omnibus Objection to Certain Claims Pursuant to F. Bankr. R. 3007 and Counterclaims, Docket No. 1832 at \*2 (Bank. W. D. Tex. Dec. 17, 2008).

<sup>8</sup> *In re Lothian Oil, Inc.*, No. 07-70121, Transcript of 12/15/2008 Hearing, Docket No. 1846 at \*105 (Bankr. W.D. Tex. Dec. 17, 2008).

<sup>9</sup> *In re Lothian Oil, Inc.*, No. 07-70121, Order Denying Motion, Docket No. 1916 (Bank. W.D. Tex. Feb. 12, 2009).

<sup>10</sup> *In re Lothian Oil, Inc.*, No. 09-cv-00030, Memorandum Opinion, Docket No. 43 at \*5 (W.D. Tex. Oct. 15, 2009).

<sup>11</sup> *Id.* at 4-5 (citing factors from *Jones v. United States*, 659 F.2d 618, 622 n.12 (5th Cir. 1981)) ("courts should examine eleven flexible factors: The (1) name of the instrument memorializing the transaction; (2) definitiveness of maturity date; (3) source of payments; (4) right to enforce payment; (5) participation in management; (6) relationship of would be 'creditors' to general creditors; (7) intent of the parties; (8) adequacy of capitalization; (9) identity of ownership; (10) source of interest payments; and (11) ability of corporation to obtain loans elsewhere").

<sup>12</sup> *Id.* at 5-6.

<sup>13</sup> *Lothian Oil*, 2011 U.S. App. LEXIS 16404, at \*7.

<sup>14</sup> *Id.* at \*8-9 (citing *In re Submicron Sys. Corp.*, 432 F.3d 448, 454 n.6 (3d Cir. 2006); *In re Dornier Aviation, Inc.*, 453 F.3d 225 (4th Cir. 2006); *In re Hedged-Invs. Assocs.*, 380 F.3d 1292 (10th Cir. 2004); *In re Autostyle Plastics, Inc.*, 29 F.3d 726, 748-49 (6th Cir. 2001)).

<sup>15</sup> 11 U.S.C. § 502(b).

<sup>16</sup> *Butner v. United States*, 440 U.S. 48, 54, 99 S. Ct. 914, 918, 59 L. Ed. 2d 136 (1979).

<sup>17</sup> *Lothian Oil*, 2011 U.S. App. LEXIS 16404, at \*10.

<sup>18</sup> *Id.* at 12.

<sup>19</sup> *Arch Petroleum, Inc. v. Sharp*, 958 S.W.2d 475, 477 n.3 (Tex. Ct. App. 1997) (citing *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3d Cir. 1968)).

<sup>20</sup> *Fin Hay Realty Co.*, 398 F.2d at 696.

<sup>21</sup> *Lothian Oil*, 2011 U.S. App. LEXIS 16404, at \*11-12.

<sup>22</sup> See, generally, *In re Dornier Aviation, Inc.*, 453 F.3d 225 (4th Cir. 2006); *In re Hedged-Invs. Assocs.*, 380 F.3d 1292, 1297 (10th Cir. 2004); *In re Autostyle Plastics, Inc.*, 29 F.3d 726, 748-49 (6th Cir. 2001)).

<sup>23</sup> *Id.*

<sup>24</sup> *In re Pacific Express, Inc.*, 69 B.R. 112, 115 (B.A.P. 9th Cir. 1986); see also *In re Airdigm Communications, Inc.*, 376 B.R. 903, 913 (Bankr. W.D. Wis. 2007).

<sup>25</sup> *Id.*

<sup>26</sup> *In re 3DO Co.*, 2004 Bankr. LEXIS 2345, at \*18-19 (Bankr. N.D. Cal. 2004).