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Unresolved Questions Remain in Recharacterizing Insider Debt

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November 7, 2017 - On August 10, 2017, the Supreme Court dismissed the writ of certiorari in *PEM Entities LLC v. Levin* as improvidently granted. *See* No. 16-492, 2017 WL 3429146, at *1 (U.S. Aug. 10, 2017). This decision leaves the circuit courts split on the issue of whether to use federal or state law in recharacterizing insider debt as equity, a critical distinction that can be dispositive as to the treatment of debt claims made by insiders of debtors.

Case Background

In *PEM Entities LLC*, Province Grande Old Liberty, LLC (the "Debtor") borrowed approximately $6.5 million from Paragon Commercial Bank (the "Loan"). The Debtor subsequently defaulted on the Loan, eventually resulting in foreclosure proceedings. The Debtor, its principal, and other related entities entered into a settlement agreement with the lender. Under the settlement, Paragon Commercial Bank sold the $6.5 million Loan to PEM Entities, LLC ("PEM") for around $1.2 million. Critically, PEM was owned by insiders of the Debtor, relied solely upon principals of the Debtor to negotiate the settlement agreement, and failed to set out formal interest rates and payment schedules with the Debtor after the settlement of the loan. When the Debtor could not maintain liquidity despite PEM's intervention, the Debtor filed this Chapter 11 case, wherein PEM filed a secured claim for $7 million. The Debtor's unsecured debtholders moved to recharacterize the secured claim as equity.

Using the 11 factor federal test for recharacterizing insider debt claims laid out in *Fairchild Dornier GmbH v. Official Comm. of Unsecured Creditors (In re Dornier Aviation (N. Am.), Inc.)*, 453 F.3d 225, 231 (4th Cir. 2006), the United States Bankruptcy Court for the Eastern District of North Carolina held that PEM's claim would be recharacterized as equity rather than debt, moving the claim to lower priority status than the unsecured debtholders. Both the district and circuit courts affirmed on appeal, with the Fourth Circuit signaling that the federal, rather than state, test for recharacterization would be proper and that PEM's actions, while arguably debt in name, was at its core a capital investment in the company's success rather than the temporary borrowing of money.

The Unresolved Circuit Split

The Supreme Court's decision to dismiss the writ of certiorari in *PEM Entities LLC* leaves in place a Circuit split on whether to use federal or state law standards to recharacterize debt. The Sixth, Tenth, Third, and Fourth Circuits all use a multi-factor test similar to the one used in *PEM Entities, LLC* that looks beyond form and to the substance of the transaction to decide whether it should be categorized as debt or equity.[1] Similarly, the Eleventh Circuit applies a two-prong federal standard that also attempts to reach the substance of the transaction.[2] On the other hand, the Fifth and Ninth Circuits have applied an approach to recharacterization based on the state law of the forum.[3] These state laws vary greatly from state to state, but they are often more friendly to debtor insiders who invest in debt and look to the form of the transaction rather than the substance.

Reason for Dismissal

The circumstances of the dismissal further dampen the hopes of a quick resolution to this circuit split. On October 11, 2016, PEM petitioned the Supreme Court for a writ of certiorari to review the Fourth Circuit decision on the issue of whether federal or state law should be applied to recharacterize debt as equity. On June 27, 2017, this writ was granted only to be dismissed as improvidently granted six weeks later, prior to merits briefing, on August 10, 2017. The Supreme Court is not obligated to explain its reasoning for dismissing certiorari and did not here. Usually, certiorari is dismissed as improvidently granted if a party attempts to change its argument in its merits brief, if the dispute seems overly fact determinative, or if the Justices believe that the case has secondary issues that may prevent the court from reaching the merits also known as "vehicle" problems.

Here, certiorari was dismissed shortly after the parties filed a joint motion to confirm party status on July 21, 2017. The original respondents for this action had settled a state court action which caused them to cease having a stake in the outcome of this case. Instead, the parties moved the court for the Debtor to step into the unsecured debtors shoes as the respondents in this action, as they had a continued interest in defending the judgment below. Given the short period of time between the filing of this motion and the dismissal of certiorari as improvidently granted, as well as the fact that merits briefing was never even completed, it is likely that the Court dismissed this case due to "vehicle" issues. That is, the Court decided that, due to the complexity of the party's status and procedural posture, the likelihood that the Court would not reach the merits of the action had risen and it was no longer worth the risk of using its limited resources to hear the case. This issue may continue to hamper attempts to bring the issue of this circuit split to the Supreme Court, as the interconnected and complex nature of relationships between parties in cases dealing with recharacterizing insider debt as equity rarely make the best simple and clear-cut vehicles for Supreme Court rulings.

Footnotes

[1]. *SeeBayer Corp. v. MascoTech, Inc. (In re AutoStyle Plastics, Inc.)*, 269 F.3d 726, 749-750 (6th Cir. 2001); *Sender v. Bronze Grp., Ltd. (In re Hedged-Investments Assocs., Inc.)*, 380 F.3d 1292, 1298 (10th Cir. 2004); *Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Sys. Corp.)*, 432 F.3d 448, 455-456 (3d Cir. 2006); *In re Dornier Aviation (N. Am.), Inc.*, 453 F.3d at 233-234.

[2]. *In re N & D Properties, Inc.*, 799 F.2d 726, 733 (11th Cir. 1986) (two-pronged test, shareholder loans may be deemed capital contributions "where the trustee proves initial undercapitalization or where the trustee proves that the loans were made when no other disinterested lender would have extended credit.").

[3]. *See Grossman v. Lothian Oil Inc. (In re Lothian Oil Inc.)*, 650 F.3d 539, 543 (5th Cir. 2011); *Official Comm. of Unsecured Creditors v. Hancock Park Capital II, L.P. (In re Fitness Holdings Int'l, Inc.)*, 714 F.3d 1141, 1148 (9th Cir. 2013).

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