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The "State" of Federal Bankruptcy Law: The Ninth Circuit's Debt Recharacterization Analysis in *In re Fitness Holdings International*

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THE "STATE" OF FEDERAL BANKRUPTCY LAW: THE NINTH CIRCUIT'S DEBT RECHARACTERIZATION ANALYSIS IN *IN RE FITNESS HOLDINGS INTERNATIONAL*

Abstract: On April 30, 2013, the U.S. Court of Appeals for the Ninth Circuit in *In re Fitness Holdings International, Inc.* held that bankruptcy courts have the authority to recharacterize debt as equity when the obligation does not constitute a "right to payment" under state law. In so holding, the court adhered to a state law approach and declined to adopt a federal rule for debt recharacterization, thus creating a split amongst the federal appeals courts. This Comment argues that the Ninth Circuit's state law approach is more desirable than promulgating a federal debt recharacterization rule because state law is more predictable and guarantees that a property interest will receive the same protections in federal bankruptcy courts as it would in state courts. This Comment also argues that a state law approach is preferable because it is rooted in precedent and avoids the risk that bankruptcy courts will infringe on substantive state policy.

INTRODUCTION

Bankruptcy courts in the United States are courts of equity.[1] In recent decades, there has been much debate over the extent and applicability of this equitable authority.[2] As a result, there have been significant inconsistencies in judicial treatments of creditors' "claims" in Chapter 7 bankruptcy proceedings.[3] Fortunately, the federal appeals courts that have considered the issue are

[1] *See* 11 U.S.C § 105(a) (2012) (providing the "[p]ower of court" provision of the U.S. Bankruptcy Code). In modern times, courts of equity are not bound by strict black letter law principles, but rather are empowered with broader authority to grant relief "in keeping with the fundamental notion of fairness." Mark G. Douglas, *Business Restructuring Review: Bankruptcy Court Empowered to Recharacterize Debt as Equity*, JONES DAY (Oct. 2003), http://www.jonesday.com/newsknowledge/publicationdetail.aspx?publication=1414, *archived at* http://perma.cc/744W-GKWG. This authority allows such courts to make decisions in the interest of producing fair and just results "to the end that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done." Pepper v. Litton, 308 U.S. 295, 305 (1939).

[2] *Compare In re* Autostyle Plastics, Inc., 269 F.3d 726, 748 (6th Cir. 2001) (holding that a bankruptcy court's equitable authority extends beyond the provisions of the Code in the interest of fairness), *with In re* Pac. Express Holding, Inc., 69 B.R. 112, 115 (B.A.P. 9th Cir. 1986) (holding that a bankruptcy court's equitable authority does not extend beyond the specific provisions enumerated within the Bankruptcy Code).

[3] *See supra* note 2 and accompanying text (identifying varying treatments of this issue between the two circuit courts). In Chapter 7 bankruptcy, a trustee is appointed to distribute the debtor's assets and is charged with determining the amount and priority of parties in the distribution scheme. 11 U.S.C. § 726(a) (2012). A "claim" in bankruptcy can mean one of two things. *Id.* § 101(5). First, a

now in agreement regarding the extent of a bankruptcy court's equitable authority.[4] In 2013, in *In re Fitness Holdings International, Inc.*, the U.S. Court of Appeals for the Ninth Circuit became the latest circuit to determine that a bankruptcy court's authority includes remedies beyond equitable subordination.[5] The federal appeals courts now unanimously allow recharacterization of debt as equity, an action not specifically provided for in the Bankruptcy Code ("The Code").[6] The Ninth Circuit's reasoning, however, contributed to an emerging circuit split regarding the applicability of this expanded equitable authority.[7] Specifically, the courts remain in significant disagreement regarding when debt recharacterization is appropriate.[8]

The doctrine of debt recharacterization constitutes drastic action by a bankruptcy court, thus heightening the implications of the circuit split.[9] Debt recharacterization consists of a "substance over form" analysis of a pre-

party has a "claim" in bankruptcy if the party has a right to payment from the debtor. *Id.* § 101(5)(A). Second, a party has a "claim" in bankruptcy if it has a right to an equitable remedy for breach of performance by the debtor if the breach gives rise to a right to payment. *Id.* § 101(5)(B).

[4] *See In re* Fitness Holdings Int'l, Inc., 714 F.3d 1141, 1147 (9th Cir.) (allowing debt recharacterization and becoming that latest circuit to do so), *reh'g denied*, 529 F. App'x 871, 873 (9th Cir. 2013).

[5] *See id.* (diverging from prior precedent—the Bankruptcy Appellate Panel of the Ninth Circuit's 1986 decision in *In re Pacific Express*—to allow for a bankruptcy court to take action beyond mere equitable subordination). The U.S. Bankruptcy Code specifically enumerates the authority for equitable subordination. 11 U.S.C. § 510(c) (2012). The doctrine of equitable subordination allows a court, after notice and a hearing, to subordinate all or part of a claim or interest relevant to the claims or interests of other creditors. *Id.* In order to equitably subordinate a claim in bankruptcy, the court must find that (1) the claimant engaged in some kind of inequitable conduct; (2) the inequitable conduct actually resulted in some harm or injury to the debtor's other creditors, or conferred an unfair advantage on the claimant; and (3) the subordination would not be inconsistent with any other provisions of the Bankruptcy Code. *See id.*; Bruce H. White & William L. Medford, *Debt-to-Equity Recharacterization: Is It More Than Equitable Subordination's Evil Twin?*, AM. BANKR. INST. J., Nov. 2004, at 26, 26.

[6] *See In re* Dornier Aviation, Inc., 453 F.3d 225, 233–34 (4th Cir. 2006); *In re* Hedged-Invs. Assocs., Inc., 380 F.3d 1292, 1298 (10th Cir. 2004). The doctrine of debt recharacterization has received significant support because it addresses concerns that are distinct from those addressed by equitable subordination. *See* Sprayregen et al., *Recharacterization from Debt to Equity: Lenders Beware*, AM. BANKR. INST. J., Nov. 2003, at 30, 30 (explaining that unlike equitable subordination that seeks to address inequitable conduct, debt recharacterization involves a factual determination as to whether or not the asserted debt is in fact an equity investment); Neil M. Peretz, *Recharacterization in the Ninth Circuit: Has the Supreme Court Finally Derailed the* Pacific Express*?*, 17 J. BANKR. L. & PRAC. 297, 297–98 (2008) (explaining that debt recharacterization is not a variation of equitable subordination, but rather a distinct remedial action available to bankruptcy courts). While equitable subordination subordinates a creditor's claim to the extent of the injury caused by the inequitable conduct, it does not provide a meaningful solution where a capital contribution is purported to be a claim when in fact it is substantively an equity investment. *See* Peretz, *supra*, at 297–98.

[7] *See, In re Fitness Holdings Int'l,* 714 F.3d at 1148; *In re Autostyle Plastics, Inc.*, 269 F.3d at 749–50; *see also infra* notes 44–58 and accompanying text (explaining the basis of the circuit split)

[8] *See In re Fitness Holdings Int'l*, 714 F.3d at 1148; *In re Autostyle Plastics, Inc.*, 269 F.3d at 749–50; *see also infra* notes 44–58 and accompanying text (explaining the basis of the circuit split).

[9] *See In re* Submicron Sys. Corp., 432 F.3d 448, 454–55 (3d Cir. 2006); *infra* notes 10–11 and accompanying text.

bankruptcy transaction.[10] If a court determines that a lender's purported loan is in fact an equity investment disguised as a loan, the court can recharacterize the debt as equity.[11] When a debt is recharacterized as equity, the lender's "claim" in bankruptcy becomes an "interest," dropping it to the bottom of the distribution scheme and virtually guaranteeing no recovery on the funds advanced to the debtor.[12]

In theory, recharacterizing debt as equity is extremely equitable.[13] By inhibiting equity investors from unfairly availing themselves of the benefits of debt, debt recharacterization reinforces the Chapter 7 priority scheme.[14] In practice, however, the federal appeals courts' diverging application of debt recharacterization creates a substantial risk of inequity.[15]

Part I of this Comment examines the Ninth Circuit's recent holding in *Fitness Holdings International* that debt recharacterization is both within a bankruptcy court's authority and that it should be applied in accordance with applicable state law.[16] Part II addresses the differing applications of debt recharacterization that have been adopted by other federal appeals courts.[17] Finally, Part III explores the implications of the various approaches under the Bankruptcy Code and argues that applying state law is the most desirable method.[18]

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[10] 31 WILLISTON ON CONTRACTS § 78:1 (4th ed. 2012). As a court of equity, the bankruptcy court evaluates the substance rather than the form of a transaction in order to protect the estate from unlawful claims for distribution. *Id.* If the claim substantively functions as something other than a debt, then it should not be treated as a debt, regardless of its form or label. *See id.*

[11] *See In re Fitness Holdings Int'l,* 714 F.3d at 1147 (instructing the bankruptcy court on remand to recharacterize the purported debt if it in fact functioned as an equity investment); *infra* notes 44–58 and accompanying text (explaining that the analysis of when a loan is actually an equity investment drastically differs across federal appeals courts).

[12] *See* 11 U.S.C. § 726(a)(6) (2012). In the Chapter 7 distribution of the debtor's assets, equity interests are at the lowest level of the priority scheme because interest holders step into the shoes of the debtor when the debtor ceases to exist. *See id.* The equity interest holders only receive distribution once all other parties have been paid in full. *See id.* Given the interests' low priority, it is unlikely that equity interests will ever be repaid. Yadd Rotem, *Pursuing Preservation of Pre-Bankruptcy Entitlements: Corporate Bankruptcy Law's Self-Executing Mechanism,* 5 BERKELEY BUS. L.J. 79, 92–93 (2008) (explaining that the value of the bankruptcy estate is usually insufficient to satisfy equity interests once all claims have been paid).

[13] *See* White & Medford, *supra* note 5, at 26. Debt recharacterization is essential to the equitable administration of the Bankruptcy Code. *See id.* The Code clearly dictates that debt and equity are treated differently in the Chapter 7 distribution scheme, so it furthers the interests of fairness to allow the court to determine when a purported debt is actually an equity investment. *See id.* Absent such an authority, the Code supplies no meaningful recourse against investors that make investments to struggling corporations but disguise the transfers as debt in order to avoid the inherent liquidation risks of equity investments. *See id.*

[14] *See id.*

[15] *See* Butner v. United States, 440 U.S. 48, 55 (1979) (explaining that applying federal law for debt recharacterization—as opposed to state law—creates a risk of inequity).

[16] *See infra* notes 19–43 and accompanying text.

[17] *See infra* notes 44–58 and accompanying text.

[18] *See infra* notes 59–81 and accompanying text.

I. Debt Recharacterization In The Ninth Circuit

A. *Factual and Procedural History*

Prior to declaring bankruptcy, Fitness Holdings International ("Fitness Holdings") had received substantial funding from its sole individual shareholder, Hancock Park, and from Pacific Western Bank.[19] Hancock Park's loan was unsecured.[20] Pacific Western Bank's loans were secured by all of Fitness Holdings' assets and were guaranteed by Hancock Park.[21] Several years after taking on the initial loans, Fitness Holdings and Pacific Western Bank agreed to refinance all of Fitness Holdings' debt.[22] Under this agreement, Pacific Western Bank made additional loans to Fitness Holdings, a portion of which were used to reimburse all of Hancock Park's loans and to release it from all of its guarantees.[23] This refinancing, however, proved unsuccessful.[24] Fitness Holdings filed for Chapter 11 bankruptcy in 2008 and later converted the filing to Chapter 7 bankruptcy in 2011.[25]

A committee of unsecured creditors, acting on behalf of Fitness Holdings in the Chapter 11 proceeding, filed the initial complaint in this case.[26] The complaint sought recovery of the funds transferred to Hancock Park as a result of the refinancing with Pacific Western Bank, alleging that the transfer was

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[19] *In re Fitness Holdings Int'l*, 714 F.3d at 1143. Hancock Park's loan consisted of eleven unsecured promissory notes for a total of $24,276,065. *Id.* The terms of each note included a maturity date by which Fitness Holdings was obligated to pay a stated principal amount and ten percent interest per year. *Id.* Pacific Western Bank's loans consisted of a $7 million revolving loan and a $5 million installment loan. *Id.*

[20] *Id*. A secured loan is a loan that is guaranteed by collateral. *See* U.C.C. § 1-201(b)(35) (2001). When making a secured transaction, the lender takes a security interest in personal property or fixtures. *See id.* In an unsecured transaction, the lender provides the loan based on a mere promise to pay but holds no right to repossess any property should the debtor fail to make payment when payment is due. *See* Anthony P. Polito, *Borrowing, Return of Capital Conventions, and the Structure of the Income Tax: An Essay in Statutory Interpretation*, 17 VA. TAX REV. 467, 497 (1998). Unsecured loans receive distribution after secured loans but before equity interests in the Chapter 7 priority scheme. *See* 11 U.S.C. § 726(a) (2012).

[21] *See In re Fitness Holdings Int'l*, 714 F.3d at 1143.

[22] *Id.*

[23] *Id.* at 1143–44. The decision to refinance debt and substitute it with existing debt is a business decision often utilized to extend the maturity date of outstanding debts in an attempt to regain solvency and avoid bankruptcy. *See* Gombosi v. Carteret Mortg. Corp., 894 F. Supp. 176, 180 (E.D. Pa. 1995).

[24] *In re Fitness Holdings Int'l*, 714 F.3d at 1144.

[25] *Id*. Chapter 11 bankruptcy filings include a plan for reorganization and rehabilitation of the debtor's business and do not call for a liquidation of the debtor's assets. *See* 11 U.S.C. § 1123 (2012). Conversely, in a Chapter 7 bankruptcy, the debtor ceases to exist and all of the debtor's assets are liquidated and distributed through the Chapter 7 priority scheme. *See id.* § 726(a).

[26] *In re* Fitness Holdings Int'l, Inc. (*Fitness I*), No. CV 10–0647 AG, 2011 WL 7763674, *1 (C. D. Cal. Aug. 31, 2011), *aff'd in part, vacated in part, rev'd in part,* 529 F. App'x. 871 (9th Cir. 2013).

constructively fraudulent.[27] The complaint also requested declaratory relief, particularly by moving the court to characterize Hancock Park's initial loan as an equity investment and not a debt.[28] The bankruptcy court dismissed all claims with prejudice.[29]

Thereafter, the case was converted to a Chapter 7 case and the appointed bankruptcy trustee appealed the dismissal of the complaint to the U.S. District Court for the Central District of California.[30] The district court affirmed the bankruptcy court, holding that precedent bars the bankruptcy court from re-characterizing debt as equity.[31] The trustee then appealed to the Ninth Circuit.[32]

B. *Ninth Circuit Allows Debt Recharacterization and Applies State Law*

The Ninth Circuit reversed both the bankruptcy and district courts, holding instead that a bankruptcy court has the authority to recharacterize debt as equity.[33] This decision was a departure from the Ninth Circuit's longstanding precedent that was established in the 1986 Bankruptcy Appellate Panel of the Ninth Circuit's *In re Pacific Express Holding, Inc.* decision.[34] In *Fitness Holdings International*, the Ninth Circuit interpreted the Bankruptcy Code to indicate that any pre-bankruptcy transfer made by a debtor can be avoided if it is not in repayment of a "debt."[35] Further, the Ninth Circuit observed that a

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[27] *Id.* A transfer is constructively fraudulent if the transfer is made within two years of filing bankruptcy and the debtor, voluntarily or involuntarily, either made the transfer with the "actual intent to hinder, delay, or defraud" the debtor or "received less than a reasonably equivalent value in exchange for the transfer." 11 U.S.C. § 548(a)(1)(A)-(B) (2012). Constructively fraudulent transfers can be avoided in bankruptcy, which thereby removes the requirement to distribute assets to the transferor. *Id.* § 548(a)(1).

[28] *Fitness I*, 2011 WL 7763674, at *2; *see supra* notes 9–15 and accompanying text (discussing debt recharacterization in full).

[29] *Fitness I*, 2011 WL 7763674, at *2.

[30] *Id.* at *1. In Chapter 7 bankruptcy, a trustee is elected to consolidate and distribute the assets of the debtor's estate because the debtor ceases to exist when bankruptcy is filed. *See* 11 U.S.C. § 702 (2012). The trustee has the right to avoid repayment of certain transfers, namely constructively fraudulent transfers. *See id.* § 548(a)(1).

[31] *Fitness I*, 2011 WL 7763674, at *5.

[32] *In re Fitness Holdings Int'l*, 714 F.3d at 1144.

[33] *Id.* at 1147.

[34] *See id.*; *see also Pac. Express Holding, Inc.*, 69 B.R. at 115. Prior to *Fitness Holdings International*, debt recharacterization had a "checkered history" in the Ninth Circuit. *See* David S. Margolis, *Debt Recharacterization in the Ninth Circuit*, AM. BANKR. INST. J., Nov. 2011, at 50, 50 (describing the "checkered" history of debt recharacterization in the Ninth Circuit). Despite the clear pronouncement in *Pacific Express* that debt recharacterization fell outside the authority of the courts, many lower courts questioned whether they had the ability to recharacterize debt given the widespread application of debt recharacterization throughout the other federal appeals courts. *See id.*

[35] *See In re Fitness Holdings Int'l*, 714 F.3d at 1145–46. In addressing the committee's claim, the Ninth Circuit first analyzed the statutory requirement that for a transfer to be constructively fraudulent, the debtor must have "received less than reasonably equivalent value." *Id.*; *see* 11 U.S.C.

"debt" under the Code means any "right to payment."[36] Therefore, if a pre-bankruptcy transfer does not fulfill a "right to payment" under state law, then the original advancement of funds is not in fact a debt and can be recharacterized as an equity investment.[37]

In holding that the question of whether a "right to payment" exists turns on state law, the Ninth Circuit relied on U.S. Supreme Court precedent.[38] In 1979, in *Butner v. United States*, the U.S. Supreme Court held that, because state law governs the creation of property interests in this country, property interests in bankruptcy should be analyzed according to state law.[39] The Court specifically discounted the creation of federal rules to determine when a "right to payment" exists in bankruptcy.[40] Accordingly, the Ninth Circuit adhered to this principle, holding that whether a "right to payment" exists in bankruptcy must turn on state law.[41]

Relying on *Butner*, the Ninth Circuit held that a court has the authority recharacterize purported "debts" when state law would authorize such action.[42] Accordingly, because the district court below erroneously held that it was barred from debt recharacterization, the Ninth Circuit vacated and remanded the case.[43]

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§ 548(a)(1) (2012). Because "reasonably equivalent value" is not defined in the Code, the Ninth Circuit applied the Code definition of "value" to determine that a transfer is not constructively fraudulent to the extent that it constitutes "dollar-for-dollar repayment" of a debtor's present or antecedent "debt." *In re Fitness Holdings Int'l*, 714 F.3d at 1145 (referencing 5 COLLIER ON BANKRUPTCY ¶ 548.03[5] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2012)); *see* 11 U.S.C. § 548(d)(2)(A) (defining "value").

[36] *In re Fitness Holdings Int'l*, 714 F.3d at 1145. The Code defines the term "debt" as "liability on a claim" and the term "claim" as a "right to payment." 11 U.S.C. § 101(5)(A) (2012); *id.* § 101(12).

[37] *See In re Fitness Holdings Int'l*, 714 F.3d at 1145.

[38] *Id.* at 1146 (citing *Butner*, 440 U.S. at 55). Supreme Court precedent dictates that, absent an act of Congress, state law determines the nature and scope of a right to payment. *Butner*, 440 U.S. at 55. The term "state law" is interpreted expansively "to refer to all nonbankruptcy law that creates substantive claims." Grogan v. Garner, 498 U.S. 279, 284 n.9 (1991). Therefore, the term "state law" is also intended to include even federal law that creates a substantive state law claim. *See id.*

[39] *See Butner*, 440 U.S. at 55; *see also* Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156, 161 (1946) ("What claims of creditors are valid and subsisting obligations against the bankrupt at the time a petition in bankruptcy is filed is a question which, in the absence of overruling federal law, is to be determined by reference to state law.").

[40] *See Butner*, 440 U.S. at 55–56; *see also* Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co., 549 U.S. 443, 450–51 (2007) (applying the *Butner* principle and holding that a court should not use a federal rule to determine whether a "right to payment" giving rise to a claim in bankruptcy exists).

[41] *See In re Fitness Holdings Int'l*, 714 F.3d at 1147.

[42] *See id.*

[43] *Id.* at 1149–50.

II. CIRCUIT SPLIT: STATE v. FEDERAL APPROACH

The Ninth Circuit's state law approach to debt recharacterization articulated in *Fitness Holdings International* is a minority approach and has created a split amongst the federal appeals courts.[44] While the federal appeals courts that have considered the issue now all endorse debt recharacterization in bankruptcy, the courts remain split as to when it should apply.[45] The Ninth Circuit's state law approach is shared only by the U.S. Court of Appeals for the Fifth Circuit.[46] The remaining federal appeals courts apply debt recharacterization using three different federal rules: (1) a per se rule; (2) a multi-factor test; and (3) an analysis aimed at the intent of the parties.[47]

The per se federal rule allows recharacterization if the trustee can prove either that the debtor was initially undercapitalized, or that the loans were made when no other disinterested lender would have extended credit to the debtor.[48] Put another way, the trustee must prove that the debtor either did not have sufficient capital to conduct normal business operations or was not eligible for loans from any other outside lenders.[49] This approach focuses heavily on the circumstances of the transaction and ignores the substance of the transfer entirely.[50]

The multi-factor test utilizes a specific set of factors to determine whether the transfer functioned as a debt or as an equity investment.[51] Although not all

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[44] *See In re* Fitness Holdings Int'l, Inc., 714 F.3d 1141, 1147 (9th Cir.), *reh'g denied*, 529 F. App'x 871, 873 (9th Cir. 2013); Dan Schechter, *Bankruptcy Courts Have Authority to Apply State Law to Recharacterize Intercorporate Loans as Equity Investment for Purposes of Fraudulent Transfer Analysis*, 17 COM. FIN. NEWSL., May 6, 2013 (explaining that all of the federal appeals courts that have considered the issue are in agreement that bankruptcy courts have the authority for debt recharacterization, but the application of that authority is still highly debated amongst the courts).

[45] *Compare In re Fitness Holdings Int'l*, 714 F.3d at 1147 (applying a state law approach to debt recharacterization), *with In re* Autostyle Plastics, Inc., 269 F.3d 726, 749–50 (6th Cir. 2001) (creating a federal rule for debt recharacterization).

[46] *See In re* Lothian Oil, Inc., 650 F.3d 539, 543 (5th Cir. 2011) (applying the principles established in the U.S. Supreme Court's 1979 *Butner v. United States* decision in finding that the applicable law governing property interests in bankruptcy is state law).

[47] *See, e.g.*, *In re* Submicron Sys. Corp., 432 F.3d 448, 455–56 (3d Cir. 2006) (intent of parties); *In re Autostyle Plastics*, 269 F.3d at 749–50 (multi-factor test); *In re* N & D Props., Inc., 799 F.2d 726, 733 (11th Cir. 1986) (per se rule).

[48] *See In re N & D Props.*, 799 F.2d at 733 (refusing to recharacterize loans as capital contributions because the bankruptcy trustee failed to prove that the debtor was either initially undercapitalized or would have been unable to receive loans from any outside investors).

[49] *See id.*

[50] *See id.* (focusing on the debtor's ability to receive loans and whether the debtor was undercapitalized, rather than on the substance of the transfer); *cf. In re Lothian Oil, Inc.*, 650 F.3d at 542 (explaining that the per se rule assesses a finite set of factors and ignores the merits of the claim). The Fifth Circuit suggests that a per se rule has the effect of discouraging debt recharacterization. *See In re Lothian Oil, Inc.*, 650 F.3d at 542. This disincentive is inconsistent with federal appeals court holdings that debt recharacterization addresses very distinct and important concerns. *See id.*

[51] *See In re Autostyle Plastics*, 269 F.3d at 749–50.

federal appeals courts use the same multi-factor test, the factors considered always examine the terms and substance of the transaction rather than the actions or intentions of the parties.[52] For example, multi-factor tests consistently consider factors such as the presence or absence of a maturity date, the presence or absence of a fixed interest rate, and any security granted.[53] The factors are weighed subjectively, which gives a court substantial flexibility in its analysis.[54]

The last approach, adopted only by the U.S. Court of Appeals for the Third Circuit, focuses on the intent of the parties.[55] This approach permits debt recharacterization in situations where the parties referred to the transaction as a loan when they in fact intended it to function as an equity investment.[56] The Third Circuit instructs that the intent of the parties "may be inferred from what the parties say in their contracts, from what they do through their actions, and from the economic reality of the surrounding circumstances."[57] Inferring intent is inherently a very case-by-case analysis and allows the court to invoke broad equitable powers.[58]

III. Applying State Law in Federal Bankruptcy Proceedings

Recharacterizing debt as equity when the transfer of funds in question does not satisfy a "right to payment" under state law is the most desirable ap-

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[52] *See id.* (applying an eleven-factor test derived from tax law that considers factors such as fixed maturity dates, schedule of repayments, and capitalization); *see also In re* Dornier Aviation, Inc., 453 F.3d 225, 233–34 (4th Cir. 2006) (using same eleven-factor test adopted in 2001 by the U.S. Court of Appeals for the Sixth Circuit in *In re Autostyle Plastics*); *In re* Hedged-Invs. Assocs., Inc., 380 F.3d 1292, 1298 (10th Cir. 2004) (applying a thirteen-factor test that includes an inquiry into the intent of the parties and eligibility for loans from outside lenders).

[53] *See In re Dornier Aviation, Inc.*, 453 F.3d at 233–34 (considering insider status, the lack of a fixed maturity date, and repayment schedule); *In re Hedged-Invs.*, 380 F.3d at 1298 (considering the source of payments, adequate capitalization, and participation in management); *In re Autostyle Plastics*, 269 F.3d at 749–50 (considering fixed interest rates, security of advances, and presence or absence of a sinking fund to provide repayments).

[54] *See In re Autostyle Plastics*, 269 F.3d at 750 (explaining that no one factor controls the inquiry and each factor must be considered within the circumstances of the particular case).

[55] *See In re Submicron Sys. Corp.*, 432 F.3d at 455–56.

[56] *See id.* The Third Circuit analyzed the multi-factor tests adopted by other federal appeals courts and recognized that while those tests contain "pertinent factors," they all share the same overarching inquiry: did the parties call the transfer one thing when they clearly intended it to function as something else? *See id.* at 455. Specifically, the court reasoned, while the form in which the parties construct the transaction may be telling, a better indicator of the actual substance of the transaction is the parties' intentions. *See id.*

[57] *See id.*

[58] *See id.*; Dana Brakman Reiser & Steven A. Dean, *Hunting Stag with Fly Paper: A Hybrid Financial Instrument for Social Enterprise*, 54 B.C. L. Rev. 1495, 1523–33 (2013) (explaining the importance of examining the specific circumstances to reveal whether a purported debt investment in fact possesses the economic characteristics of equity).

proach.[59] Because the state law approach remedies many of the overarching issues presented by the creation of federal rules for debt recharacterization, other federal appeals courts should adopt this approach.[60] First, applying state law is more equitable and predictable than a federal rule because it guarantees that a property interest will be analyzed in the same manner before and during bankruptcy.[61] Second, a state law approach is rooted in U.S. Supreme Court precedent and thus will likely enjoy more long-term applicability and acceptance.[62] Third, a state law approach minimizes the risk that bankruptcy courts will infringe on substantive state policy.[63]

The state law approach guarantees that property interests will receive the same protections in federal bankruptcy court as they would under state law had the debtor never filed for bankruptcy.[64] Because property interests are created and defined by state law, absent some federal interest to the contrary, property interests should not be analyzed differently simply because bankruptcy has ensued.[65] Many federal appeals courts point to the interest of equity as a federal interest that supplants this state law approach.[66] In practice, however, the federal rule approaches create inequity by affording property interests different protections in bankruptcy than under state law.[67] Moreover, applying state law allows for uniform treatment of property interests prior to bankruptcy and once in bankruptcy court.[68] This uniformity is desirable because is creates certainty

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[59] *See In re* Fitness Holdings Int'l, Inc., 714 F.3d 1141, 1147 (9th Cir.), *reh'g denied*, 529 F. App'x 871, 873 (9th Cir. 2013); *In re* Lothian Oil, Inc., 650 F.3d 539, 543 (5th Cir. 2011).

[60] *See In re Fitness Holdings Int'l*, 714 F.3d at 1147; *In re Lothian Oil, Inc.*, 650 F.3d at 543.

[61] *See* Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co., 549 U.S. 443, 450–51 (2007); Butner v. United States, 440 U.S. 48, 55 (1979); *infra* notes 64–69 and accompanying text.

[62] *See Butner*, 440 U.S. at 55; *infra* notes 70–74 and accompanying text.

[63] *See* Friedman v. Kurker, 438 N.E.2d 76, 80 (Mass. App. Ct.), *review denied*, 440 N.E.2d 1177 (Mass. 1982); *infra* notes 75–81 and accompanying text.

[64] *See Butner*, 440 U.S. at 55.

[65] *See id*. The Constitution of the United States instructs that Congress has the authority to establish "uniform Laws on the subject of Bankruptcies throughout the United States." U.S. CONST. art. I, § 8, cl. 4. Accordingly, if Congress has not created a federal bankruptcy rule governing debt recharacterization, the courts should treat property interests in the same manner as they would have been treated if bankruptcy had not occurred. *See Travelers Cas. & Sur. Co. of Am.*, 549 U.S. at 450–51; *Butner*, 440 U.S. at 55.

[66] *See In re* Hedged-Invs. Assocs., Inc., 380 F.3d 1292, 1298–99 (10th Cir. 2004); *In re* Autostyle Plastics, Inc., 269 F.3d 726, 748 (6th Cir. 2001) (claiming the bankruptcy courts' 11 U.S.C. § 105(a) (2012) equitable powers as grounds for supplanting state law when a federal interest exists).

[67] *See* Manuel D. Leal, *The Power of the Bankruptcy Court: Section 105*, 29 S. TEX. L. REV. 487, 498–99 (1988). Despite many courts liberally utilizing § 105(a) power, the provision allows for action in furtherance of the Code, not for the addition of new judge-made provisions. *See id*. An expansive view of bankruptcy courts' powers has the effect of creating rules that conflict with other substantive areas of the law and create substantial inequity. *See id.* at 498–500.

[68] *See Travelers Cas. & Sur. Co. of Am.*, 549 U.S. at 450–51; *Butner*, 440 U.S. at 55.

for both property owners and lenders and because it avoids the risk of one party receiving a windfall simply because bankruptcy ensued.[69]

Further, the state law approach is rooted in Supreme Court precedent that dictates that state law governs the creation and treatment of property interests.[70] Given the significant impact of debt recharacterization, it is important for a court's analysis of it be founded in precedent.[71] Relying on precedent limits judicial interpretation of the law and yields much more consistent, predictable results.[72] Unlike the federal rules approaches that are not rooted in precedent, the state law approach ensures that bankruptcy courts do not overreach the extent of their equitable power by supplementing the Code with other substantive areas of the law.[73] Moreover, because applying state law to property interests is rooted in precedent, this approach is unlikely to be challenged as falling outside the powers of the bankruptcy courts.[74]

Finally, the state law approach minimizes the risk that a bankruptcy court will infringe on substantive state policy.[75] Federal debt recharacterization rules may align with the approaches of some states, but in many instances can con-

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[69] *See Butner*, 440 U.S. at 55; *see also* Lewis v. Mfrs. Nat'l Bank, 364 U.S. 603, 608–09 (1961) (explaining that voiding a claim in bankruptcy simply because a debtor failed to conform with conflicting federal and state laws would could create a "windfall" for the debtor because it could avoid repayment of a substantial loan that it otherwise would have been liable for); Juliet M. Moringiello, *A Tale of Two Codes: Examining § 522(F) of the Bankruptcy Code, § 9-103 of the Uniform Commercial Code and the Proper Role of State Law in Bankruptcy*, 79 WASH. U. L. Q. 863, 911 (2001) (stressing the importance of applying state law conceptions of property in bankruptcy proceedings in order to avoid debtors obtaining a windfall).

[70] *See Butner*, 440 U.S. at 54 (explaining that property interests are created and defined by state law).

[71] *See* Blake H. Bailey, *Bankruptcy*, 45 TEX. TECH. L. REV. 603, 636 (2013) (recognizing the importance of Fifth Circuit precedent when arguing that state law should be applied to debt recharacterization).

[72] *See id.* Adopting a state law approach to debt recharacterization is arguably a "cautious view" of debt recharacterization because it limits the scope of 11 U.S.C. § 105(a) (2012). *See id.* Requiring courts to strictly apply the applicable state law inhibits courts from interpreting § 105(a) as granting absolute equitable power. *See id.*

[73] *See* Karen M. Gebbia-Pinetti, *Interpreting the Bankruptcy Code: An Empirical Study of the Supreme Court's Bankruptcy Decisions*, 3 CHAP. L. REV. 173, 256–60 (2000). By creating a federal rule, the courts are unnecessarily bringing bankruptcy law and areas of non-bankruptcy law into conflict. *See id.* The justices of the Supreme Court have disagreed on interpretive methodology that should prevail when this occurs. *See id.* Some Justices believe a court should maintain a bankruptcy-centric view while others prioritize the other substantive law and take a non-bankruptcy-centric view. *See id.*

[74] *See Butner*, 440 U.S. at 54. In contrast, the Sixth Circuit's decision to invoke an eleven-factor tax-based rule into bankruptcy law is arguably well outside the inherent equitable powers of the court. *Cf. In re Autostyle Plastics*, 269 F.3d at 749 n.12. Notably, in a footnote, the Sixth Circuit explicitly acknowledges that there is some disagreement as to whether invoking a tax-based test in bankruptcy is appropriate. *Id.*

[75] *See Friedman*, 438 N.E.2d at 80 (applying a state law approach that conflicts with federal bankruptcy rules).

flict with state law.[76] While federal debt recharacterization rules regularly discount the intentions of the transferor, state law approaches often highlight the importance of considering the objective intentions of the transferor.[77] Furthermore, the multi-factor federal rules do not require a showing of inequitable conduct, whereas many states require some semblance of inequitable conduct in order to apply debt recharacterization.[78] Effectively, when federal debt recharacterization rules conflict with state law, they function to supplant substantive state policy.[79] Supplanting substantive state policy and substantive state rights creates a substantial risk of inequitable administration of the law and forum shopping.[80] Accordingly, adopting a state law approach to debt recharacterization is desirable because it eliminates these risks.[81]

CONCLUSION

The Ninth Circuit in *Fitness Holdings International* held that debt recharacterization is within the authority of bankruptcy courts and should be applied based on a state law approach. Although applying state law is a minority approach, it is the most desirable and should be adopted by the other federal appeals courts. Applying state law guarantees equal protection of property interests before and during bankruptcy, relies on long-standing precedent, and eliminates the risk of federal rules infringing on substantive state policy.

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[76] *Compare In re* BH S & B Holdings LLC, 420 B.R. 112, 160 (Bankr. S.D.N.Y. 2009) (dismissing debt recharacterization claim for failure to plead the necessary fact to support the *Autostyle* factors), *with Friedman*, 438 N.E.2d at 80 (applying its own approach to debt recharacterization by closely considering the "objective intention of the contributor").

[77] *Compare In re Autostyle Plastics*, 269 F.3d at 749–50 (applying a federal debt recharacterization rule that considers only the substance of the transfer), *with Friedman*, 438 N.E.2d at 80 (describing that Massachusetts state law recognizes that debt recharacterization "depends to some extent on the objective intention of the contributor").

[78] *See In re Hedged-Invs.*, 380 F.3d 1292, 1298 (10th Cir. 2004); *In re Autostyle Plastics*, 269 F.3d at 749–50. *Compare In re* Dornier Aviation, Inc., 453 F.3d 225, 233–34 (4th Cir. 2006) (applying strict factors that do not include an equity consideration), *with Friedman*, 438 N.E.2d at 80 (refusing to recharacterize a purported loan without some showing of inequitable conduct).

[79] *Friedman*, 438 N.E.2d at 80.

[80] *See* Hanna v. Plumer, 380 U.S. 460, 467–68 (1965). Federal rules should not be applied when doing so would create substantial incentives to forum shop and a risk of inequitable administration of the laws. *See id.*

[81] *See id*; *In re Fitness Holdings Int'l*, 714 F.3d at 1147.