GROSSMAN V. LOTHIAN OIL: THE FIFTH CIRCUIT TAKES A FRESH LOOK AT DEBT RECHARACTERIZATION

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To Our Clients and Friends:

Recently, in *Grossman v. Lothian Oil Inc. (In re Lothian Oil Inc.)*,[1] the Fifth Circuit for the first time addressed the controversial doctrine of debt recharacterization. While debt recharacterization—a bankruptcy court determination that an alleged debt is actually equity—has gained increasing acceptance by courts in recent years, its many detractors on and off the bench have questioned its legal basis. Debt recharacterization, in contrast to equitable subordination or the subordination of all or part of a claim to all or part of another claim on equitable grounds, is not explicitly authorized by the Bankruptcy Code.

In *Lothian*, the Fifth Circuit endorsed the practice but, unlike circuit courts before it, grounded the doctrine in the ordinary application of state law to the allowance of claims in bankruptcy. *Lothian* is thus both a timely reminder to investors of the risk of debt recharacterization and also a new twist to its legal grounding and application that places emphasis on state law distinctions between debt and equity.

BACKGROUND

In 2005, Lothian Oil and Israel Grossman, a non-insider, entered into a handwritten "loan agreement" pursuant to which Grossman provided $200,000 to Lothian in return for a 1% royalty on the production from some of Lothian's properties. Grossman was to be repaid from the proceeds of "equity placements." No interest rate or due date was specified. Grossman provided an additional $150,000 the following month on similar terms.

Two years later, Lothian filed for bankruptcy and Grossman filed various proofs of claim. Lothian disputed Grossman's claims for the "loan" transactions, and asserted that they were actually equity investments, rather than "true" loans. The bankruptcy court agreed. Applying the doctrine of debt recharacterization, the court recharacterized Grossman's

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[1] *2011 WL 3473354 (5th Cir. Aug. 9, 2011), available at:* *http://www.ca5.uscourts.gov/opinions/pub/10/10-50683-CV0.wpd.pdf*

claims as mere equity interests. Grossman appealed and the district court reversed, declining to apply the debt recharacterization doctrine to the claims of a non-insider creditor.

THE FIFTH CIRCUIT'S DECISION IN *LOTHIAN*

On appeal, the Fifth Circuit agreed with the bankruptcy court, and held that Grossman's claim should be recharacterized as equity. In so doing, the circuit court declined to adopt a *per se* rule that debt recharacterization is limited to the claims of insiders.

In reaching this result, the Fifth Circuit took the opportunity to consider the legal grounds for debt recharacterization. Other circuits that have approved debt recharacterization in appropriate circumstances have done so on one of two grounds. Some courts have relied on the bankruptcy court's equitable power—codified in section 105(a) of the Bankruptcy Code—to "issue any order…necessary or appropriate to carry out the provisions of" the Bankruptcy Code. Other courts have held that debt recharacterization is implicit in the court's power to equitably subordinate claims under section 510(c) of the Bankruptcy Code. However, critics both on and off the bench have noted that section 105(a) powers are limited to implementation of the specific provisions elsewhere in the Bankruptcy Code, and that the remedy of debt recharacterization—which subordinates a claim to a level *pari passu* with equity interests—is qualitatively different from equitable subordination.

Recognizing that its own jurisprudence limits use of section 105(a), the Fifth Circuit took a different approach. Writing for the panel, Chief Judge Edith Jones held in *Lothian* that debt recharacterization must be justified under the ordinary provisions of section 502(b), which sets out the standards for claims allowance. Section 502(b) provides that a disputed claim will not be allowed if, among other things, the "claim is unenforceable against the debtor . . . under . . . applicable law." This invokes the familiar principle in bankruptcy that the import of instruments and agreements will be determined under applicable non-bankruptcy law, typically state law.

The Fifth Circuit therefore applied Texas law to the two agreements at issue. The circuit found that Texas courts have used a multi-factor test (borrowed from federal tax law) to determine whether obligations that purport to be debt are, in fact, equity, and that under the Texas factors, Grossman's loans were actually equity. The economic effect on the recharacterized debt was predictably stark: in the *Lothian* liquidation, unsecured creditors were paid in full while equity received nothing.

LOTHIAN IMPLIES NEW HURDLES TO DEBT RECHARACTERIZATION

It remains to be seen whether other circuits will follow the Fifth Circuit in requiring that debt recharacterization be based on applicable state law. In the Fifth Circuit and in any other jurisdiction where the *Lothian* analysis is adopted, however, debt recharacterization may be less widely available in bankruptcy proceedings. *Lothian* approves of debt recharacterization and places it on a firmer statutory basis. But in so doing, *Lothian* introduces new hurdles to its use, because state law on debt recharacterization is often scarce or simply nonexistent. Where such state law is the "applicable law," courts following *Lothian* may well conclude that debt recharacterization is not an available remedy.

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Please feel free to contact us with any questions.

Steven R. Gross
+1 212 909 6586
srgross@debevoise.com

Michael E. Wiles
+1 212 909 6653
mewiles@debevoise.com

Richard F. Hahn
+1 212 909 6235
rfhahn@debevoise.com

George E. B. Maguire
+1 212 909 6072
gebmaguire@debevoise.com

M. Natasha Labovitz
+1 212 909 6648
nlabovitz@debevoise.com

My Chi To
+1 212 909 7425
rmcto@debevoise.com

Jasmine Ball
+1 212 909 6845
jball@debevoise.com