

# One Minute Memo<sup>®</sup>



## Bankruptcy Court Applies Third Circuit test for addressing “debt” versus “equity” question.

### The Issue

In *Patel v. Shubh Hotels, LLC (In re Shubh Hotels Pittsburgh, LLC)*, the Bankruptcy Court for the Western District of Pennsylvania addressed whether certain cash advances by a corporate insider constituted “debt” or should be recharacterized as an “equity contribution.” Recharacterization generally refers to the inquiry by bankruptcy courts to determine if a debt actually exists for distribution and plan voting purposes. Recharacterization is significant because equity interests are often extinguished in bankruptcy cases without any compensation being paid to such interest holders. In contrast, holders of unsecured claims may receive a *pro rata* distribution of cash from a debtor’s bankruptcy estate.

A court’s authority to treat a debt as if it were actually an equity contribution in instances of undercapitalization is derived from principles of equity under common law. In such an instance, the bankruptcy court ignores the form of a transaction and gives effect to its substance. Unlike the related relief of equitable subordination (by which a creditor’s claim is equitably subordinated to some or all other claims), the Bankruptcy Code is silent as to the ability of a bankruptcy court to recharacterize a claim as an equity interest. Even though the right of recharacterization exists at common law, a few courts have declined to exercise this remedy because of confusion with equitable subordination under Bankruptcy Code section 510.

In *Shubh Hotels*, the Pennsylvania bankruptcy court became one of the latest courts to weigh in on the issue, adopting the Third Circuit’s reasoning in *re SubMicron Sys. Corp.*, 432 F.3d 448 (3rd Cir. 2006) and applying an eleven-factor test to conclude that the advances in question constituted equity contributions instead of debt.

### Background

In *Shubh Hotels*, the Debtor was a limited liability company whose sole managing member also held ownership interests in another non-debtor hotel entity, Shubh Hotels, LLC (“Claimant”). In the years leading up to the chapter 11 bankruptcy filing, the Debtor’s managing member caused Claimant to make \$15,227,670.09 in cash advances (“Advances”) to the Debtor. Thereafter, Claimant filed a general unsecured claim in the amount of \$15,227,670.09 asserting that the Advances constituted “loans to corporation.” In support of its claim, Claimant attached a list of funds transferred, but failed to attach any other supporting documentation (i.e. loan agreements, promissory notes, term sheets, payment schedules, bank records, or canceled checks).

A creditor and the Official Committee of Unsecured Creditors objected to Claimant’s unsecured claim and sought to recharacterize the Advances as equity contributions.

### The Decision

The Bankruptcy Court framed the issue as a determination of whether the Advances were properly characterized as “loans”

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or an “equity contribution.” The Bankruptcy Court, following *SubMicron Sys. Corp.*, sought to determine the intent of the parties at the time of the transaction. To aid in determining the intent of the parties, the Bankruptcy Court found it appropriate to consider “the economic reality of the surrounding circumstances,” including: (1) the names given to the instruments, if any, evidencing the indebtedness; (2) the presence or absence of a fixed maturity date and schedule of payments; (3) the presence or absence of a fixed rate of interest and interest payments; (4) the source of repayments; (5) the adequacy or inadequacy of capitalization; (6) the identity of interest between the creditor and the stockholder; (7) the security, if any, for the advances; (8) the corporation’s ability to obtain financing from outside lending institutions; (9) the extent to which the advances were subordinated to the claims of outside creditors; (10) the extent to which the advances were used to acquire capital assets; and (11) the presence or absence of a sinking fund to provide prepayments.

Applying the Third Circuit’s framework, the Bankruptcy Court held that Claimant’s unsecured claim was properly characterized as an equity contribution. The court based its decision on the objectors proffered evidence, including: (1) the testimony from the Chief Operating Officer of Claimant that the advances were recorded on the Debtor’s books as equity; (2) the Debtor’s balance sheet prepared just seven days prior to the Debtor’s petition date that did not reflect that any money was owed to Claimant; (3) the Debtor’s bankruptcy schedules signed under penalty of perjury did not reflect that any money was owed to Claimant; and (4) an expert report concluded that the transactions between Claimant and the Debtor were appropriately accounted for as equity transactions.

Finally, while the Bankruptcy Court noted that the intent of the parties is normally a factual issue that requires an evidentiary hearing, the Bankruptcy Court nonetheless determined that summary judgment was appropriate because the objecting parties provided sufficient evidence to shift the burden to the Claimant and because the Claimant failed to put forth any evidence establishing a disputed issue of fact. As a result, the Claimant did not even have an opportunity to present its case at trial.

## Implications

Transactions between related entities and other insiders draw increased scrutiny in bankruptcy cases. The result in *Patel v. Shubh Hotels, LLC* serves as a reminder of the importance of properly documenting transactions between related entities to conclusively establish the intent of the parties - whether the transactions are loans or equity contributions. As such, related entities should consider and apply the eleven factors set forth in *SubMicron Sys. Corp.* (and followed in *Patel*) to properly document and characterize each transaction. In instances where a related entity intends to make a loan, such party should, at a minimum, execute a valid, binding note. Failure to do so may result in recharacterization of the loan as an equity contribution if the borrower subsequently seeks relief under the Bankruptcy Code.

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