Ninth Circuit Widens Circuit Split Over Application of State or Federal Bankruptcy Law To Determine Whether Claims of Insider-Lenders Should be Recharacterized as Equity

In an important decision for private equity sponsors and other insiders who advance loans to their businesses, on April 30, 2013, the Ninth Circuit Court of Appeals in *In re Fitness Holdings International* confirmed that bankruptcy courts may recharacterize debt as equity, but held that recharacterization is determined by state law. In its ruling, the Ninth Circuit joins the U.S. Court of Appeals for the Fifth Circuit in deferring to state law on this issue and explicitly rejects the various federal law based tests that have been adopted by a majority of U.S. Circuit Courts of Appeal. Under the Ninth Circuit's approach, choice of law provisions in loan documentation will play a more important role in litigation over insider-debt transactions.

The Insider Loans

Between 2003 and 2006, Fitness Holdings issued approximately $24 million of promissory notes with maturities ranging from 2006 to 2009 to its sole shareholder, Hancock Park. In June 2007, Fitness Holdings refinanced its debt with a $17 million term loan and an $8 million revolving loan. The loan agreement for the refinancing specified that approximately $9 million of the newly extended loans should be used to payoff existing bank loans, and approximately $12 million should be used to payoff Hancock Park's promissory notes.

The Bankruptcy Court and District Court Decisions

On October 20, 2008, Fitness Holdings filed for chapter 11 bankruptcy in the Central District of California. In the Bankruptcy Court, the unsecured creditors' committee filed a complaint against Hancock Park seeking to recover the payments on Hancock Park's promissory notes as fraudulent transfers and to characterize the financing provided by Hancock Park as equity, rather than debt. On January 15, 2010, the Bankruptcy Court dismissed the claims against Hancock Park, citing as precedent a 1986 decision by the Ninth Circuit Bankruptcy Appellate Panel in *In re Pacific Express, Inc.*, which had held that the Bankruptcy Code "did not authorize courts to characterize claims as equity or debt, but limited courts to the statutory remedy of equitable subordination under [Bankruptcy Code section 510]." On appeal, the District Court upheld the Bankruptcy Court's decision, stating that, as a matter of law, it was barred from recharacterizing Hancock Park's loans as equity investments. The chapter 7 trustee then further appealed to the Ninth Circuit Court of Appeals.

The Ninth Circuit Decision

Under Bankruptcy Code sections 548 and 550, a transfer by a debtor may be avoided as a constructively fraudulent transfer if a debtor does not receive "reasonably equivalent value" in exchange. The Ninth Circuit began its analysis by noting that, although the phrase "reasonably equivalent value" is not defined in the Bankruptcy Code, the term "value" is defined and includes the "satisfaction or securing of a present or antecedent debt." Thus, the Ninth Circuit reasoned, "to the extent a transfer constitutes repayment of the debtor's antecedent or present debt, the transfer is not constructively fraudulent."

The Ninth Circuit concluded that if a transfer is made in satisfaction of a "right to payment," such as satisfaction of an outstanding loan, then the transfer is made for "reasonably equivalent value," which precludes a finding that the transfer was constructively fraudulent. The Ninth Circuit concluded, however, that it must use state law to determine whether a transfer was made in consideration of a "right to payment." "[I]n an action to avoid a transfer as constructively fraudulent under [Bankruptcy Code section 548(a)(1)(B)], if any party claims that the transfer constituted the repayment of a debt (and thus was a transfer for 'reasonably equivalent value'), the court must determine whether the purported 'debt' constituted a right to payment under state law."

In its decision, the Ninth Circuit expressly rejected the Ninth Circuit Bankruptcy Appellate Panel's *Pacific Express* decision, and instead agreed with five other U.S. Circuit Courts of Appeal (3rd Circuit, 4th Circuit, 6th Circuit, and 10th Circuit) that bankruptcy courts are authorized to recharacterize debt. The Ninth Circuit, however, rejected varying federal based legal frameworks and tests adopted by other Circuits, and, instead, adopted the Fifth Circuit's approach in *Lothian Oil* of looking to state law. The Ninth Circuit found deference to state law "more consistent with Supreme Court precedent than that of the Circuits that have fashioned a federal test for recharacterizing an alleged debt in reliance on their general equitable authority under [Bankruptcy Code section 105(a)]." In reaching its decision, the *Fitness Holdings* Court cited favorably a law review article by two Ropes & Gray LLP partners, James M. Wilton and Stephen Moeller-Sally, "Debt Recharacterization Under State Law" 62 Bus. Law. 1257 (August 2007). The Ninth Circuit vacated the District Court's dismissal of the trustee's constructive fraudulent transfer claim and remanded the matter for further proceedings consistent with the Ninth Circuit's approach that contemplates application of state law.

Implications for Insider-Lenders

The Ninth Circuit's decision in *Fitness Holdings* confirms bankruptcy court authority to recharacterize debt as equity, but widens a circuit split over the applicable choice of law for debt recharacterization. In general, state law concerning the issue of debt recharacterization is less well developed than the law that has developed in recent years in bankruptcy courts. However, at least in certain jurisdictions, state law is less favorable to debt recharacterization than federal law and, therefore, more likely to support the enforceability of insider loans. Because two Federal Circuits now require application of state law to determine whether an insider loan may be recharacterized as equity, insider-lenders should carefully consider choice of law in documenting loans.

For further information regarding this Alert, please contact Alyson Allen, Mark I. Bane, James M. Wilton, Stephen Moeller-Sally, or your regular Ropes & Gray contact.