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The Recharacterization of Loan Agreements under Applicable Bankruptcy and Non-Bankruptcy Law

The Statutory Predicate for Recharacterization

To increase their share of a finite bankruptcy pie, creditors, debtors and other parties in interest in a case will seek to reduce or eliminate competing claims. This objective may be accomplished using various provisions of the Bankruptcy Code. Section 502(b)(1) is the statutory provision providing for the objection to, and disallowance of, claims based on the applicable laws and rules and by the enforcement of any agreement between or among the relevant parties. Section 510(c) is the statutory provision that governs the equitable subordination of claims where the claim arises from or is tainted by the inequitable conduct of a party as a result of such bad conduct. Subordination does not eliminate claims; rather, it results in the subordinated claim being removed from one class of claims and placed in a class that is afforded a lower priority in the pecking order of the payments to be made in a bankruptcy case. In many instances, a subordinated claim receives no distribution. By virtue of the subordination, the claimants remaining in the class formerly occupied by the subordinated claim may benefit essentially by receiving a proportionate share of a distribution that would otherwise have been paid to the now subordinated claim.

The Bankruptcy Code, however, is silent with regard to the recharacterization of a purported claim as something less (i.e., an equity security interest). Because no section of the Bankruptcy Code expressly provides for recharacterization, it has been left to the courts to determine whether or not they have the authority to recharacterize.

1. A “claim” under Section 101(5) of the Bankruptcy Code includes the “right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.”
Most courts, when asked to consider recharacterization, have held that the bankruptcy courts have the authority to do so. A majority of the courts authorizing recharacterization, including the Third, Fourth, Sixth, and Tenth Circuits, have found that bankruptcy courts may recharacterize pursuant to the broad equitable powers granted by Section 105(a) of the Bankruptcy Code. In re SubMicron Sys., 432 F.3d 448, 454 (3d Cir. 2006); Dornier Aviation (North America), Inc. v. Official Comm. of Unsecured Creditors (In re Dornier Aviation), 453 F.3d 225, 231 (4th Cir. 2006); Sender v. Bronze Group, Ltd. (In re Hedged–Investments Assocs., Inc.), 380 F.3d 1292, 1297 (10th Cir. 2004); In re AutoStyle Plastics, Inc., 269 F.3d 726, 748, 750 (6th Cir. 2001). The “bankruptcy court’s equitable powers have long included the ability to look beyond form to substance.” In re Dornier Aviation (North America), Inc., 453 F.3d at 233. In fact, the equitable power of the court to recharacterize is viewed as essential to effectuating the Bankruptcy Code’s priority scheme. Id. at 233; In re AutoStyle Plastics, Inc., 269 F.3d at 748; In re Hedged–Investments Assocs., Inc., 380 F.3d at 1298.

The Fifth and Ninth Circuits have found that recharacterization is required in appropriate circumstances by Butner v. United States, 440 U.S. 48, 54 (1979), when applicable non-bankruptcy law would characterize something that at first glance may look like a loan as a contribution to capital. In re Lothian Oil, Inc., 650 F.3d 539, 542–43 (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).

In Lothian Oil, the Fifth Circuit held that recharacterization of a purported debt as a capital contribution is permitted and that recharacterization is not limited to claims of insiders. The Fifth Circuit’s approach to recharacterization differs from the several circuits that rely upon the equitable powers of a bankruptcy court as the basis for recharacterization. Rather than relying on the Section 105(a) “all writs” provision of the Bankruptcy Code, the Fifth Circuit applied state law to recharacterize a claim as an equity security interest by employing Section 502(b)(1) of the Bankruptcy Code—the Bankruptcy Code section that provides for the allowance and disallowance of claims. The Fifth Circuit reasoned that resorting to the general equitable powers of the bankruptcy court was inappropriate because it was unnecessary to do so, since Section 502(b)(1) explicitly grants authority to bankruptcy courts to allow and disallow claims. Thus, the Fifth Circuit’s analysis focused on the governing agreement and applicable state law, and not bankruptcy law, when deciding what rights were actually created by the agreement of the parties, despite any descriptive labels used by the parties (i.e., substance over form).

The reasoning employed by the Lothian court appears to be sound. Thus, insiders and non-insiders alike in jurisdictions that follow the Lothian Oil approach must be concerned with the recharacterization risk with respect to a transaction that at first blush may be set up to create a claim for a debt, but in reality documents a contribution of an equity security interest. Of course, under Lothian Oil, the risk to insiders will only exist in states like Texas that do not distinguish between insiders and non-insiders under their laws with regard to recharacterization.

The Seventh Circuit is an outlier with respect to recharacterization, as it has not “definitively stated whether [it] recognize[s] a cause of action for recharacterization. FCC v. Airadigm Commc’ns, Inc. (In re Airadigm Commc’ns, Inc.), 616 F.3d 642, 657 n. 11 (7th Cir. 2010). However, the Seventh Circuit has acknowledged that other circuits that have decided the issue have permitted recharacterization in appropriate circumstances.

One potential result of the differing approaches employed by the circuits is forum shopping. Parties with questionable “loans” to companies that have a choice of venue may seek to have the borrower/debtor file for bankruptcy relief in a jurisdiction where the authority of a bankruptcy court to order recharacterization is limited or uncertain. Another potential result is that the U.S. Supreme Court will be called upon to address the circuit split.

2. An “equity security” is defined as either “(A) share in a corporation, whether or not transferable or denominated ‘stock’, or similar security; (B) interest of a limited partner in a limited partnership; or (C) warrant or right, other than a right to convert, to purchase, sell, or subscribe to a share, security, or interest of a kind specified in subparagraph (A) or (B) of this paragraph.” 11 U.S.C. § 101(16).
The Eleven Factors to be Considered with Regard to a Recharacterization Contest

In AutoStyle, the Sixth Circuit held that a bankruptcy court has the inherent power to recharacterize a claim as an equity interest since bankruptcy courts have judicial authority to use their equitable powers to allow or disallow claims. Using Roth Steel Tube Co., v. Comm’r of Internal Revenue as a guide, the Sixth Circuit developed 11 factors to be considered when determining whether a bankruptcy court should recharacterize a claim as an equity interest. The factors to be considered are as follows:

1. The wording used in the instruments evidencing the indebtedness
2. The presence of a fixed maturity date and schedule of payments
3. The presence of a fixed rate of interest and schedule of interest payments
4. The source of repayments (whether they are fixed or tied to the success of the business)
5. The adequacy of capitalization
6. The identity of interest between the creditor and the stockholder (or holder of a similar ownership interest)
7. The security for repayment of the loan
8. The borrower’s ability to obtain financing from outside lending institutions (as opposed to from an Insider or Affiliate, as those terms are defined in Section 101 of the Bankruptcy Code)
9. The extent to which repayment is subordinated by the operative documents to the repayment of debts payable to other creditors of the borrower
10. The extent to which an advance was used to acquire capital assets
11. The presence of a sinking fund to provide repayments

No one factor controls. The courts, therefore, review the facts of each case pertaining to each of the 11 factors. Generally, a transaction negotiated at arm’s length between a willing lender and an unrelated willing borrower will lead a court to defer to the transaction documents, rather than recharacterizing the transaction. See In re SubMicron Sys., 434 F. 3d at 455 n.8 (listing various multi-factor tests); Dornier Aviation, 453 F. 3d at 233–34; Hedged-Inv., 380 F. 3d at 1298; Fin Hay Realty Co. v. United States, 398 F. 2d 694, 696 (3d Cir. 1968).

Although the Fifth Circuit applied state law to recharacterize and disallow a claim under 502(b)(1) of the Bankruptcy Code in Lothian Oil, the court analyzed the agreement in question using an analytical model that was virtually indistinguishable from the 11-factor test used by courts that recharacterize using their general equitable powers. See, e.g., Sender v. Bronze Group, Ltd. (In re Hedged-Invs. Assocs. Inc.), 380 F. 3d 1292, 1298 (10th Cir. 2004) (citing multiple other cases; citations omitted). Where, as in Texas, applicable state law directs the court to apply the prevailing multi-factor test, the results achieved in the Fifth and Ninth Circuits are likely to be substantially similar to the results reached by courts that recharacterize pursuant to Section 105(a) and employ the 11-factor analytical model.

When a loan complies with the formalities for a valid loan agreement and the advanced funds are treated as a loan in the borrower’s business records, courts are typically reluctant to recharacterize a loan as an equity contribution, even when the borrower was undercapitalized. In SubMicron Systems, 434 F. 3d at 457, for example, the court concluded that an existing lender’s loan to an undercapitalized debtor had been properly characterized as a debt when the lending documents called the advances debt and established a fixed maturity date and fixed interest rate. Although the company was undercapitalized, the court concluded that the loan had been made to the distressed company in an attempt to protect the lender’s existing loans.

The court in In re Hedged-Investments Assocs., Inc., 380 F. 3d at 1298 declined to recharacterize an advance documented as a loan as equity, noting that the transaction documents fulfilled the proper formalities and that the lender had the right to enforce payment of principal and interest. Furthermore, the lender did not have control of management, and the debtor could have secured funds from other lenders at around the time of the transaction. Although the debtor was thinly capitalized, the loan did not have a fixed maturity date, the payment of interest out of a pooled investment account could have been an indication of an equity contribution, and the compliance with formalities and the parties’ evident intent that the transaction was to be a loan showed that the transaction had established a debt.

Likewise, in American Twin LTD.. P’ship v. Whitten, 392 F. Supp. 2d 13, 22–23 (D. Mass. 2005), the court concluded that the notes at issue were debt, not equity, emphasizing the compliance with formalities in the issuance of the notes. Although the lender was a minority shareholder, the lender did not control the debtor, and the funds were advanced for operating expenses, which is generally indicative of debt. Furthermore, although the debtor was undercapitalized, its
ultimate failure was caused by its poor business model and other similar factors.

Similarly, in Gernsacher v. Campbell (In re Equip. Equity Holdings, Inc.), 401 B.R. 792, 855–62 (Bankr. N.D. Tex. 2013), the court concluded that although several factors supported characterizing the advance of funds as equity, the balance of factors weighed in favor of the conclusion that the formalized notes represented debt. Despite the undercapitalization of the debtor, the tight correlation between equity interests and the values associated with the notes, and the creditor’s control of the majority of the debtor’s stock, the court heavily weighed the formal characterization of the notes as debt and the debtor’s business records’ treatment of the notes as debt. Moreover, the funds were used to reduce senior debt and to provide working capital, which weighed in favor of characterizing the funds as a loan. Finally, although the debtor was undercapitalized, there were other causes for the debtor’s ultimate financial failure.

On the other hand, when the transaction lacks formalities, especially when the party advancing funds is an insider, courts are more likely to recharacterize the alleged debt as equity. In In re Dornier Aviation (North America), Inc., 453 F.3d at 234, the Fourth Circuit concluded that an insider transaction that failed to comply with certain formalities of a loan actually constituted an equity contribution. Where the loan lacked a fixed maturity date, the debtor was not required to pay the loan until it became profitable, the debtor had a loan history of unprofitability, the debtor’s liabilities after restructuring far exceeded its assets, and the purported creditor assumed the debtor’s losses, the transaction represented an equity investment rather than debt. Although the purported creditor argued that transfers of inventory cannot constitute an equity investment, the court concluded that adopting such a position would simply incentivize equity investors to structure their capital contributions as sales of inventory.

Even where the transaction is evidenced by a so-called “promissory note,” courts may ignore nomenclature where the parties do not conduct their business as lender and borrower. In Miller v. Dow (In re Lexington Oil & Gas Ltd.), 423 B.R. 353, 366 (Bankr. E.D. Okla. 2010), the court recharacterized a claim as an equity interest, despite the execution of a promissory note, because the payment obligation in the documents was solely dependent on the profitability of the borrower. The court stated that in order for a transaction to give rise to a true claim, there must be a reasonable expectation that the repayment obligation does not solely depend on the success of the borrower’s business. Id. at 365. In Lexington, the delay of the obligation to pay any principal or interest for a two year period under the governing documents was further evidence that the purported lenders actually provided equity. Finally, the undercapitalization of the borrower and the failure of the capital providers (the purported lenders) to take prudent actions to protect their rights as lenders—for example, by providing for payment of accrued interest when the notes were rewritten, was evidence that the purported loan transaction was in reality a transaction that provided for an equity investment.

**Applying the 11-Factor Test: In re SIAG Aerisyn, LLC**

A decision from the U.S. Bankruptcy Court for the Eastern District of Tennessee Southern Division is instructive. Paris v. SSAB Enters, LLC (In re SIAG Aerisyn, LLC), 2014 Bankr. LEXIS 4586, at *5 (Bankr. E.D. Tenn. Nov. 3, 2014). During the 90-day period prior to the SIAG bankruptcy filing, it paid a creditor, SSAB, approximately $2.6 million. After the bankruptcy filing, SIAG sued SSAB to avoid these payments as preferential under Section 547(b) of the Bankruptcy Code.

A trustee (including a debtor-in-possession in a Chapter 11 case) may avoid a transfer as a preference only if the transfer (1) was to or for the benefit of a creditor, (2) was for or on account of an antecedent debt owed by the debtor before the transfer was made, (3) was made while the debtor was insolvent, (4) was made on or within 90 days before the date of the debtor’s bankruptcy filing, and (5) enables such creditor to receive more than the creditor would receive if the transfer had not been made and the debtor’s bankruptcy were a Chapter 7 case. The only element of plaintiff’s case at issue was whether SIAG, as debtor, was insolvent when it paid SSAB during the 90 days prior to the bankruptcy filing. The court never reached the issue of insolvency, as it was called upon first to decide whether the advances SIAG received from one of its affiliates was really a loan (debt) or actually a capital contribution, giving rise to an equity interest, rather than to a claim.

The court never actually answered the insolvency question. This is because it first had to rule on SSAB’s motion for partial summary judgment as to whether the advance SIAG received from an affiliate was a loan (claim) or a capital contribution (equity interest).

**Facts**

The relevant facts of SIAG are as follows:

During the two years prior to the bankruptcy filing, SIAG received approximately $11.5 million in advances from an affiliate. In its schedules, SIAG listed a claim owed to its affiliate in the amount of approximately $9.9 million as “advance from parent.” As of the petition date, SIAG had repaid approximately $2.4 million to its affiliate.

Defendant SSAB argued that Section 547(b) did not apply because SIAG was solvent at the time the debtor made the transfers to SSAB, as the advances from SIAG’s affiliate actually
were an equity contribution and not a loan. SSAB relied on AutoStyle to support its position that the $9.9 million should be recharacterized as an equity investment. After reviewing the AutoStyle factors, the court concluded that there were genuine issues of material fact as to whether SIAG and its affiliate intended the advances to be a loan or a capital contribution.

**Analysis**

Upon consideration of the first AutoStyle factor, the court found that the existence of the note itself was not dispositive on the recharacterization issue. The trustee provided a copy of the note evidencing the parent’s advance to the debtor, corporate meeting minutes, and a unanimous written consent signed by the debtor’s board of managers. SSAB challenged this evidence, arguing that the failure to create the note prior to the first advances and SIAG’s failure to classify the note as a promissory note rather than an advance in its schedules meant that the transaction was an equity investment disguised as a loan. Another fact relied upon by SSAB was the failure of SIAG’s affiliate to file a proof of claim. Though the court agreed that several facts raised doubt as to whether the note was truly a “note,” the court held that the existence of the note itself established genuine issues of fact.

Upon consideration of the second AutoStyle factor, the note at issue was a demand note. Demand notes typically do not have a fixed maturity date or repayment schedule. An advance without a fixed maturity date and fixed obligation to repay looks a lot more like an equity investment than a loan. The court found that this factor weighed in favor of SSAB’s position.

Upon consideration of the third AutoStyle factor, the presence of an interest rate and the calculation of interest were enough for the court to decide that this factor weighed against partial summary judgment that the advance was an equity contribution.

Upon consideration of the fourth AutoStyle factor, the court determined that as a rule, if repayment is tied to the success of a borrower’s business, the transaction looks like an equity investment rather than a loan. SIAG’s former vice president and CFO testified that the parties understood that SIAG would make periodic payments to an affiliate only if SIAG generated sufficient cash from operations. The court determined that was inconclusive and, therefore, this factor weighed against partial summary judgment.

Upon consideration of the fifth AutoStyle factor, the court considered, among other things, the testimony of the debtor’s former vice president and CFO that SIAG was substantially undercapitalized and the advances at issue were necessary to operate the business. There was also evidence that another affiliate provided SIAG with an initial investment of $5 million and that SIAG’s net income was approximately $2.2 million during the first months of its operation. Based on that evidence and evidence of SIAG’s solvency presented by SSAB, the court found that genuine issues of material fact existed as to whether SIAG was undercapitalized at the relevant time.

Upon consideration of the sixth AutoStyle factor, the court found it unclear whether the affiliate’s advances to the debtor were in proportion to its equity interest in SIAG. The more proportionate a stockholder’s advance is to the stockholder’s ownership interest in a borrower, the more likely an advance was intended to be a capital contribution. On the other hand, a sharply disproportionate ratio between a stockholder’s percentage ownership interest and the amount advanced indicates that the advances were intended to be loans. SIAG’s operating agreement and other testimony suggested that the affiliate making the advances was not SIAG’s owner. The demand note, however, stated that the affiliate, through one of its subsidiaries, owned a 70% equity interest in SIAG.

Upon consideration of the seventh AutoStyle factor, the court determined that the demand note indicated that there was no collateral provided by SIAG to secure repayment of the amount of the advances in question. Absence of security for an advance suggested to the court that the advances were in the nature of an equity contribution.

Upon consideration of the eighth AutoStyle factor, the court sought to determine whether an unaffiliated reasonable creditor would act in the same manner as the affiliate that made the advances. The evidence suggested SIAG would almost certainly have struggled to obtain financing from an unaffiliated lending source. There was no evidence that SIAG...
even tried to obtain alternative financing. Despite finding that this factor weighed in favor of recharacterization, the court noted that this factor was not dispositive because it is often the case that struggling companies can only obtain loans from an affiliate.

Upon consideration of the ninth AutoStyle factor, the court determined that even though SIAG made two repayments, the parties also understood that SIAG would only make repayments after it paid its vendors. An advance that is last in line behind the claims of all other creditors raises doubt as to whether such advance is a true loan, giving rise to a claim. The court found this factor neutral.

Upon consideration of the tenth AutoStyle factor, the court determined that when a borrower uses an advance to pay operating expenses, rather than to acquire capital assets, an advance looks more like bona fide debt. In this case, the court found that SIAG needed and used the advance to fund operations expenses. Thus, this factor militated in favor of a finding that the advances were a true debt obligation giving rise to a claim.

Upon consideration of the eleventh and final AutoStyle factor, the court found that the absence of a sinking fund to secure repayment indicates that an advance was a capital contribution and not a true loan giving rise to a claim. An accountant testified that demand notes are usually not accompanied by a repayment schedule or a sinking fund because demand notes are usually paid with earnings. Thus, this final factor weighed against partial summary judgment, since it was not dispositive one way or the other on the recharacterization issue.

Unsurprisingly, due to the conflicting evidence adduced with regard to the 11 AutoStyle factors, the court concluded that there were genuine issues of material fact as to whether the SIAG and its parent intended the advance to be a loan or a capital contribution.

Conclusion and Some Practical Guidance

The law regarding recharacterization by bankruptcy courts is developing rapidly. The analysis is fact-intensive and not always consistent. Parties entering into a transaction must be aware of the insolvency risk and document their transactions correctly to achieve a desired outcome.

The Lothian Oil decision is important because variations between state laws could yield different outcomes in recharacterization cases based on underlying state law (i.e., cases litigated in the Fifth and Ninth Circuits). For example, in Lothian Oil, although the district court found that it could not recharacterize non-insider debt claims under federal law, the Fifth Circuit reversed because Texas law had no per se rule limiting recharacterization to the claims of insiders.

What makes SIAG such an interesting case is its clear and focused application and analysis of the evidence in relation to each of the 11 AutoStyle factors. The Fifth Circuit decision in Lothian Oil is similarly instructive. Thus, these cases can be used for guidance by (1) transactional lawyers when called upon to document a deal, and (2) bankruptcy lawyers, trial lawyers, and the courts when they next face a contest regarding the status of an advance and are asked to answer the question—is it a debt or really a capital contribution?

Although several of the AutoStyle factors cannot be altered at the time a transaction is being documented and closed (e.g., the identity of the creditor with the shareholder and the participation of the creditor in management), other factors can indeed be controlled. As a practical matter, and consistent with the lessons of SIAG and Lothian Oil, a party making an advance intended to be paid back as a loan would be well served to:

- Back up the loan with formal documentation, including a standard promissory note
- Make the loan only on normal business terms by imposing an interest rate and payment terms comparable to those which could be obtained from a unaffiliated lender—and—
- Avoid terms that are red flags for claim recharacterization, such as:
  - A contingency on the obligation to repay
  - Redemption provisions
  - Provisions granting voting power to the note holder

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