Tests of Character:
Challenges to Unsecured Claims in the Mount Olive and American Housing Foundation Bankruptcies

Matthew D. Sobolewski – McLaughlin & Stern, LLP – msobolewski@mclaughlinstern.com
Neil Steinkamp, CVA, CCA – nsteinkamp@srr.com
Robert A. Levine, CPA – rlevine@srr.com

Introduction

Claims based on prepetition loans (especially those made by insiders) are often challenged in bankruptcy cases on the basis that they are not actually debt and should be recharacterized as equity. If the challenge is successful, this can result in a less-than-desired outcome for a creditor since a debt claim, among other things, has a higher priority than an equity interest in the debtor company. Generally, when bankruptcy courts consider whether or not to recharacterize debt as equity, they apply a multi-factor test and / or a fact-intensive inquiry into the actual intent of the parties. This article examines the recent rulings and approaches taken by two different bankruptcy courts with respect to recharacterization of claims.

In the Matter of Mt. Olive Hospitality, LLC

VWI Properties, LLC ("VWI"), the prepetition purchaser of the secured debt associated with the hotel property owned by Mount Olive Hospitality, LLC ("debtor"), filed several motions challenging the validity of certain unsecured claims against the debtor totaling over $4 million and the characterization of those claims as debt.[1] In this article, we consider VWI's process for objecting to the alleged note-holders' claims and the approach taken by the bankruptcy court to determine whether recharacterization of the debt claims as equity was appropriate.

Process for Objecting to Claims

Four of the 13 challenged claimants filed untimely proofs of claim and the others failed to file any proof of claim.[2] Notwithstanding the foregoing, the bankruptcy court noted that the debtor listed all of these claims on its Schedule F (as amended) and this listing "constitute[s] prima facie evidence of the validity and amount of the claims of creditors, unless they are scheduled as disputed, contingent, or unliquidated."[3] None of these claims were scheduled as such by the debtor and, therefore, prima facie validity was afforded to each claim.[4] Once prima facie validity is afforded, the burden shifts to the objector (VWI) to "produce sufficient evidence to negate the prima facie validity of the filed claim."[5] If the objector can accomplish this, the burden shifts back to the claimant to establish, by a preponderance of the evidence, the validity of its claim.[6]

The question of whether a contribution should be characterized as debt or equity typically arises when the claimant's intent is not clear based on the record.[7] In *Mt. Olive*, the claimants attempted to meet their evidentiary burden by relying upon, among other things, various promissory notes.[8] The bankruptcy court, however, found that the "evidentiary demonstration by VWI regarding the

[1] *In the Matter of Mt. Olive Hospitality, LLC*, No. 12-32781 (JHW), 2014 WL 2040769, at *5 (Bankr. D.N.J. May 16, 2014).
[2] *Id*. at *6.
[3] *Id*. (citing Fed. R. Bankr. P. 3003(b)).
[4] *Id*.
[5] *Id*. (quoting *In re Lampe*, 665 F.3d 506, 514 (3d Cir. 2011)).
[6] *Id*. (citing *Lampe*, 665 F.3d at 514).
[7] *Id*. at *12.
[8] *Id*. at *6.

preparation of certain of the promissory notes at issue conclusively establishes that those notes must be completely disregarded as substantiation for the claim for which they are submitted, because the circumstances of their preparation are so implausible that the version offered by the debtor cannot be believed."[9] That said, even without the promissory notes to evidence the claims, the bankruptcy court noted that the claimants could still prevail (and avoid the recharacterization) if they could establish, by a preponderance of the evidence, that their actual intent was for these advances to be loans and not equity and that the loans were made to the debtor.[10] Indeed, the bankruptcy court explained that what a debtor did with the advance after receiving it or how it recorded the advance on its books and records can be overcome by a claimant through competent evidence of its clear and unequivocal intent to make a loan to the debtor.[11] That said, should a claimant be a principal of the debtor (as was the case here), the debtor's actions (e.g., recording the advance as equity, alteration of the debtor's records post-petition) can be more difficult to overcome to establish the advance as a loan.[12]

Debt v. Equity Characterization

Courts have developed criteria to assist in evaluating an instrument as either debt or equity, including a 13-factor test applied by some courts.[13] The bankruptcy court considered some of these factors in its analysis. For example:

- **Label on the instrument:** Each claim was supported by a promissory note, but, as previously mentioned, the bankruptcy court disregarded these notes as substantiation for the claims.[14]
- **Source of payments to be made under the instrument:** "[N]o regular payment of principal or interest was made to these claimants," indicating that the payments may have been dependent upon earnings.[15]
- **Holder's right to enforce payments:** There was no evidence of any formal demands for payment made by the claimants.[16]
- **Degree of capitalization and debtor's ability to obtain loans from outside lenders:** "[I]f the notes were all considered to be debt, the debtor … would have been too thinly capitalized, and would probably not have been able to consummate [the primary mortgage]."[17]
- **Source of payment for the interest:** No interest payments were made to the note holders, but rather interest continued to accrue as payments were deferred.[18]

Notwithstanding its consideration of the foregoing factors, to conclude whether the claimants met their evidentiary burden, the bankruptcy court elected not to apply a specific multi-factor test or "mechanistic scorecard."[19] It instead decided to follow the Third Circuit's decision in *In re SubMicron Systems Corp.* and engage in a fact-intensive inquiry into "what the parties actually intended and acted on in each case."[20] The bankruptcy court explained that, under this framework, the actual intent of the parties for each transaction "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."[21] For the most part, the bankruptcy court found most persuasive the clear and unequivocal testimony of the successful claimants that they intended their respective contributions to be loans and that the recipient of the funds was to be the debtor.[22] Moreover, the debtor's failure to properly record the advances of the successful claimants as loans on its books and records until years later (and after the bankruptcy filing) did not change the bankruptcy court's characterization.[23]

In re American Housing Foundation

In *Walter O'Cheskey v. Herring Nat'l Bank (In re American Housing Foundation)*, the bankruptcy court did not primarily focus on the actual intent of the parties and instead opted for a multi-factor test to determine the proper characterization of the claims at issue.[24] This was in part due to the nature of the underlying transactions and the contracting parties' "close relationship," and the fact that, based on the record, "[t]he intent of the parties [was] muddled."[25]

On June 11, 2009, American Housing Foundation ("AHF") filed a voluntary petition pursuant to Chapter 11 of the Bankruptcy Code.[26] Among AHF's creditors was Herring National Bank ("Herring Bank"), which filed its original proof of claim on October 6, 2009.[27] Included in Herring Bank's claim were amounts arising from three separate transactions.[28] The trustee objected to Herring Bank's claim to the extent it was based on two of these transactions—a $1,505,000 investment in LIHTC Barrington-Bell Plaza Development, Ltd. ("Barrington-Bell") and a $2 million investment in LIHTC River Falls-Three Foundations Development, Ltd. ("River Falls").[29] In analyzing Herring Bank's claim and the trustee's objections thereto, the bankruptcy court looked "to both the form and the substance of the deals" and "delve[d] behind the form of transactions and relationships to determine the substance."[30]

9 *Id.*
10 *Id.* at *9-11.
11 *Id.* at *12.
12 *See id.* at *12-13.
13 *Id.* at *9.
14 *Id.* at *6-9.
15 *Id.* at *10.
16 *Id.* at *10.
17 *Id.* at *11.
18 *Id.*
19 *Id.* at *9-10 (citing *In re SubMicron Systems Corp.*, 432 F.3d 448, 456-57 (3d Cir. 2006)).
20 *Id.* at *10.
21 *Id.* at *9 (quoting *SubMicron*, 432 F.3d at 456).
22 *See id.* at *15, 17.
23 *Id.* at *17.
24 *Walter O'Cheskey v. Herring Nat'l Bank (In re American Housing Foundation)*, 520 B.R. 208, 226-27 (Bankr. N.D. Tex. Sept. 30, 2014).
25 *Id.* at 227-28.
25 *Id.* at 227-28.
26 *Id.* at 210.
27 *Id.* at 210-11.
28 *Id.* at 211.
29 *Id.*
30 *Id.* at 225 (quoting *In re United Energy Corp.*, 944 F.2d 589, 596 (9th Cir. 1991)).

The bankruptcy court initially evaluated the structure of the above-referenced transactions.[31] The Barrington-Bell transaction included an unconditional promise to repay the principal within a stated term (24 months), plus a return of 12% per annum.[32] Both transactions were guaranteed by AHF.[33] Additionally, the River Falls transaction was secured in favor of Herring Bank by 75 units of partnership interest in River Falls.[34] As a result of these transactions, Herring Bank held a 25% limited partnership interest in Barrington-Bell and a 20% limited interest in River Falls.[35] However, with respect to the River Falls transaction, the partnership also issued a promissory note payable to Herring Bank documenting the transaction as a loan (versus an equity contribution) with a 12% per annum return and a September 25, 2008 maturity date.[36] The bankruptcy court determined that these "differing treatments [of the River Falls transaction] cannot be reconciled."[37] Ultimately, these two deals were determined to be "bogus deals . . . [as] [t]here were no properties in which the funds were invested, and the partnerships, apart from Herring Bank's contributions, had no other assets."[38]

To determine whether Herring Bank's claim should be recharacterized, the bankruptcy court utilized the 16-factor test set forth by the Third Circuit in *Fin Hay Realty Co. v. United States*.[39] The bankruptcy court noted that "[a]bsence of a security is a 'strong indication that the advances were capital contributions rather than loans.'"[40] This point distinguishes the River Falls transaction from the Barrington-Bell transaction, where the former was secured by partnership units and the latter was only guaranteed by AHF with no collateral or security.[41] The testimony of Campbell Burgess, who was the president of Herring Bank at the time of these two deals, further distinguished the two transactions. Mr. Burgess testified that the Barrington-Bell deal "was intended to be an equity investment"[42] and that "had it been a note, the bank would have addressed the default in some formal way by, for example, a renewal, extension, or forbearance agreement."[43]

Based on the factors set forth in *Fin Hay Realty* and the record, the bankruptcy court concluded that "[t]he Barrington-Bell claim—on its face—arises from Herring Bank's purchase of an equity interest in Barrington-Bell" and that "[t]he River Falls deal was structured as a loan and . . . should be treated as a loan, with a guaranty of the loan issued from AHF."[44]

Conclusion

While the *Mt. Olive* bankruptcy court gave some consideration to a multi-factor test, it ultimately relied upon an inquiry into the actual intent of the parties to characterize the disputed claims. Where the claimants were able to provide "clear and unequivocal statements" regarding their intent to provide loans to the debtor, the bankruptcy court sustained their claims and characterized approximately $1.5 million of the amount at issue as debt.[45] Indeed, given the deficiencies of the promissory notes issued to the claimants, the bankruptcy court relied heavily upon the testimony of the claimants to determine the intent of the parties and the true character of the challenged claims.

By comparison, because the intent of the parties was "muddled," the *American Housing* bankruptcy court decided to apply a multi-factor test and rely more heavily on the form and substance of the two transactions at issue and the risks borne by Herring Bank.[46] Regardless of which approach is taken, they both demonstrate that when attempting to discern whether the parties intended certain treatment for a particular instrument, the "[a]nswers lie in facts that confer context case-by-case."[47]

Matthew D. Sobolewski is a Partner at McLaughlin & Stern, LLP. He practices primarily in the areas of complex commercial, bankruptcy, and consumer finance litigation. Mr. Sobolewski can be reached at +1.212.455.0375 or msobolewski@mclaughlinstern.com.

Neil Steinkamp, CVA, CCA is a Managing Director in the Dispute Advisory & Forensic Services Group at SRR. He has extensive experience providing a broad range of business and financial advice to trial lawyers and in-house counsel. Mr. Steinkamp's experience has covered many industries and matter types resulting in comprehensive understanding of the application of damages concepts and other economic analyses. Mr. Steinkamp can be reached at +1.646.807.4229 or nsteinkamp@srr.com.

Robert A. Levine, CPA is a Manager in the Dispute Advisory & Forensic Services Group at SRR. He has experience providing forensic accounting, complex commercial disputes, and IP damages services. Mr. Levine can be reached at +1.248.432.1294 or rlevine@srr.com.

.

31 *Id*. at 224.
32 *Id*.
33 *Id*.
34 *Id*. at 213.
35 *Id*. at 212, 214.
36 *Id*. at 213.
37 *Id*. at 225.
38 *Id*.
39 *Id*. at 226-27 (citing *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3d Cir. 1968)).
40 *Id*. at 228 (quoting *In re AutoStyle Plastics, Inc.*, 269 F.3d 726, 751 (6th Cir. 2001)).
41 *Id*.
42 *Id*. at 219.
43 *Id*. at 213.
44 *Id*. at 229.
45 *Mt. Olive Hospitality*, 2014 WL 2040769, at *13-16, 19, 23.
46 *American Housing Foundation*, 520 B.R. at 227.
47 *Mt. Olive Hospitality*, 2014 WL 2040769, at *9 (quoting *SubMicron*, 432 F.3d at 456).