

Bankruptcy Court Recharacterizes Alleged Loan as Equity Under Delaware Law

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When is a loan not a loan? The SDNY Bankruptcy Court in *In Re: Live Primary, LLC*^[1] held that a \$6 million start-up loan was actually an equity contribution after analyzing the terms of the transaction and the intent of the parties. The court recharacterized the loan as equity given the alleged loan functioned as an equity investment would be expected to function. As a result, the insider investor's claim was subordinated to the claims of creditors of the company.

The Risks of Recharacterization

Shareholders, sponsors, and third-party lenders should be aware of the risks of recharacterization. Many debt instruments held by such parties have risk profiles similar to equity investments, such as payment-in-kind (PIK) debt, mezzanine debt, and convertible notes. Bankruptcy courts look beyond the "label" of a transaction, analyzing substance over form to reveal an equity contribution disguised as debt. The significance of recharacterization is that if the court determines that a loan is more accurately treated as an equity contribution, the court will subordinate the claim of the alleged creditor to the debtor's debt obligations under the Bankruptcy Code's distribution scheme, which ranks debt claims ahead of equity claims in order of distribution in bankruptcy.

The Purpose of Recharacterization

The purpose of recharacterization is to prevent a shareholder from shifting the risk of equity ownership to the debtor's other creditors. For example, an insider may provide financing for a start-up or financially distressed company unable to obtain third-party financing. If the company is successful, the insider will be repaid on the loan with interest, and the value of any equity the insider holds may increase. If the company is unable to repay the loan but has not yet filed for bankruptcy, the insider may categorize the loan as a contribution to equity. This has the effect of giving the insider something of value — more equity — if it can't be repaid in cash at the expense of the company's other creditors who also can't be repaid. If the company files for bankruptcy, the insider will file a claim on the loan as a creditor and be repaid prior to when it would have been repaid as an equity holder under the Bankruptcy Code's distribution scheme. By doing so, the insider will also dilute the amount available to be repaid to the company's true creditors.

The Case

In this case, debtor Live Primary LLC (Live Primary) is a coworking and shared office space with a focus on wellness started by two former WeWork executives. In 2015, Lisa Skye and Danny Orenstein founded Live

Primary with most of the initial funds coming from a \$6,000,000 contribution from colleague Joel Schreiber through a limited liability company that Schreiber formed called Primary Member LLC (Primary Member). Schreiber provided a draft operating agreement for Live Primary that referred to the indebtedness to Live Primary as a “loan” rather than a capital contribution from Primary Member (Schreiber also held a 40% membership interest in Live Primary through Primary Member).

The operating agreement contemplated that the loan may be memorialized by a separate loan agreement, and each disbursement under the loan must be evidenced by a promissory note. However, as Live Primary continued to open new locations and the monies were disbursed, no separate loan agreement was entered into, and no promissory notes were ever issued. Interest accrued on the loan at 1.0% per year, compounded annually. There was no schedule of payments for principal, and accrued interest was only payable only upon a specified liquidity event or Live Primary’s first underwritten public offering.

Recharacterization Factors

Primary Member alleged in its proof of claim that the indebtedness was a loan. Live Member countered that the indebtedness was in fact an equity contribution. Courts in the Sixth Circuit (as well as the Third, Fourth, and Tenth circuits, and the Southern District of New York) evaluate the merits of recharacterization claims on the basis of the 11 factors set forth in the Sixth Circuit decision *In re AutoStyle Plastics, Inc.*[\[2\]](#):

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 repayments.

Depending on the context and the particulars of a transaction, each factor may vary in importance. When looking

at the totality of the factors, courts consider the parties' intent and whether the terms are comparable to an arm's length transaction.

In this case, the absence of a fixed maturity date and schedule of payments, the nominal interest rate of 1%, the unsecured nature of the loan, and the only opportunities of repayment being tied to a liquidity event or IPO all supported the court's finding that the loan was in fact an equity investment. Live Primary's minimal capitalization (\$1,000 had been contributed by the members at the time of the advance) and the lack of revenue led to the court's finding that a reasonable outside lender would likely not have made a loan, and were persuasive facts in recharacterizing the loan. The fact that the proceeds of the loan had been used to fund operating expenses rather than capital expenditures denoted another factor that weighed toward recharacterization. Ultimately, the court held that the loan should be recharacterized, given the loan functioned as equity would function and the proof of claim was not allowed.

Minimizing the Risks of Recharacterization

To minimize the risk of recharacterization, shareholders, sponsors, and third-party lenders should ensure that the form and substance of the transaction are comparable to an arm's length transaction. The factors in the *AutoStyle* decision can be a guide. The parties should also memorialize their intent, for example that the advances are meant to be debt and that attempts to obtain third-party debt financing were unsuccessful. These strategies may avoid recharacterization risk.

[1] 2021 WL 772248 (Bankr. S.D.N.Y. March 2, 2021).

[2] 269 F.3d 726 (6th Cir. 2001).

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