

## CREDITOR'S RIGHTS TOOLKIT

# What Is the Difference Between Recharacterization and Equitable Subordination and How Can They Affect My Claim?

When a company files for bankruptcy, its creditors often ask the same question: will I get paid? The answer, in part, depends on the priority and proposed treatment of each creditor's claim in the bankruptcy (i.e., who gets paid and in what order).<sup>1</sup> In addition to the Bankruptcy Code's other provisions affecting the priority of a claim, the doctrines of recharacterization and equitable subordination can affect the priority of a challenged claim by effectively postponing or eliminating payment on the claim.

## Recharacterization

Recharacterization involves recategorizing debt (often in the form of a loan) as equity. A court will analyze the substance of a financial transaction to determine whether an asserted claim is debt as opposed to mere equity. If such asserted debt is equity, it can be subordinated to all other claims and will become last in line for payment, significantly reducing or eliminating any chance of recovery. The purpose of recharacterization is to ensure that actual debt claims are paid fairly and equitably before equity interests.

The analysis for recharacterization is fact-intensive. Courts may consider numerous factors when determining whether a claim reflecting a debt should be recharacterized as an equity interest, including, but not limited to, (i) the wording of the documents evidencing indebtedness; (ii) the presence or absence of a fixed maturity date, fixed interest rate, or a schedule of payments; (iii) the source of any repayments; (iv) the company's ability to obtain financing from third parties, and (v) whether the funds provided to the company were used to acquire assets. The Bankruptcy Court has the power to disregard labels and to focus on the substance to ensure compliance with the Bankruptcy Code's priority scheme.

## Equitable Subordination

Equitable subordination involves subordinating (i.e., lowering) the priority of a claim based on the creditor's inequitable conduct. Equitable subordination generally assumes the claim reflects a legitimate obligation, but

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<sup>1</sup> See [What Is the Absolute Priority Rule and How Does It Affect Payment on My Claim in Chapter 11 Bankruptcy?](#)

subordinates such obligation based on the creditor's bad acts. The purpose of equitable subordination is to reorder the priority of certain claims to prevent an unfair and inequitable distribution to the company's creditors.

A party attempting to equitably subordinate a claim must satisfy three elements: (1) the creditor holding the claim must have engaged in some type of inequitable conduct, such as fraud; (2) the misconduct must have injured the other creditors of the company or conferred an unfair advantage on the claimant; and (3) equitably subordinating the claim must not be inconsistent with the Bankruptcy Code.

## Key Issues

- **INSIDERS**

Both recharacterization and equitable subordination often arise in connection with a claim of an insider (a party who exercises control of, or otherwise has an extensive relationship with, the bankrupt company) who loans or provides advances to a distressed company. Though a party's status as an insider does not categorically subject the party's claim to recharacterization or equitable subordination, the claim of an insider may be scrutinized.

- **INEQUITABLE CONDUCT**

Equitable subordination requires a finding that the creditor committed fraud of some other inequitable conduct. Recharacterization does not require any such finding of inequitable conduct.

- **PARTIAL CHANGE IN PRIORITY**

Recharacterization recategorizes the entire amount of debt to equity, leaving the entirety of the asserted claim last in line behind all other creditors for payment. Equitable subordination will subordinate debt to the extent it offsets the creditor's inequitable conduct and resulting harm. If the amount owed exceeds this harm, the claim may be partially subordinated, kicking only a portion of the claim to the back of the line for payment. Notably, even if a court subordinates a claim, it will be paid before equity holders receive any payment.

- **SOURCE OF AUTHORITY**

There is no express provision in the Bankruptcy Code authorizing recharacterization. Rather, certain courts have held that a court's ability to recharacterize a claim stems from equitable, inherent powers and judicial authority. Recharacterization, therefore, might be applied differently depending on the jurisdiction, or may not be available at all. Unlike recharacterization, section 510 of the Bankruptcy Code expressly permits equitable subordination of a claim if a creditor engaged in some inequitable conduct.

## Takeaway

Equitable subordination and recharacterization are often asserted together. While both equitable subordination and recharacterization similarly affect the priority of a claim in a bankruptcy, the purpose, process, burden, and results of each doctrine are distinct. If a creditor finds itself defending against one or both doctrines, the creditor should retain competent legal counsel to ensure that the creditor's claim is placed in the best priority position to receive payment.