



by David S. Kupetz

# The Fitness of RECHARACTERIZATION

## *Fitness Holdings* affirms a nuanced, fact-based analysis of insider financing

THE ENTITLEMENT of creditors' claims to distribution ahead of holders of equity interests in the debtor is inherent in the Bankruptcy Code.<sup>1</sup> "Treating an equity investor on a par with unsecured creditors disregards the principles underlying the absolute priority rule in a manner that undermines this basic bankruptcy concept."<sup>2</sup> Consequently, the similar, and sometimes overlapping, but distinct doctrines of recharacterization and equitable subordination were developed by case law.<sup>3</sup> While equitable subordination has been incorporated into the Bankruptcy Code,<sup>4</sup> recharacterization continues to be applied solely as a creation of case law.<sup>5</sup>

Recharacterization and equitable subordination are doctrines "aimed at different conduct and have different remedies (although sometimes based on the same facts)."<sup>6</sup> The recharacterization analysis generally involves determining whether a funding instrument labeled as debt is in fact an equity investment. Since the substance of the transaction governs over form, if a debt transaction was actually an equity infusion, the recharacterized claim will be treated as equity.<sup>7</sup>

In contrast, equitable subordination is based on an assessment of the creditor's behavior. It is used to remedy inequity or

unfairness to the debtor's other creditors by demoting the subordinated creditor's right to repayment to the rights of other creditors or equity holders. Accordingly, while some courts have confused the doctrines or have mistakenly found that equitable subordination supplants recharacterization in the context of bankruptcy,<sup>8</sup> the doctrines address distinct concerns and require bankruptcy courts to conduct different inquiries.<sup>9</sup>

In *Fitness Holdings International, Inc.*,<sup>10</sup> the Ninth Circuit Court of Appeals addressed for the first time the question of whether bankruptcy courts have the power to recharacterize debt to equity.<sup>11</sup> While it may seem obvious that bankruptcy courts have this power, the Ninth Circuit's Bankruptcy Appellate Panel in *In re Pacific Express, Inc.*, had earlier held that bankruptcy courts lack such authority because "characterization of claims as equity or debt" is governed and limited by equitable subordination under Bankruptcy Code section 510(c).<sup>12</sup> Rejecting

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*Pacific Express*, the Ninth Circuit joined other Courts of Appeals in concluding that the Bankruptcy Code provides bankruptcy courts with the power, distinct and independent from equitable subordination, to recharacterize claims.<sup>13</sup>

### **Fitness Holdings**

Fitness Holdings International, Inc. (FHI), was a chain retailer of high-end fitness equipment. Hancock Park Capital II, L.P., a vehicle created by a private equity firm, was FHI's sole shareholder and one of its primary

monetary defaults. At this point, FHI was unable to achieve any further accommodations from PWB.

In October 2008, FHI filed a voluntary petition commencing a chapter 11 bankruptcy case. Subsequently, the unsecured creditors' committee appointed in FHI's chapter 11 case brought an adversary proceeding against Hancock Park, principals of Hancock Park who were also officers of FHI, and PWB. In this lawsuit, the committee asserted that payments to Hancock Park from the new secured financing were fraudulent trans-

actions and, as a matter of law, it was barred from recharacterizing such loans as equity investments."<sup>21</sup>

### **Other Federal Courts of Appeals**

The majority approach adopted by various circuit Courts of Appeals addressing recharacterization in the bankruptcy context has used multifactor tests imported from tax cases. The Third, Fourth, Sixth, and Tenth Circuits have used the bankruptcy court's power under Bankruptcy Code Section 105 as the basis for the court's authority to rechar-

**The Ninth Circuit** concluded that a bankruptcy court has the power to determine whether a transaction creates a debt or an equity interest for purposes of Section 548, whether a transaction creates a debt if it creates a "right to payment" under state law, and whether, if it did not, the court may recharacterize the debt to equity under applicable state law.

lenders.<sup>14</sup> Between 2003 and 2006, FHI borrowed more than \$24 million from Hancock Park on an unsecured basis, pursuant to 11 subordinated promissory notes.

In 2004, FHI borrowed \$12 million from Pacific Western Bank (PWB) secured by all of FHI's assets. Hancock Park guaranteed FHI's obligations to PWB.<sup>15</sup> By June 2006, FHI was suffering financial difficulties and sought to refinance its debt. Under a new refinancing arrangement, FHI borrowed \$25 million from PWB on a secured basis in June 2007, thus increasing PWB's loans to FHI by \$13 million. PWB's security interests in FHI's assets covered the full amount of the new financing. Moreover, under the new financing, \$8,886,204 was disbursed to pay off PWB's original secured loan, and \$11,995,500 was disbursed to Hancock Park to pay down its unsecured promissory notes, thereby effectively releasing Hancock Park from its guarantee of FHI's obligations to PWB.<sup>16</sup>

In the following months, FHI, as a high-end consumer retailer, suffered serious sales losses as the increasing weakness of the economy and steep declines in the retail sector deepened. PWB demanded and obtained from FHI a new guarantee for the entire \$25 million that FHI owed PWB. As FHI continued to struggle, PWB made demand for payment in full under both the new secured financing and the new guarantee based on various non-

fers that could be avoided.<sup>17</sup>

The committee further complained that the payment to Hancock Park, using proceeds from the new secured financing, was a conversion of unsecured insider debt, which may actually be equity infusions, into secured debt, and thus allegedly benefitted Hancock Park but not FHI. The committee contended that whether an instance of actual fraud (because done with actual intent to "hinder, delay, or defraud" FHI's creditors) or of constructive fraud (because FHI received no value), the transfers were fraudulent under Section 548 of the Bankruptcy Code<sup>18</sup> and California's fraudulent transfer statute.<sup>19</sup>

The bankruptcy court dismissed all claims that the Committee asserted against Hancock Park, the principals of Hancock Park, and PWB with prejudice for failure to state a plausible claim for relief. Thereafter, FHI's chapter 11 case was converted to a chapter 7 case. Following the appointment of the chapter 7 trustee, the trustee replaced the committee as the plaintiff in the litigation and appealed the bankruptcy court's dismissal of the complaint to the district court. The district court affirmed the bankruptcy court's ruling dismissing the case for failure to state a claim.<sup>20</sup> "The district court held that under longstanding precedent of the Ninth Circuit Bankruptcy Appellate Panel, Hancock Park's advances to Fitness Holdings were

recharacterized as equity.<sup>22</sup> The Courts of Appeals applying multifactor tests have not deviated significantly.<sup>23</sup> The Sixth Circuit laid out an 11-factor test. It considers 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 of capitalization, 6) the identity of interest between the creditor and the shareholder, 7) the security, if any, for the advances, 8) the corporation's ability to fund 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.<sup>24</sup>

The Third Circuit, however, noted that a "mechanistic scorecard" approach is not the answer to the recharacterization question.<sup>25</sup> As a result, while a formulaic checklist certainly assists the court in "analyzing whether a loan should be regarded as debt or equity, courts utilizing a multifactor test must contextualize the facts giving rise to the loan and keep in mind the economic realities surrounding such loan."<sup>26</sup> Further, the multifactor tests should be considered with the recognition that these tests are derived from

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1. The doctrine of equitable subordination is incorporated into the Bankruptcy Code.  
True.  
False.
2. The doctrines of recharacterization and equitable subordination are aimed at the same conduct.  
True.  
False.
3. The Ninth Circuit addressed for the first time the question of whether bankruptcy courts have the power to recharacterize debt to equity in *In re Fitness Holdings International, Inc.*  
True.  
False.
4. The Ninth Circuit's bankruptcy appellate panel in *In re Pacific Express* held that bankruptcy courts have the power to recharacterize debt to equity.  
True.  
False.
5. A basic concept underlying the Bankruptcy Code is that claims of creditors are entitled to distribution ahead of holders of equity interests in the debtor.  
True.  
False.
6. The Ninth Circuit's decision in *Fitness Holdings* rejected the earlier decision of the Ninth Circuit's bankruptcy appellate panel in *Pacific Express*.  
True.  
False.
7. The doctrine of recharacterization has its roots in tax law.  
True.  
False.
8. The Ninth Circuit was the first Court of Appeals to conclude that bankruptcy courts have the power to recharacterize claims.  
True.  
False.
9. The Ninth Circuit, in *Fitness Holdings*, found that a transfer that constitutes payment of a debtor's debt cannot be a constructively fraudulent transfer under Section 548 of the Bankruptcy Code.  
True.  
False.
10. In determining whether debt should be recharacterized to equity, the substance of the transaction will govern over the form of the transaction.  
True.  
False.
11. The Ninth Circuit used the bankruptcy court's power under Section 105 of the Bankruptcy Code as the basis for the court's authority to recharacterize debt as equity.  
True.  
False.
12. In *Fitness Holdings*, the Ninth Circuit found that whether there is a right to payment in the context of bankruptcy is determined by applicable nonbankruptcy law.  
True.  
False.
13. The basic rule in bankruptcy cases is that state law governs the substance of claims.  
True.  
False.
14. The doctrine of recharacterization is explicitly set forth in the Bankruptcy Code.  
True.  
False.
15. In *Fitness Holdings*, the Ninth Circuit held that a transaction creates a debt if it involves a right to payment under state law.  
True.  
False.
16. The Ninth Circuit, in *Fitness Holdings*, concluded that a bankruptcy court does not have the power to determine whether a transaction creates a debt or an equity interest for purposes of Section 548 of the Bankruptcy Code.  
True.  
False.
17. The majority approach adopted by Courts of Appeals addressing recharacterization in the bankruptcy context has used multifactor tests imported from tax cases.  
True.  
False.
18. In *Fitness Holdings*, the Ninth Circuit joined other Courts of Appeals in concluding that the Bankruptcy Code does not provide bankruptcy courts with the power, distinct and independent from equitable subordination, to recharacterize claims.  
True.  
False.
19. In cases involving tax matters, the Ninth Circuit has held that in attempting to determine the true intended substance of a funding transaction, courts consider the economic realities of the transaction at the time it was made and whether the parties intended the funding to be at the risk of the success of the business (equity) or a definite obligation payable in any event (debt).  
True.  
False.
20. In *Fitness Holdings*, the Ninth Circuit rejected the approach to recharacterization taken by the other Courts of Appeal, except for the Fifth Circuit in *In re Lothian Oil*.  
True.  
False.

tax cases involving very different issues than priority disputes in bankruptcy cases and take into account the realities of modern financing.<sup>27</sup>

The Eleventh Circuit adopted an alternative two-prong test that has been described as “amazingly broad.”<sup>28</sup> Under this minority approach, shareholder loans may be deemed as capital contributions in circumstances in which the trustee proves either initial undercapitalization or that the loans were made when no other disinterested lender would have extended credit.<sup>29</sup> In contrast, the Fourth Circuit has held that “a claimant’s insider status and a debtor’s undercapitalization alone will normally be insufficient to support the recharacterization of a claim.”<sup>30</sup>

In *In re Lothian Oil*,<sup>31</sup> the Fifth Circuit articulated a legal framework in which the actual test to be applied for recharacterization may be very similar to that applied by the majority of Courts of Appeals following the multifactor approach; however, a bankruptcy court must look to the applicable nonbankruptcy law (state law) to determine whether the claims at issue may be recharacterized as equity.<sup>32</sup> Further, the Fifth Circuit rejected the per se rule applied by the district court limiting application of recharacterization to insiders, stating, “Unless state law makes insider status relevant to characterizing equity versus debt, that status is irrelevant in federal bankruptcy proceedings.”<sup>33</sup>

### **Ninth Circuit’s Decision in *Fitness Holdings***

In *Fitness Holdings*, the Ninth Circuit addressed “whether a debtor’s prebankruptcy transfer of funds to its sole shareholder in repayment of a purported loan may be a constructively fraudulent transfer under 11 U.S.C. § 548(a)(1)(B).”<sup>34</sup> The Ninth Circuit found that the issue of recharacterization was squarely before it for the first time in the context of a bankruptcy case, stating, “In order to answer this question, we must determine whether a bankruptcy court has the power to recharacterize the purported loan as an equity investment.”<sup>35</sup> While *Pacific Express*<sup>36</sup> had previously found that bankruptcy courts lacked such power and were limited to utilizing the doctrine of equitable subordination as explicitly set forth in section 510(c) of the Bankruptcy Code, a district court in *Daewoo Motor America, Inc.*,<sup>37</sup> declined to follow *Pacific Express*.<sup>38</sup>

Ninth Circuit cases involving tax matters, however, have a long history of addressing recharacterization of debt to equity, and the court has held that in attempting to determine the intended substance of the transaction, “the court looks to the economic realities of the transaction at the time it was made and to whether the parties intended

their advance at that time to be at the risk of the success of the business (equity) or a definite obligation payable in any event (debt).”<sup>39</sup>

The commencement of FHI’s bankruptcy case created an estate comprising all its assets.<sup>40</sup> The estate’s representative (the chapter 7 trustee), in order to protect the interests of the estate, may bring an action to avoid a transfer made before the commencement of the case that is allegedly either intentionally fraudulent or constructively fraudulent.<sup>41</sup> A transfer is constructively fraudulent and can be avoided by the estate’s representative<sup>42</sup> if the debtor made the transfer on or within two years before the date of the filing of the bankruptcy petition, the debtor “received less than reasonably equivalent value in exchange for such transfer or obligation,” and, in general, the debtor was insolvent or was rendered insolvent by the transfer or obligation.<sup>43</sup>

In analyzing the requirement for a constructively fraudulent transfer that the debtor “received less than a reasonably equivalent value in exchange for such transfer or obligation,”<sup>44</sup> the Ninth Circuit examined a series of interlocking statutory definitions.<sup>45</sup> The phrase “reasonably equivalent value” used in Section 548(a)(1)(B)(i) is not defined in the Bankruptcy Code.<sup>46</sup> However, “value” is defined and includes the “satisfaction or securing of a present or antecedent debt of the debtor.”<sup>47</sup> “Under this definition, [p]ayment of a preexisting debt is value, and if the payment is dollar-for-dollar, full value is given.”<sup>48</sup> Accordingly, the Ninth Circuit found that “to the extent a transfer constitutes a repayment of the debtor’s antecedent or present debt, the transfer is not constructively fraudulent.”<sup>49</sup>

The Ninth Circuit next addressed the definition of the term “debt.” The term is defined as “liability on a claim” in the Bankruptcy Code.<sup>50</sup> The Bankruptcy Code defines “claim,” in relevant part, as “a 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.”<sup>51</sup> “The Code thus broadly defines ‘debt’ as liability on virtually any type of ‘right to payment.’”<sup>52</sup>

The Ninth Circuit then turned to the determination of whether there is a “‘right to payment’ that constitutes a ‘claim’ under the [B]ankruptcy Code.”<sup>53</sup> Following U.S. Supreme Court precedent, the Ninth Circuit found that the nature and scope of a right to payment in bankruptcy is determined by applicable nonbankruptcy law, “The Supreme Court has ‘long recognized that the basic federal rule in bankruptcy is that state law governs the substance of claims, Congress having generally left the determination of property rights in the assets of a bankrupt’s

estate to state law.’”<sup>54</sup> The Ninth Circuit found that “subject to any qualifying provision to the Bankruptcy Code... a court must determine whether the asserted interest in the debtor’s assets is a ‘right to payment’ recognized under state law.”<sup>55</sup>

The Ninth Circuit concluded that a bankruptcy court has the power to determine whether a transaction creates a debt or an equity interest for purposes of Section 548, whether a transaction creates a debt if it creates a “right to payment” under state law, and whether, if it did not, the court may recharacterize the debt to equity under applicable state law.<sup>56</sup> By rejecting *Pacific Express*, the Ninth Circuit was joining the other Courts of Appeals in concluding that the Bankruptcy Code provides courts with the authority to recharacterize claims in bankruptcy cases.<sup>57</sup> However, the Ninth Circuit also rejected the recharacterization framework for the inquiry taken by the other Courts of Appeals, except for the Fifth Circuit in *Lothian Oil*.<sup>58</sup> Accordingly, the Ninth Circuit remanded the question of constructively fraudulent transfer to the district court and explained that viewing the claim through the correct lens “requires the identification of the pertinent legal principles under applicable state law.”<sup>59</sup>

The question of recharacterization of debt to equity has its roots in tax law and therefore most frequently has been addressed in federal court.<sup>60</sup> Nonetheless, law has developed in various states recognizing debt recharacterization as a potential defense to the enforceability of insider loans.<sup>61</sup>

While the Ninth Circuit did not expressly address the question of applicable state law in its published opinion of *Fitness Holdings*, the Hancock Park notes contain governing law provisions providing for the application of California law, and *Fitness Holdings* is a Delaware corporation.<sup>62</sup> California and Delaware state laws, however, have not yet definitively addressed the question of recharacterization of debt to equity. State courts would likely apply a multifactor test along the lines of those used by the Ninth Circuit in tax cases and the Third, Fourth, Sixth, and Tenth Circuits in bankruptcy matters. The multifactor tests, however, may possibly conflict with general principles of contract interpretation under state law to the extent that they allow external circumstances to override the express intent of the parties set forth in the transaction documents. Furthermore, certain multifactor tests take equitable considerations into account, while others preclude them.<sup>63</sup> If a claimant’s behavior is taken into account in the recharacterization inquiry and a driving factor in the analysis is fairness and equity, the line between equitable subordination and recharacterization blurs, thereby determining that the applicable form of relief

is equitable subordination and not recharacterization.

Whether an investment is determined to be debt or equity can have significant impact in tax and bankruptcy situations. However, the setting for addressing these issues is very different in bankruptcy from tax matters, which frequently involve solvent companies. The focus of analysis in a tax case is whether a transaction between the investor and the corporation should be deemed to be a debt that would generate a tax benefit to the investor. In contrast, in a bankruptcy case, the issue is frequently whether the claimant/investor who provided a "loan" to a financially distressed enterprise should be treated on par with other creditors or be subordinated. Nonetheless, the law of recharacterization of debt to equity, as applied in bankruptcy cases, has generally been imported from federal tax law.

Ultimately, recharacterization is a question of fact that must be addressed on a case-by-case basis.<sup>64</sup> The question is whether the parties to the transaction intended the "loan" to be a disguised equity contribution. Their intent may be inferred from what is stated in the contract, from what the parties do, and from the economic reality of the circumstances. It is imperative, however, that the economic realities of modern finance and the frequently limited options available to financially distressed businesses are recognized. Much of modern financing can be viewed as falling on a continuum between conventional debt and equity. Moreover, an insider is often the only source of funds for a struggling company. Recharacterization should not be applied in a manner that discourages good faith loans or that defines debt financing in a more limited way than in the real world of modern finance. ■

<sup>1</sup> See *O'Donnell v. Tristar Esperanza Props., LLC* (In re Tristar Esperanza Props., LLC), 488 B.R. 394, 404 (9th Cir. B.A.P. 2013).

<sup>2</sup> *Id.*, citing *In re Granite Partners, L.P.*, 208 B.R. 332, 344 (Bankr. S.D. N.Y. 1997) and 11 U.S.C. § 1129(b)(2)(B)(ii).

<sup>3</sup> *Gernsbacher v. Campbell* (In re Equip. Equity Holdings, Inc.), 2013 Bankr. LEXIS 1526, at \*139 (Bankr. N.D. Tex. 2013).

<sup>4</sup> 11 U.S.C. § 510(c).

<sup>5</sup> *In re Equip. Equity Holdings, Inc.*, 2013 Bankr. LEXIS 1526, at \*139.

<sup>6</sup> *Id.*

<sup>7</sup> See *Cohen v. KB Mezzanine Fund II, LP* (In re SubMicron Sys.), 432 F. 3d 448, 454 (3d Cir. 2006); *In re Equip. Equity Holdings, Inc.*, 2013 Bankr. LEXIS 1526, at \*139-40; *Daewoo Motor Am., Inc. v. Daewoo Motor Co., Ltd.* (In re Daewoo Motor Am., Inc.), 471 B.R. 721, 734-35 (C.D. Cal. 2012); *Daewoo Motor Am., Inc. v. Daewoo Motor Co., Ltd.* (In re Daewoo Motor Am., Inc.), 2010 Bankr. LEXIS 6302, \*34-35 (Bankr. C.D. Cal. 2010).

<sup>8</sup> See *Unsecured Creditors' Comm. v. Pioneer Com'l Funding Corp.* (In re Pacific Express, Inc.), 69 B.R. 112, 115 (9th Cir. B.A.P. 1986).

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<sup>9</sup> See *In re SubMicron Sys.*, 432 F. 3d at 454; *In re Equip. Holdings, Inc.*, 2013 Bankr. LEXIS 1526, at \*139-40; *In re Daewoo Motor Am., Inc.*, 471 B.R. at 734-35.

<sup>10</sup> Official Comm. of Unsecured Creditors v. Hancock Park Capital (*In re Fitness Holdings Int'l, Inc.*), 2013 U.S. App. LEXIS 8729 (9th Cir. 2013).

<sup>11</sup> *In re Daewoo Motor Am., Inc.*, 471 B.R. at 730.

<sup>12</sup> *In re Pacific Express, Inc.*, 69 B.R. at 115; see 11 U.S.C. §510(c).

<sup>13</sup> *In re Fitness Holdings Int'l, Inc.*, 2013 U.S. App. LEXIS 8729, at \*16-17; *Grossman v. Lothian Oil, Inc.* (*In re Lothian Oil*), 650 F. 3d 539, 542-43 (5th Cir. 2011); *In re SubMicron Sys.*, 432 F. 3d 448, 454 (3d Cir. 2006); *In re Dornier Aviation*, 453 F. 3d 225, 231 (4th Cir. 2006); *Sender v. The Bronze Group Ltd.* (*In re Hedged-Investments Assoc., Inc.*), 380 F. 3d 1292, 1298 (10th Cir. 2004); *Bayer Corp. v. MascoTech, Inc.* (*In re Autostyle Plastics, Inc.*), 269 F. 3d 726, 748 (6th Cir. 2001).

<sup>14</sup> See *In re Fitness Holdings Int'l, Inc.*, 213 U.S. App. LEXIS 8729, at \*3. For the facts of the *Fitness Holdings* case, see the Ninth Circuit's published opinion and various pleadings filed in the underlying adversary proceeding, bankruptcy case no. 2:08-bk-27527-BR, adversary proceeding no. 2:09-ap-01610-BR, and docket nos. 20, 44, 59, and 72 in the adversary proceeding. The author's law firm was counsel to the debtor in possession in the chapter 11 case of FHI but did not participate in the adversary proceeding.

<sup>15</sup> *In re Fitness Holdings Int'l, Inc.*, 213 U.S. App. LEXIS 8729, at \*4 (9th Cir. 2013).

<sup>16</sup> *Id.* at \*4-5.

<sup>17</sup> The committee asserted claims against Hancock Park and PWB for alleged fraudulent transfers based on constructive fraud under Section 548(a)(1)(B) of the Bankruptcy Code and Section 3439.04(a)(2) of the California Civil Code, and for fraudulent transfers based on actual fraud under Section 548(a)(1)(A) of the Bankruptcy Code and Section 3439.04(a)(1) of the California Civil Code.

<sup>18</sup> 11 U.S.C. §548.

<sup>19</sup> Civ. CODE §3439.04(a).

<sup>20</sup> *In re Fitness Holdings Int'l, Inc.*, CV 10-0647 AG, 2011 U.S. Dist. LEXIS 155104, 2:08-bk-27527-BR, 2011 WL 7763674, at \*1 (C.D. Cal. Aug. 31, 2011). See also *In re Fitness Holdings Int'l, Inc.*, 213 U.S. App. LEXIS 8729, at \*6 (9th Cir. 2013).

<sup>21</sup> *Id.* (citing *In re Fitness Holdings Int'l, Inc.*, 2011 U.S. Dist. LEXIS 155104, at \*5).

<sup>22</sup> 11 U.S.C. §105(a).

<sup>23</sup> See *In re Autostyle Plastics, Inc.*, 269 F. 3d 726, 747-53 (6th Cir. 2001); *In re SubMicron Sys. Corp.*, 432 F. 3d 448, 455 n.8 (3d Cir. 2006); *In re Dornier Aviation (N. Am), Inc.*, 453 F. 3d 225, 233-34 (4th Cir. 2006); *In re Hedged-Invs. Assocs., Inc.*, 380 F. 3d 1292, 1298 (10th Cir. 2004).

<sup>24</sup> *In re Autostyle Plastics*, 269 F. 3d at 749-50.

<sup>25</sup> *In re SubMicron Sys. Corp.*, 432 F. 3d at 456.

<sup>26</sup> *In re Equip. Equity Holdings, Inc.*, 2013 Bankr. LEXIS 1526, at \*146 (Bankr. N.D. Tex. 2013).

<sup>27</sup> *Id.* at \*147-49 (citation omitted).

<sup>28</sup> *Id.* (citing *Estes v. N & D Props., Inc.* (*In re N&D Props., Inc.*), 799 F. 2d 726, 733 (11th Cir. 1986)).

<sup>29</sup> *In re Equip. Equity Holdings, Inc.*, 2013 Bankr. LEXIS 1526, at \*141-42 (citing *In re N&D Props., Inc.*, 799 F. 2d at 733); *Diasonics, Inc. v. Ingalls*, 121 B.R. 626, 631 (Bankr. N.D. Fla. 1990); and *Mukamal v. Bakes*, 383 B.R. 798, 829 (S.D. Fla. 2007)).

<sup>30</sup> *In re Dornier Aviation (N. Am), Inc.*, 453 F. 3d at 225, 234 (4th Cir. 2006).

<sup>31</sup> *In re Lothian Oil*, 650 F. 3d at 539, 543 (5th Cir. 2011).

<sup>32</sup> *Id.*

<sup>33</sup> *Id.* at 544-45.

<sup>34</sup> *In re Fitness Holdings Int'l, Inc.*, 2013 U.S. App.

LEXIS 8729, at \*2 (9th Cir. 2013). Remaining claims are addressed in an unpublished memorandum (docket no. 46 in 9th Cir. case no. 11-56677) issued contemporaneously with the published opinion. *Id.*, at \*3 n.1.

<sup>35</sup> *Id.* Because the bankruptcy court and the district court dismissed the trustee's complaint for failure to state a claim, the standard of review applied by the 9th Circuit was de novo and the question was whether the plaintiff had failed to allege a plausible claim for relief. *Id.*, at \*7.

<sup>36</sup> *In re Pacific Express, Inc.*, 69 B.R. 112, 115 (9th Cir. B.A.P. 1986).

<sup>37</sup> *In re Daewoo Motor Am., Inc.*, 471 B.R. 721 (C.D. Cal 2012).

<sup>38</sup> *Id.* at 730.

<sup>39</sup> *In re Daewoo Motor Am., Inc.*, 2010 Bankr. LEXIS 6302 at \*36-37 (Bankr. C.D. Cal. 2010).

<sup>40</sup> Schwab v. Reilly, 130 S. Ct. 2652, 2657 (2010); *In re Fitness Holdings Int'l, Inc.*, 213 U.S. App. LEXIS 8729 at \*8 (9th Cir. 2013).

<sup>41</sup> 11 U.S.C. §548(a)(1)(A) (intentional fraud); 11 U.S.C. §548(a)(1)(B) (constructive fraud). See *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 535, 114 S. Ct. 1757 (1994).

<sup>42</sup> 11 U.S.C. §550.

<sup>43</sup> 11 U.S.C. §548(a)(1)(B)(i).

<sup>44</sup> 11 U.S.C. §548(a)(1)(B).

<sup>45</sup> *In re Fitness Holdings Int'l, Inc.*, 2013 U.S. App. LEXIS 8729 at \*10 (9th Cir. 2013).

<sup>46</sup> *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 535 (1994); *In re Fitness Holdings Int'l, Inc.*, 2013 U.S. App. LEXIS 8729 at \*10.

<sup>47</sup> 11 U.S.C. §548(d)(2)(A).

<sup>48</sup> *In re Fitness Holdings Int'l, Inc.*, 2013 U.S. App. LEXIS 8729, at \*10 (citing 5 COLLIER ON BANKRUPTCY ¶548.03[5] (16th ed. 2012)).

<sup>49</sup> *Id.* (citing *Freeland v. Enodis Corp.*, 540 F. 3d 721,

735 (7th Cir. 2008)).

<sup>50</sup> 11 U.S.C. §101(12); see also *Johnson v. Home State Bank*, 501 U.S. 78, 84 n.54 (1991).

<sup>51</sup> 11 U.S.C. §101(5)(A).

<sup>52</sup> *In re Fitness Holdings Int'l, Inc.*, 2013 U.S. App. LEXIS 8729, at \*11.

<sup>53</sup> *Id.* at \*12.

<sup>54</sup> The Ninth Circuit stated that the term "state law" is often used "expansively...to refer to all nonbankruptcy law that creates substantive claims." *Grogan v. Garner*, 498 U.S. 279, 284 n.9, 111 S. Ct. 654, 112 L. Ed. 2d 755 (1991). See also *In re Fitness Holdings Int'l, Inc.*, 2013 U.S. App. LEXIS 8729 at \*12-13 (9th Cir. 2013) (citing *Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co.*, 549 U.S. 443, 450, 127 S. Ct. 1199 (2007) (internal quotation marks omitted)); *Butner v. United States*, 440 U.S. 48, 54, 99 S. Ct. 94 (1979).

<sup>55</sup> *In re Fitness Holdings Int'l, Inc.*, 2013 U.S. App. LEXIS 8729 at \*13-14 (quoting *Raleigh v. Illinois Dep. of Revenue*, 530 U.S. 15, 20, 120 S. Ct. 1951 (2000)). In a bankruptcy case, claims generally are to be allowed, except to the extent "unenforceable against the debtor and property of the debtor, under any agreement or applicable law...." 11 U.S.C. §502(b).

<sup>56</sup> *In re Fitness Holdings Int'l, Inc.*, 2013 U.S. App. LEXIS 8729, at \*15. While the Trustee brought a "recharacterization" claim as a separate cause of action, the Ninth Circuit interpreted his claim "as a request for a determination that Fitness Holdings' transfer to Hancock Park was not made in repayment of a 'debt' as that term is defined in the Code." *Id.* at \*8 n.4.

<sup>57</sup> *Id.* at \*16.

<sup>58</sup> *Id.* at \*17-20 (citations omitted). *Lothian Oil* involved loan agreements providing that repayment would be in the form of equity interests and royalties and did not provide for interest rates or maturity dates.

The court construed the debtor's request to recharacterize the loans as equity as a request to disallow the lender's claim under Bankruptcy Code Section 502 on the grounds that the purported loans were "unenforceable against the debtor and property of the debtor, under any agreement or applicable law." *Id.* at 543 (quoting 11 U.S.C. §502(b)(1)).

<sup>59</sup> *In re Fitness Holdings Int'l, Inc.*, 2013 U.S. App. LEXIS 8729, at \*22-23 (9th Cir. 2013).

<sup>60</sup> *In re Daewoo Motor Am., Inc.*, 471 B.R. 721, 729 (C.D. Cal. 2012) (citing *A.R. Lantz Co. v. United States*, 424 F. 2d 1330, 1330-31 (9th Cir. 1970)).

<sup>61</sup> *American Twine Ltd. P'ship v. Whitten*, 392 F. Supp. 2d 13, 21 (D. Mass. 2005); *Arch Petroleum, Inc. v. Sharp*, 958 S.W. 2d 475, 477 n.3 (Tex. Ct. App. 1997); *In re Tenzanzi v. Fiberglass Swimming Pools, Inc.*, 414 A. 2d 484 (R.I. 1980); *Jelatt v. DeDakis (In re Mader's Store for Men)*, 254 N.W. 2d 171, 185-87 (Wis. 1977); *Schaub v. Kortgard*, 372 N.W. 2d 427, 430 (Minn. Ct. App. 1985). See *In re Daewoo Motor Am., Inc.*, 471 B.R. 734-35.

<sup>62</sup> See *In re Fitness Holdings Int'l, Inc.*, no. 2:08-bk-27527-BR, adversary proceeding no. 2:09-ap-01610-BR, docket no. 20. Under the internal affairs doctrine, courts apply the law of the state of incorporation to govern claims that implicate a corporation's internal affairs. *Batchelder v. Kawamoto*, 147 F. 3d 915, 929 (9th Cir. 1998).

<sup>63</sup> Compare, e.g., *In re Daewoo Motor Am., Inc.*, 471 B.R. at 734-35; *American Twine*, 392 F. Supp. 2d at 21.

<sup>64</sup> See *Submicron Sys.*, 432 F. 3d 448, 455-56 (3d Cir. 2006); *Friedman's Liquid. Trust v. Goldman Sachs Credit Ptnrs. (In re Friedman's, Inc.)*, 452 B.R. 512, 518-19 (Bankr. D. Del. 2011); *Radnor Holdings Corp. v. Tennenbaum Capital Ptnrs.*, 353 B.R. 820, 838-39 (Bankr. D. Del. 2006).

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