Dequity

The Blurring of Debt and Equity in Securitized Real Estate Financing

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Synopsis: This paper explores the legal differentiation of equity and debt in subordinate real estate financing. Various financing vehicles that occupy a gray space between true debt and true equity have replaced traditional asset secured debt lending. This paper investigates the legal rights and responsibilities of parties functioning in the gray area. The goal of this examination is to identify potential conflicts and unforeseen consequences of investments possessing attributes of both equity and debt in the event of default.

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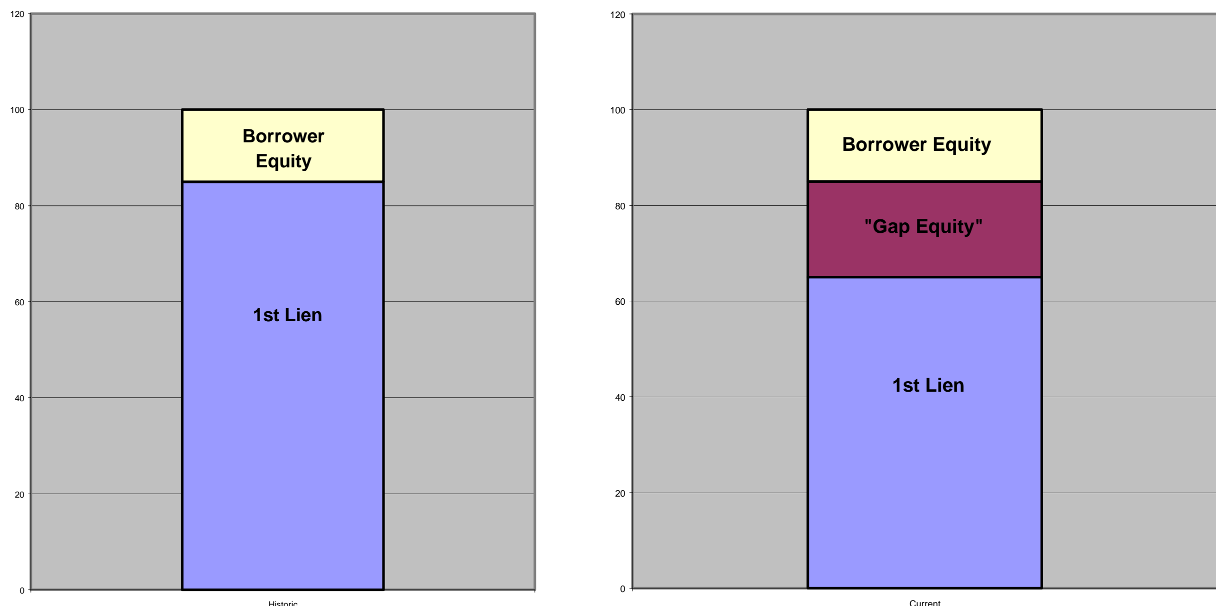
There was a time in the not so distant past when a real estate borrower and lender entered into a financing transaction whereby, in exchange for a nonrecourse loan of upwards to 90% of the value of the asset, the borrower would grant the lender a first lien mortgage on the real property. The legal rights and obligations between borrower and lender were uncontroversial and quite straightforward. If the borrower failed to pay, the lender was limited to a single (yet powerful) course of action: foreclosure.

Fast-forward to today's real estate market. Lenders and borrowers are no longer working in an insular decision making mode. Unlike more traditional corporate finance, where the firm makes shifting internal decisions as to debt/equity ratio in its capitalization, real estate firms have a more static debt ceiling imposed by external forces. Securitization of commercial real estate loans in the Commercial Mortgage Backed Securities ("CMBS") market imposes a market discipline that generally caps Loan to Value (LTV) ratios of



first lien debt no higher than 65% (remaining 35% as borrower equity).[1] In other words, required borrower equity has increased by 25%. I will refer to this funding hole as the "gap equity." Borrowers with a seemingly insatiable taste for leverage will seek to plug this gap with additional third party financing.

The most straight forward choice would be to finance this gap equity through obtaining a second loan on the property. A subordinate lien on the asset would secure this second loan. However, the rating agencies in CMBS transactions frown on what would traditionally be denominated a "hard second," leaving borrowers and other capital investors to fashion new forms of capital infusion. These alternative forms of capitalization have attributes of both debt and equity, hence the moniker "dequity."[2]

But what exactly does a holder of these dequity obligations possess? As we walk the middle road between true first lien debt and pure borrower equity, the legal rights and obligations of the parties blur. This paper will highlight some of the more common methods of financing gap equity to illustrate why this new financing has attributes of both equity and debt and how this melding affects the legal relationship between owner and investor.

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[1] See eg, Nicholas Levidy & Tad Philipp *CMBS: Moody's Approach to A-B Notes and other Forms of Subordinate Debt*, MOODY'S INVESTORS SERVICE STRUCTURED FINANCE SPECIAL REPORT, February 4, 2000 pp. 2-4; Sameer Nayar & Tad Philipp, *CMBS:Moody's Approach to Rating Large Loan/Single Borrower Transactions*, MOODY'S INVESTORS SERVICE STRUCTURED FINANCE SPECIAL REPORT, July 7, 200, p. 3-4.

[2] For discussion of intersection between debt and equity, see Matthew P. Haskins, *Can the IRS Maintain the Debt-Equity Distinction in the Face of Structured Notes?*, 32 HARV. J. ON LEGIS. 525 (1995); Charles P. Normandin, *The Changing Nature of Debt and Equity: a Legal Perspective, in* ARE THE DISTINCTIONS BETWEEN DEBT AND EQUITY DISAPPEARING? (Richard W. Kopcke & Eric S. Rosengren, eds., 1989).

By innovating around the twin prohibitions on over leveraging and subordinate debt, the market offers a smorgasbord of alternatives to finance gap equity. Due to pressure from the rating agencies, firms and investors create hybrid investment vehicles while trying carefully to denominate these investments are more “equity like” and less “debt like.” The open question is what happens upon default? Could a court recharacterize the dequity investment granting (or limiting) rights of the parties? Furthermore, can contractually agreed upon ordering of creditors (through such documents such as intercreditor agreements) withstand the pressure of recharacterization?

Contract theory will be the analytic engine propelling this discussion. Specifically, this paper will compare the effect of discrete contracts (debt-like instruments) and relationship contracts (equity-like instruments) on the rights and obligations of subordinate lenders financing the gap equity. Naturally while the loan is in good standing, the legal effect of the type of financing of gap equity is close to inconsequential (although there certainly may be economic differences). As long as everyone is getting paid, all parties are happy. The differences matter only in the event of default. While the rights of the holder of a true second mortgage are well traveled and the rights of the holder of equity are well known, the rights of those who fall somewhere between debt and equity, the dequity holders, are subject to a certain amount of conjecture.

For background to the analysis, Section One of this paper will first introduce the CMBS market and its influence over commercial mortgage finance. Then, in light of the financing changes in today’s real estate finance market, several alternatives to straight

debt/straight equity will be analyzed in Section Two. To a varying degree, these alternatives have attributes of both equity and debt. The third section examines how and when debt and equity are differentiated. Both economic and accounting differences are discussed, but the emphasis will fall on how and why legal distinctions are made between equity and debt. Finally, Section Four turns to the potential shifting of economic and legal strategies if an investment is recharacterized. The goal of this paper is to heighten awareness of potential issues in default when real estate capitalization incorporates not only equity and debt but also intermediate and combination vehicles.

I. Overview of the CMBS Market

In the aftermath of the real estate recession of the late 1980's an infusion of "Wall Street" money began to flow into "Main Street" real estate.[3] Real estate financing shifted away from whole loans (retail or "Main Street" loans) to the sale of securities backed by the income stream produced by loans ("Wall Street").[4] Currently, these Wall Street securities represent a $347.9 billion[5] market commanding almost a 20% share of all commercial real estate financing.[6] Even this 20% figure is somewhat misleading. Although only 1/5 of the present market may be securitized, the policies, practices and limitations of the CMBS market bleed into the entire commercial market because many lenders underwrite

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[3] *See* Joseph Forte, *Wall Street Remains a Key Player in Commercial Real Estate Financing Despite Capital Market Fluctuations*, 73 N.Y. ST. B.J. 34 (2001).
[4] For a complete history of the origins of the CMBS market, see Georgette C. Poindexter, *Subordinated Rolling Equity, Analyzing Real Estate Loan Defaults in the Era of Securitization*, 50 EMORY L.J. 519 (2001).
[5] Federal Reserve Board of Governors, *Flow of Funds Accounts of the United States*, March 10, 2005. [
[6] The size of the commercial real estate finance market is $1.693 trillion. *Id*..

with an eye towards potential resale of the loans onto the secondary market.[7] Therefore, the practices of the CMBS market have far reaching, percussive effects throughout the entire real estate industry.

The process of securitizing commercial mortgages requires amassing a pool of loans that produce an income stream. Investment banks sell security instruments that are funded through the income received from the monthly payment of principal and interest on the underlying loans. The quality of this income stream naturally determines the character of the securities that can be sold.[8]

Rating agencies, such as Moody's, Standard & Poor's or Fitch, play an integral role in any CMBS transaction. These agencies classify the securities by assessing the quality of the underlying income stream. In their analysis, the agencies focus on two key factors: the probability of default and the severity of loss.[9] In other words, they ask what is the likelihood that an investor will not be paid on time (due to interruptions in the underlying cash flow) and, if there is a loss, what percent of the pool will be impacted?

In sizing and tranching the pool one of the most important determinants employed by the rating agencies is the loan to value ratio. The amount of leverage placed on the asset must be capped low enough to withstand a drop in market value. Otherwise the lender

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[7] Because of the sheer volume of the commercial real estate market, the potential size of the CMBS market could dwarf any other, including corporate debt. Michael Madison, *The Real Properties of Contract Law*, 82 B.U. L. Rev 405, 464 (2002).

[8] For a complete explanation of the process see, Poindexter, *supra* note 4, at 535-41.

[9] Neil D. Baron, *The Role of Rating Agencies in the Securitization Process* 81, *in* A PRIMER ON SECURITIZATION (Leon Kendall & Michael Fishman eds. 1996).

may suffer losses after foreclosure due to the non-recourse nature of the loan. Although 80-90% LTV commercial loans were commonplace prior to the real estate depression of the early 1990s, more conservative underwriting practices have led to a 65% limit on LTV. [10] In other words, the lien can be no more than 65% of the value of the asset. In the event of foreclosure this allows the property value to drop 35% without the lender sustaining a loss.

Loan to value ratios, however includes *all* debt encumbering the asset. With this in mind, rating agencies drill down into the transaction to analyze subordinate financing. At the inception of the CMBS market, rating agencies essentially prohibited traditional subordinate financing because second mortgages have the ability to impact the value of the asset. However, as the market has matured,[11] rating agencies have acknowledged that the method (as opposed to the mere existence) of subordinate financing defines the important issue.[12] Therefore they have presented the parameters of the impact of several types of subordinate financing. For example, if we assume that the Aaa component of the offering is 40% LTV (with a 65/25 Senior/Subordinate split) the Aaa tranche will be

[10] Horowitz & Morrow, *Mezzanine Financing,* REAL ESTATE FINANCING DOCUMENTATION: STRATEGIES FOR CHANGING TIMES, SK006 ALI-ABA 961, 963-4. See also, Baron, supra note 9, at 84-85. Using residential securitization as an example, the author points out that during the Texas real estate depression in the 1980s (when LTV ratios often hovered around 90%), 3% of loans with a 60% LTV, 25% of loans with a 90% LTV, and all loans with 100% LTV defaulted.

[11] Current estimates on the size of the mezzanine market range from $65,000,000,000 to $135,000,000,000. Kathleen Fitzpatrick, *Mezz Debt is a Magnet for Borrowers and Lenders*, NATIONAL REAL ESTATE INVESTOR 1, Feb 1, 2003.

[12] For a detailed and descriptive explanation of how rating agencies view the default impact of these several forms of gap financing, see Nicholas Levidy & Tad Philipp, *CMBS: Moody's Approach to A-B Notes and other Forms of Subordinate Debt*, MOODY'S INVESTORS SERVICES STRUCTURED FINANCE SPECIAL REPORT, Feb. 4, 2000 *supra note 1*.

reduced by 1.5% to 5%, depending on the type of subordinate financing. As an example, this is how Moody's would interpret different forms of subordinate financing:[13]

Form of Subordinate Debt	Reduction from Aaa tranche
Preferred Equity	1.5-2.5
Mezzanine Debt	1.5-2.5
A/B Notes	3.0-4.0
Second Mortgage	4.0-5.0

Thus, the pricing of the senior debt is a function of the rights of the holders of subordinate financing. As the rights of subordinate investors to demand payment is curtailed, the value of the first lien is increased. To maximize the value of their loan to the mortgage pool (and therefore reduce the cost of their financing since reductions from the Aaa tranche increase the cost of borrowing), the real estate firm seeking financing should limit the "debt" like attributes of the subordinate investment just up to the point of satisfying the tranching requirements of the rating agencies.

II. Bridging the Gap Between Debt and Equity

In response to the CMBS market's hard line on leverage ratios, real estate finance has moved beyond straight debt/straight equity into an era of more creative gap-bridging finance. This gap equity can be funded through several different vehicles ranging from more "equity-like" to more "debt-like.". Common financing responses include: issuance of preferred equity in the borrower, mezzanine loans, A/B loans and "soft seconds" in the form of subordinated mortgages. Concomitant with such creativity, though, comes the

[13] *Id.* By way of explanation this means that if the loans in the pool had second mortgages the Aaa tranche would be reduced by 4-5%. From an economic perspective the more of the pool pushed into the higher rated tranches (which have a lower yield), the better for the issuer.

loss of a bright line to delineate rights and obligations of the parties. Before discussing how these intermediate investments impact the relationship between the firm and the investor a brief explanation of each vehicle is in order beginning with the most "equity-like" and ending with the most "debt-like".[14]

Preferred equity

Preferred equity is when a financing source makes a capital contribution to mortgage borrower in exchange for an equity share in the borrower. This equity is preferred in right of payment over the common equity in borrower. Holders of the preferred equity are entitled to preferred distribution of the borrower's excess cash flow until equity is repaid plus agreed upon return on preferred equity. This form of investment steps away from true equity in that holders obtain a debt-like attribute of payment preference over all other types of equity (although, of course, the holders of the "common equity" may have preferred distribution rights as among themselves as a class).

Mezzanine debt

A mezzanine loan is a loan to the equity holders of a mortgage borrower secured by a pledge of equity interests in the mortgage borrower.[15] This is a relatively large and robust

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[14] More information about these vehicles can be obtained from Levidy & Philipp, *supra* note 12. *See also* Christopher Dunn*, Criteria on A/B structure in CMBS Transactions*, STANDARD & POOR'S STRUCTURED FINANCE, May 15, 2000; Stephen Choe & Huxley Somerville, *ABCs of A/B Notes—Evaluating A/B Note Structures in Commercial Mortgage Transactions*, FITCH IBCA STRUCTURED FINANCE, March 6, 2000; Daniel Chambers and Robert Vrchota, *ABCs of A/B/C Notes—Evaluating A/B/C Note Structures in Commercial Mortgage Transactions*, FITCHRATINGS STRUCTURED FINANCE, December 10, 2001; Joseph P. Forte, *Mezzanine Finance: A Legal Background*, CMBS WORLD 20-25, Spring 2002.

[15] For a concise discussion of the use of mezzanine debt in real estate financing, see William G. Murray, Jr., *Mezzanine Financing*, 489 PRACTICING L. INST. REAL EST. L. 247 (2003). Mezzanine loans tend to be a shorter term investment, . *Horowitz & Morrow, supra note 1 at 978*.

market ranging from $65B to $135B.[16] Obligors on the note are the equity holders of the borrower—not the mortgage borrower. The mezzanine lender has the ability to foreclose on the equity in the borrower in the event of a default, and would assume ownership and control of mortgage borrower and effective control of the mortgaged property (subject to liens and encumbrances).

This scenario presents a somewhat confounding mixture of equity and debt attributes. Nominally debt, it differs from true mortgage debt because it is debt not of the asset's owner, but rather that of the asset's equity holders. It is more akin to convertible debt in the corporate world, but the exercise point is default; i.e., the strike price is zero.[17] Even this analogy, though, falls short because it reverses normal economic incentives. In convertible debt the holder generally exercises the conversion option to take advantage of the arbitrage advantage between the conversion price and the prevailing stock price.[18] Here conversion theoretically would occur upon the diminution in value of the firm (and, by extension, of the firm's equity value).

A/B loans

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[16] Kathleen Fitzpatrick, *Mezz Debt is a Magnet for Borrowers and Lenders*, NAT'L REAL EST. INVESTOR 1, 1, Feb 1, 2003.

[17] An alternative analogy would be that the equity owners have effectively sold their firm to the mezzanine lender but hold a call option to buy the firm back with a strike price equal to principal + interest on the loan.

[18] *See*, Herwig J. Schlunk*, Little Boxes: Can Optimal Commodity Tax Methodology Save the Debt-Equity Distinction?*, 80 TEX. L. REV. 859, 884 (2002) ("Economically, convertible debt is like equity when equity performs well (because the debt will be converted) but is like debt when equity performs badly (and the conversion feature is not exercised)."). Interestingly, in contrast to convertible debt, convertible preferred stock is one shade closer to equity in that it posses precisely the attribute that emerges when the mezzanine "debt" is foreclosed upon: right to corporate governance. In fact venture capitalists prefer convertible preferred stock to convertible debt precisely because it confers upon them this right to participate in firm governance. See, Deborah A. DeMott, *Agency and the Unincorporated Firm*, 54 WASH. LEE LAW REV. 595, 607 (1997).

The A/B structure is a variation on the standard participation loan in that it represents a senior and junior co-lending arrangement within a first mortgage loan[19]. The fundamental shift here is that whereas mezzanine debt is secured by the equity in the borrower purchasing the underlying real estate, the B piece in an A/B structure is secured by the real estate itself. There is single note and single mortgage but the ownership of loan is divided into two interests, an A and a B. The A note is securitized in a CMBS transaction and the B note is usually sold to a third party and held outside the CMBS transaction.[20]

The distinction between this structure and a more standard participation scenario is that there is payment priority and loss allocation. In standard participation all payments are *pari passu*. Likewise, in most A/B transactions, the note holders are paid pro rata before a default. However, in an A/B transaction, payments are senior subordinated in event of default, meaning that there is sequential pay first to A then to B. Likewise, losses incurred are allocated from bottom up, starting with B's interest. This technique moves us closer to debt-like attributes, especially before default. After default, however, the B note holder (who previously has waived its rights in bankruptcy) is in a weaker position than an ordinary second lien holder because of an intercreditor agreement that (among other requirements) forces the B holder to "stand still" in the event of default.

"Soft Second" Subordinated debt

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[19] This structure has been even further modified to include A/B/C notes where the C piece is unrated. For further explanation, see Chambers & Vrchota, supra n. 14, at 1.
[20] See, Choe & Somerville, supra note 14. Generally there is one long term (7-10 years) issued by a large institutional lender which is then split internally. The "A" piece is sold into a CMBS pool. The "B" piece is either held by the issuer or sold separately.

A subordinated mortgage is a loan secured by lien on property that is subordinate in priority to the first mortgage lien. Generally, though, rating agencies prohibit second liens behind a securitized first, as it is contrary to the bankruptcy's fundamental goal of remoteness. To ameliorate (but not eliminate) this prohibition the second lender will sign a "stand still" agreement making it a "soft second." In the standstill agreement, the second lender agrees not to interfere with the foreclosure on the first and may waive rights in bankruptcy. Obviously, this is the closest to "straight debt" of all the alternatives presented.

The Equity – Debt Continuum

As with other types of corporate finance, these alternatives exist on a continuum between equity and senior debt.[21] As the techniques become more specialized, characterizing a deal as "more equity-like" versus "more debt-like" may involve drawing seemingly arbitrary lines.[22] Perhaps the randomness of the labeling is a reflection of the motivation for choosing a particular vehicle to finance the gap. The tool chosen to finance the gap equity is largely outside the power of the borrower and is not driven by borrower concerns. Rather, it is driven by the rating agencies in securitized transactions.

Since rating agencies disdain naked subordinate debt, borrowers and lenders go to great lengths to disguise gap financing as anything other than subordinate debt. Therefore, in CMBS transactions, characterization of an investment as closer to debt or closer to equity

[21] The variety and volume of debt/equity hybrids has likewise proliferated in corporate debt. See, Haskins, *supra* n. 2 at 526.
[22] *See*, David B. Hariton, *Distinguishing Between Equity and Debt in the New Financial Environment*, 49 Tax L. Rev. 499, 501 (1994).

has significant pricing and economic repercussions. The next step, then, is to fine tune the categorization of the possible methods of gap financing according to the criteria that matters most to the rating agencies: the relationship of the investor to the firm/senior debt in the event of default. In conjunction with this analysis we should include the perspective of the investor as well as expectations of the firm.

III. Debt/Equity Dichotomy

Even after describing the various methods of creating hybrid investment vehicles, the underlying question remains: why do rating agencies treat investment vehicles differently? It is more than a cosmetic or naming issue. The fundamental concern is that the less the investment looks like debt, the less likely it is to impact on default risk and the less likely it is to impair the value of the underlying real estate collateral.

To explore the dichotomy the rating agencies are attempting to draw, we can look to several disciplines where such distinctions have been crafted, including economics and accounting. Such characterization questions usually come to head in the context of tax and bankruptcy, so the legal analysis undertaken in these fields is instructive. In this way we can gather insight as to when (or even whether) such meticulous attention to gradations of characterization matters.

Economics

As this paper is focused on the effects attempts of legal ordering upon default, a full exposition of the economics of firm capitalization and debt/equity decision making is

beyond the scope of this article. However, the legal environment does not exist in a vacuum; it works within the framework of the economic decisions undertaken in firm capitalization. As such, a basic discussion of capitalization is in order.

From the Modigliani and Miller perspective, capital structure should not affect firm value.[23] In fact, most analyses of secured debt start from the observation that, in a perfect market, a firm's capital structure cannot add value.[24] Of course this neglects the effect of double taxation of corporate income.[25] However, if we leave aside the tax, the decision to finance through secured debt might be viewed as an economic choice designed to reflect a desired outcome of legal ordering upon default.

In fact, the economics literature supports this view. Of course the financial reasons to go beyond straight debt are multifaceted. They include innovation, risk reallocation, and management entrenchment.[26] However, target debt levels will be influenced by the probability of financial distress of the firm. Companies with higher operating risk should be expected to use less debt.[27] Companies who have riskier profiles are less likely to take

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[23] Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM ECON. REV. 261, 267-70 (1958).
[24] For more discussion and citations on this point, see Claire A. Hill, *Is Secured Debt Efficient?*, 80 TEX. L. REV. 1117, 1120 (2002).
[25] Modigliani and Miller likewise acknowledged the effect of corporate income tax on firm capitalization by showing that if a corporate income tax is in effect firm should use entirely debt since this allows corporate taxes to be avoided. Franklin Allen, *The Changing Nature of Debt and Equity: A Financial Perspective*, in ARE THE DIFFERENCES BETWEEN EQUITY AND DEBT DISAPPEARING?, CONFERENCE SERIES NO. 33, FEDERAL RESERVE BANK OF BOSTON, 12-38 (Richard W. Kopcke & Eric S. Rosengren eds., 1989); *See* Franco Modigliani & Merton H. Miller, *Corporate Income Taxes and the Cost of Capital: A Correction*, 53 Am. Econ. Rev. 433, 433-443 (1963). As federal income tax law changes to eliminate (or at least decrease) the taxation on corporate dividends this argument becomes less salient.
[26] *See* Allen, *supra* note 25, at 14-15.
[27] *See*, Paul Marsh, *The Choice Between Equity and Debt: An Empirical Study*, 37 J. Fin. 121, 121-144 (1982).

on contractual obligations of debt. In fact, one study showed that bankruptcy risk was a determining factor in whether a company issues debt or equity.[28] The higher the risk, the more likely the company was to issue equity.[29] Therefore, there is support for the assertion that contractual obligations (or lack thereof) are a determinative factor in choosing between equity and debt.[30] At default these obligations will be tested.

Accounting

Accounting rules have begun to change to reflect a desire for transparency.[31] As the initial stage of part of a larger FASB project, FASB 150 requires reclassification of financial instruments with characteristics of both equity and debt. Financial instruments previously treated as part of shareholders' or mezzanine equity will now be treated as

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[28] *Id*. at 142. Of course an alternate explanation for debt avoidance is that the higher risk translates into more expensive debt. Furthermore the advantages of leverage may be less salient because the riskiness of the venture demands a higher return and you do not need as much leverage to achieve a desired expected return on equity.

[29] The natural extension of this argument is that structuring of capitalization can affect the probability of default. In other words, marginal firms that take on more debt may have a higher probability of default because of the absolute obligation to repay at a specified time as contrasted with equity with a more discretionary repayment obligation.

[30] We can even take this argument one step further to bring in the effect of the number of debt creditors. The ability to renegotiate debt after default can be linked to the number of creditors with claims against the firm. The optimal debt structure should be that which balances the effect of both the number of creditors in addition to a debt/equity trade off. *See*, Patrick Bolton & David Scharfstein, *Optimal Debt Structure and Number of Creditors*, 104 J. POL. ECON. 1 (1996).

[31] For example, in January of 2004 FASB issued a draft of *Qualifying Special-Purpose Entities and Isolation of Transferred Assets,* which would amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.* The purpose of the proposal is to provide specific guidance on accounting procedures for transfers of financial assets from a company to an off-balance sheet structure known as a qualifying special-purpose entity (QSPE). The guidance would alter the accounting for QSPEs as follows: The proposal prohibits an entity from being a QSPE if a company that transfers assets to the entity enters into a commitment (such as a financial guarantee, liquidity commitment or total return swap) to provide additional cash or other assets to fulfill the QSPE's obligations to its beneficial interest holders. Also, if an entity can reissue beneficial interests, the proposal would prohibit that entity from being a QSPE if any party involved with the entity has certain risks or combinations of risks and decision-making abilities. Additionally, the proposal prohibits an entity from being a QSPE if it holds equity instruments, such as shares or partnership interests. Last, the proposal clarifies certain of the requirements in Statement 140 related to legally isolating assets and surrendering control of assets.

liabilities. Returns on investment will be treated as interest expense rather than dividends.[32]

There are several instruments affected by FASB 150, including mandatory redeemable shares (not including stock that may be redeemed at the issuer's option) and freestanding repurchase obligations (including put options and forward contracts that obligate the firm to purchase its own shares).[33] Most relevant to the present analysis is that other freestanding contracts are covered under FASB 150. Instruments such as equity kickers and warrants are included, as they are obligations of the firm to repay investment with its own shares in amounts unrelated or inversely related to share price.[34] This will impact mezzanine loans that are secured by pledges of equity.

The changes in treatment of certain instruments grow from a post-Enron environment of investment transparency. Labels are discarded in favor of revealing the underlying substance of the transaction. Instruments denominated as equity must now be accounted for as debt, because they constitute obligations of the firm to repay an investor, even though repayment may take the form of issuer stock. This emphasis on the nature of the obligation of the firm to repay (notwithstanding the method—stock not cash) falls right in line with the legal dichotomy of debt versus equity that also looks to the nature of the obligation to repay the investment.

[32] Financial Accounting Standards Board, Summary of Statement 150: Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity (05/03).
[33] *Id*.
[34] *Id*.

Legal

Significant legal distinctions between equity and debt arise in two relevant areas of law: tax and bankruptcy. A common thread, though, runs between the bodies of law. In both practices, the characterization turns on an analysis of what obligations the firm owes to the investor and what rights the investor possesses if those obligations are not met.

Taxation

Often when discussing tax differences between equity and debt, analysis focuses on the economic impacts and decisions of the firm, rather than the legal relationship between the investor and the firm. For the purposes of the present analysis, the focus must shift to the legal distinction courts draw between equity and debt, leaving aside the economic impact of these distinctions. This is not to imply that the tax distinctions are inconsequential. Presently, corporate earnings are double taxed when distributed as dividends but not double taxed when distributed as interest and principal on debt capital.[35] As such, characterization as equity or debt has a tremendous impact on the economic functioning of the firm.

The importance of the tax law for our purposes is the underlying legal reasoning of why debt is treating differently than equity. Tax courts look to corporate governance rights and contractual obligation of repayment to differentiate debt from equity.[36] How the

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[35] Hariton, *supra* n. 22, at 499-500. However, if the entity is structured as a partnership (rather than a corporation) this tax effect is not present. There are other more subtle differences that depend on partnership/corporation difference. For example, partners can increase the outside basis in their partnership if they bear the ultimate risk of loss for the partnership's liabilities (e.g., through guarantee of debt). *See*, Richard Winston, *Shareholder Guarantees of S Corporation Debt: Matching the Tax Consequences with Economic Reality*, 81 VA. L. REV. 223, 239 (1995). Such a discussion strays from the core of this paper.
[36] Tax issues generally center on reclassification parameters. *See*, Anthony P. Polito, *A Modest Proposal Regarding Debt-Like Preferred Stock*, 20 Va. Tax Rev. 291, 295-96 (2000).

courts deal with the blurring of the debt/equity dichotomy in tax cases and characterization of capital contribution and may inform later discussion as to how far an investment can stray from traditional concepts and still retain equity or debt core values.[37] The tax courts do not give bright line guidance but they do endeavor to characterize instruments to reflect their economic reality rather than their nominal title.[38]

The classification of contributions to an entity as "debt" or "equity" for tax purposes can be a complex matter, particularly where a close corporation and its shareholders are involved.[39] The general distinction between debt and equity is formulated as follows: Shareholders place their money 'at the risk of the business' while lenders seek a more

[37] For example, convertible debt is treated as pure debt by the Internal Revenue Service until conversion at which point it becomes pure equity. As one commentator noted, quoting a leading treatise: "In effect, until conversion, debt genes are treated as dominant and equity genes are treated as recessive." Haskins, supra n.2, at 533 (citing BORIS I. BITIKER & JAMES S. EUSTICE, FEDERAL INCOME TAX OF CORPORATIONS AND SHAREHOLDERS. 4.60-.62 (6th ed. 1994)). The issue for later discussion is how recessive must the equity gene be before contractual obligation to pay is impaired.
[38] For discussion, see Haskins, *supra* note 2, at 540. For a different perspective, see Herwig J. Schlunk, *Little Boxes: Can Optimal Commodity Tax Methodology Save the Debt-Equity Distinction?,* 80 TEX. L. REV. 859, 859 (2002) ("The tax law frequently taxes economically similar items in very different ways… corporate equity is taxed in one way and corporate debt in another.").
[39] Once the contribution has been properly classified, determination of the appropriate tax treatment for an entity distribution is a fairly routine matter. The entity may deduct interest paid on indebtedness, but not dividend distributions. Returns on equity are taxable income to the recipient, while nonrecognition is the rule for returns of principle. I.R.C. §§ 163(a), 316.

reliable return.[40] When an investment bears a substantial risk of the business enterprise, it is more likely equity than debt.[41]

While there is less than total agreement as to the applicable legal criteria to distinguish debt from equity for tax purposes, [42] there is uniformity amongst courts of varying

[40] More specifically,

> [T]he 'risk of the business' formulation has provided a shorthand description that courts have repeatedly invoked. Contributors of capital undertake the risk because of the potential return, in the form of profits and enhanced value, on their underlying investment. Lenders, on the other hand, undertake a degree of risk because of the expectancy of timely repayment with interest. Because a lender unrelated to the corporation stands to earn only a fixed amount of interest, he is usually unwilling to bear a substantial risk of corporate failure or to commit his funds for a prolonged period. A person ordinarily would not advance funds likely to be repaid only if the venture is successful without demanding the potential enhanced return associated with an equity investment.

Slappey Drive Indus. Park v. United States, 561 F.2d 572, 581 (5th Cir. 1977).

[41] *Id*.

[42] The Fifth Circuit, for example, considers the following issues: (1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a fixed maturity date; (3) the source of payments; (4) the right to enforce payment of principal and interest; (5) participation in management flowing as a result; (6) the status of the contribution in relation to regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) source of interest payments; (11) the ability of the corporation to obtain loans from outside lending institutions; (12) the extent to which the advance was used to acquire capital assets; and (13) the failure of the debtor to repay on the due date or to seek a postponement. See e.g., In re Receivership Estate of Indian Motorcycle Mfg., Inc., 2003 WL 21380547 (D.Mass. 2003); Estate of Mixon v. United States, 464 F.2d 394, 402 (5th Cir. 1972); Montclair, Inc. v. Commissioner of Internal Revenue, 318 F.2d 38 (5th Cir. 1963).

The Eight Circuit, like the Fifth Circuit, the Eighth Circuit considers whether the corporation is grossly undercapitalized; whether the maturity date of the loan is fixed and whether the shareholder/lender participates in management. However, the Eight Circuit implements a broader approach and also considers: (1) Whether the shareholder loan (and similar loans by other shareholders) is made directly proportional to equity holdings; (2) Whether repayment of the shareholder loan is dependent on the corporation's profitability; (3) Whether the shareholder loan was subordinate to other debt; (4) Whether arms length bargaining would have produced a loan under similar terms and conditions; (5) Whether the shareholder loan is secured by collateral; (6) Whether the corporation establishes a sinking fund for repayment of the shareholder loan; and (7) Whether the corporation has a high debt to equity ratio when it receives the loan. See, e.g., J.S. Biritz Constr. Co. v. Comm'r, 387 F.2d 451, 456-57 (8th Cir. 1967).

Likewise, the Third Circuit has identified 16 different factors to be weighed in resolving this question but emphasizes that the various factors are mere aids to answer the ultimate question: i.e., whether the investment, analyzed in terms of its economic reality, constitutes risk capital entirely subject to the fortunes of the venture or represents a strict debtor-creditor relationship. Fin Hay Realty Co. v. United States, 398 F.2d 694, 697 (3d Cir. 1968); see also Joseph Lupowitz Sons, Inc. v. Commissioner, 497 F.2d 862, 865-66, n. 8 (3d Cir. 1974); Trans-Atlantic Co. v. Commissioner, 469 F.2d 1189, 1193 (3d Cir. 1972).

jurisdictions in their respect for substance over form.[43] All tax courts evaluate the relationship between the entity and the contributor according to an objective test of economic reality to determine the nature of the contribution.[44]

In tax law, most classification controversies involve government challenges to taxpayers who seek debt treatment for instruments with both debt and equity characteristics. In these cases, the fundamental inquiry is whether an outside lender would have made a loan in the same form and on the same terms as the one in question.[45] Factors that weigh in favor of a debtor-creditor relationship include: the regular payments of principal and interest by the recipient; the right of the contributor to compel full repayment of the advance; the ownership of sufficient assets from which the recipient can repay the advance; a fixed maturity date; the adequate capitalization of the recipient, and the ability of the recipient to obtain loans on similar terms from outside lending institutions.[46] In identity of interest cases, that is, when an individual both contributes capital and lends funds to an entity, additional factors come into play. The advances are more likely to be

[43] See e.g., In re Receivership Estate of Indian Motorcycle Mfg., Inc., 2003 WL 21380547 (D.Mass. 2003); Estate of Mixon v. United States, 464 F.2d 394 (5th Cir. 1972); Montclair, Inc. v. Commissioner of Internal Revenue, 318 F.2d 38 (5th Cir. 1963); J.S. Biritz Constr. Co. v. Comm'r, 387 F.2d 451, (8th Cir. 1967); Fin Hay Realty Co. v. United States, 398 F.2d 694, 697 (3d Cir.1968); Joseph Lupowitz Sons, Inc. v. Commissioner, 497 F.2d 862, 865-66, n. 8 (3d Cir. 1974); Trans-Atlantic Co. v. Commissioner, 469 F.2d 1189, 1193 (3d Cir. 1972).

[44] *Litton Business Systems, Inc. v. Comm.*, 61 T.C. 367, 377 (1973).

[45] Segel v. Comm'r, 89 T.C. 816, 828 (1987). For purposes of deductibility of interest payments, "debt" is defined as "an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof." Overnite Transp. Co. v. Comm'r of Revenue 54 Mass. App. Ct. 180, 186 (Mass.App.Ct. 2002) (quoting Gilbert v. Commissioner of Int. Rev., 248 F.2d 399, 402 (2d Cir. 1957)).

[46] Hardman v. United States, 827 F.2d 1409, 1412 (9 Cir. 1987); Mixon, 827 F.2d at 403-11, Lane v. United States, 742 F.2d 1311, 1317 (11th Cir.1984), Dixie Dairies Corp. v. Commissioner, 74 T.C. 476, 495 (1980), Laidlaw Transp., Inc. v. Comm'r, 75 T.C.M. (CCH) 2598, 2619 (1998). Many courts consider a fixed maturity date to be the most significant feature of a debtor-creditor relationship. Unitex Indus. v. Comm'r, 30 T.C. 468, 473 (1958).

characterized as equity if the advances are made in direct proportion to its ownership interest[47] or if the contributor participates in management of the entity.[48]

Risk also plays a key role in the debt-equity determination. For example, a tax court is more likely to classify an advance as equity where the advance is subject to subordination because the risk of delinquency on the repayment of the advance increases.[49] The use of advanced funds to finance start-up costs and initial operations, and the contingency of principal and interest payments upon earnings are additional factors that increase the risk of investment and, accordingly, weigh towards treatment of an advance as equity.[50] The sufficiency of the debt-equity ratio, requirements for collateral or other security and a consistent history of payments of principal and interest are factors that decrease the risk of investment and, therefore, weigh towards treatment of an advance as bone fide debt. [51] For tax characterization purposes, the courts have not fixed a single determinative factor to ascertain whether an advance is a capital contribution or bone fide debt. Rather, they employ a more holistic approach. The task of the court is to evaluate, not merely tally, the applicable criteria.[52] Several factors, though, are consistently scrutinized such as whether there is adequate capitalization, whether the contributor has the right to enforce

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[47] Roth Steel Tube Company v. Commissioner of Internal Revenue, 800 F.2d 625, 630 (6th Cir. 1986).
[48] Hardman, 827 F.2d at 1412.
[49] Nassau Lens Co., 308 F.2d 39, 47 (2d Cir. 1962); Charter Wire, Inc. v. United States, 309 F.2d 878, 880 (7th Cir. 1962).
[50] William J. Rands, *The Closely Held Corporation: Its Capital Structure and the Federal Tax Laws*, 90 W. VA. L. REV. 1009 (1988); Haffenreffer Brewing Co. v. C.I.R., 116 F.2d 465, 468 (1st Cir.1940) ("Perhaps the most significant fact is the lack of a fixed maturity date at which time the holder can demand payment whether or not there are net earnings.") (March 29, 2000).
[51] Hardman v. United States, 827 F.2d at 1414; Internal Revenue Service Advisory, 1996 WL 33107194 (December 1996).
[52] John Kelly, Co. v. Comm., 326 U.S. 521, 530 (1946); Tyler v. Tomlinson, 414 F.2d 844, 848 (5th Cir. 1969).

payment of principal and interest, whether arms' length bargaining would have produced a loan under similar terms and conditions; and whether the contributor participates in management as a result of the contribution. This fundamental analysis is instructive for our purposes for it highlights critical differences between equity and debt. Such differentiation will guide later analysis and help explain why differing funding sources have different rights in the event of default.

Bankruptcy

As in tax, bankruptcy treatment of equity versus debt likewise directly impacts the legal relationship between firm and investor. The bankruptcy code distinguishes between secured claims and equity.[53] Obviously, secured debt is in a more advantageous position with regard to payment from the bankrupt estate. But the distinctions are finer than this broad brush statement. As the Bankruptcy Code recognizes the validity of subordination agreements, subordinated debt is classified separately from non-subordinated debt. Furthermore, distinctions between equity classes are recognized and preferred stock will be dealt with as a separate class from common stock.[54]

Clearly the bankruptcy courts are adept at dealing with classifications of either debt or equity. Where it becomes difficult is classifying a claim that has attributes of both debt and equity. In other words, slicing a box of debt or equity securities into separate claim categories is not particularly difficult. But what of the super-preferred equity that looks amazingly similar to the super-subordinated (but nonetheless nominally secured) debt?

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[53] See, 11 USC §101(5) (claim); 11 USC §101(12) (debt); and 11 USC §101(16) (equity security).
[54] For more discussion, see Normandin, *supra* note 2 at 59.

Should these claims be lumped into one box? For guidance the courts will fall back on the firm governance principals that will be examined more depth later in this paper.[55]

There is significant cross-over between bankruptcy and tax jurisprudence regarding the distinctions between debt and equity. Like tax courts, bankruptcy courts that confront this issue may employ equitable concepts and, if the economic substance warrants, reclassify an investment as equity or debt.[56] The bankruptcy code grants bankruptcy courts considerable discretion with respect to the treatment of an investment as debt or equity. First, bankruptcy courts may reprioritize any claim or interest as per any other claim or interest pursuant to their general equitable powers. Second, these courts also may reprioritize claims of creditors pursuant to the doctrine of equitable subordination.

Recharacterization: The Exercise of General Equitable Power

Recharacterization is the method that bankruptcy courts use to reclassify investments, exercising their general equitable powers pursuant to Section 105 to disregard the form of a transaction and classify claims asserted against a debtor as equity or interests asserted against a debtor as debt. [57]

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[55] For an exhaustive treatment of the view of bankruptcy courts, see Peter V. Pantaleo and Barry W. Ridings, *Reorganization Value*, 51 BUS. LAW. 419 (1998).

[56] *See, e.g.*, Bayer Corp. v. Mascotech, Inc. (*In re* Autostyle Plastics, Inc.), 269 F.3d 726 (6th Cir., 2001) (applying the *Roth Steel* factors to determine whether transaction was properly classified as a loan); In re Hillsborough Holdings Corp., 176 B.R. 223 (M.D. Fla. 1994) (finding an intercompany payable exhibited characteristics of debt and was, therefore, a bona fide loan, despite also exhibiting some indicae of an equity investment.). For a detailed discussion of the application of the *Roth Steel* factors in bankruptcy cases, see Jo Ann J. Brighton, *Capital Contribution or a Loan?*, 21 Am. Bankr. Instit. J. 1, 42-45 (2002).

[57] 11 U.S.C. § 105(a) (2000) (empowering bankruptcy judges with the authority to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Code]"). *But see* Pacific Express, Inc., 69 B.R. 112, 115 (arguing that since there is no specific provision in the Code that authorizes recharacterization, bankruptcy courts have no authority to do so.), *In re Pine Tree Partners, Ltd.*, 87 B.R. 481, 491 (arguing same).

The majority of courts construe this section of the code as permitting the courts to reorder the priorities of any type of claim to any other type of claim as necessary to produce an equitable result.[58]

In recharacterization cases, the court will reclassify debt as equity if (i) the parties intended an instrument labeled "debt" to have the advantages and disadvantages of equity and (ii) the treatment of the instrument as debt would significantly disadvantage genuine creditors. [59] The courts frequently utilize recharacterization in cases where shareholders have substituted debt for adequate risk capital.[60]

Equitable Subordination

The second method that bankruptcy courts may use to reclassify an investment is through the doctrine of equitable subordination.[61] Although its application produces similar results, equitable subordination is a concept distinguishable from recharacterization.[62] Equitable subordination penalizes egregious conduct of a nominally superior claim holder who directs the firm in such a way that causes harm to inferior claim holders.[63] Designed

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[58] As discussed infra, under the doctrine of equitable subordination, a loan may not ordinarily be subordinated to interests; this, however, is the de facto result in recharacterization cases.
[59] *See, e.g.,* Pepper v. Litton, 308 U.S. 295 (1939).
[60] Brighton, *supra* note 56 at 2.
[61] 11 U.S.C. § 510(c) (2000).
[62] A minority of courts freely interchange the two doctrines. *See, e.g. In re* Mobile Steel Co., 563 F.2d 692 (5th Cir. 1977); *In re* Fabricators, Inc., 926 F.2d 1458 (5th Cir. 1991). However, the majority distinguish equitable subordination and recharacterization based upon the restrictive language of Section 510(c), which does not authorize the recasting of a claim as an interest. *See e.g.*, *In re* Hyperion Enterprises, Inc., 158 B.R. 555 (D.R.I. 1993); U.S. v. Colorado Invesco, 902 F. Supp. 1339, 1342 ("[T]he first determination must be whether the loan transaction was a contribution to capital or a loan.").
[63] Typically, a lender will not be classified as a controlling or insider shareholder (and hence will not be open to equitable subordination) under certain circumstances, such as where the contract under question flows from an arm's length relationship;the firm was adequately capitalizedand the terms of the contract do

to protect against abuses by company insiders, equitable subordination allows a court to subordinate claims of insiders to claims asserted by bondholders, trade creditors, or other stockholders. For bankruptcy purposes, both priority claims and secured claims can be subordinated to the claims of general unsecured creditors. The courts use the doctrine of equitable subordination sparingly, as it is a remedial measure.[64]

Section 510(c), the cornerstone of the doctrine of equitable subordination, allows bankruptcy courts to subordinate the claim of an overreaching creditor to the claims of other creditors. The threat of equitable subordination of claims produces extreme reluctance amongst debt holders to take an active management role in distressed firms.[65] In cases of multiple funding, subordination agreements ordinarily grant the senior debtholder a superior right to collection of indebtedness *vis a vis* junior creditors. That is, junior debtholders receive no distribution until the senior debtholder receives payment in full and, frequently, any distributions received by a junior holder must be surrendered to the senior creditor until its claim is satisfied.[66] As a general rule, subordination agreements are enforceable in bankruptcy according to their terms and to the same extent

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not result in injury to creditors or confer an unfair advantage on the claimant. Brighton, *supra* note 56 at 44-45

[64] *See*, Brighton, *supra* note 56, at 44 discussing Section 510(c) of the Bankruptcy Code *See, e.g. In re* Cumberland Farms Inc., 181 B.R. 678 (Bankr. D. Mass. 1995)), *aff'd in part, modified in part, and reversed in part by* Hascotes v. Cumberland Farms, Inc. 216 B.R. 690 (D.Mass. 1997). (noting that the doctrine is not a penal measure and therefore ought not be utilized to take assets.) A creditor is justly entitled to upon liquidation of the debtor's assets and award those assets to others without right or claim to them).

[65] Mitchell Berlin &Loretta J. Mester, *Optimal Financial Contracts for Large Investors: The Role of Lender Liability*, Center for Financial Institutions Working Papers 99-33, *available at* http://ideas.repec.org/p/wop/pennin/99-33.html.

[66] The amounts recovered by senior claimholders through these provisions, referred to as "double dividends," depend upon the size of the junior claims and the amounts awarded to unsecured creditors. In any event, the senior creditor will only be entitled to collect such amount as is necessary to satisfy its claims in full. Hollace T. Cohen, *Adventures in Subordination, an Uncertain Terrain*, *in* NORTON ANNUAL SURVEY OF BANKRUPTCY LAW (2002)

as they would be under non-bankruptcy law. [67] Bankruptcy courts, however, have the discretion to classify lenders as insiders in cases where the lender exercises overwhelming domination and control over a debtor.[68]

For equitable subordination to apply, three elements must be satisfied: (1) the party to be subordinated has engaged in inequitable conduct; (2) that conduct has injured other creditors or given the party against whom subordination is sought an unfair advantage; and (3) subordination of the claim is consistent with the purposes of the Bankruptcy Code.[69] The definition of "inequitable conduct" is narrow, and courts limit application of the doctrine of equitable subordination to cases of fraud, illegality, breach of fiduciary duty and undercapitalization.[70] Courts normally subordinate claims only to the degree necessary to offset the unfair advantage or harm caused by the inequitable conduct.[71]

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[67] See 11 U.S.C. §510(a).
[68] *See* Jo Ann J. Brighton, *Capital Contribution or a Loan?*, 21 American Bankruptcy Institute Journal 1, 45 (2002). Brighton summarizes the relevant factors as follows: (1) stock ownership, (2) interference with the operations of the debtor's borrowers, (3) participation in management decisions, (4) orders as to which creditors the debtor will pay, (5) placement of lender employees as directors or officers of the debtor, (6) hiring and firing of debtor personnel, (7) participation in shareholder meetings, (8) participation in director meetings, (9) participation in management meetings and (10) arm's length transactions with debtor.
[69] *See* Freeland v. I.R.S., 264 B.R. 916 (N.D. Ind. 2001); *see also* U.S. v. Noland, 517 U.S. 535 (1996) (doctrine of equitable subordination may not be applied absent a finding of inequitable conduct); *but see In re* Atlantic Rancher, Inc., 279 B.R. 411 (2002) (noting that since passage of 11 U.S.C. §510(c), third element is probably moot and the courts need not address it).
[70] *In re* Eufaula Industrial Authority, 266 B.R. 483, Bankr. L. Rep. (CCH) P 78499 (B.A.P. 10thCir. 2001). On occasion, courts have applied the equitable subordination doctrine in noninsider cases; however, the degree of wrongful conduct must be tantamount to fraud, overreaching or spoliation, or involving moral turpitude. *In re* 80 Nassau Associates, 169 B.R. 832, 25 Bankr. Ct. Dec. (CRR) 1371, 31 Collier Bankr. Case 2d (MB) 620 (Bankr. S.D.N.Y. 1994); *In re Castletons, Inc*., 990 F.2d 551, 28 Collier Bankr. Cas. 2d (MB) 991, Bankr. L. Rep. (CCH) P 75220, 21 U.C.C. Rep. Serv. 2d 1062 (10thCir. 1993); *In re* Dry Wall Supply, Inc., 111 B.R. 933, 938 (D. Colo. 1990).
[71] *See In re* Mobil Steel, 563 F.2d 692, 699 (5thCir. 1977) (noting that in cases of egregious conduct, claimants may seek disallowance of a claim in full).

Thus, recharacterization and the attendant exercise of general equitable powers have distinct advantages over the doctrine of equitable subordination for a bankruptcy court. In recharacterization cases, a supposed "loan" never qualifies as a claim and, therefore, the stiffer requirements of equitable subordination need not be met. Additionally, the court can invoke its general equitable powers to mold the relief granted to comport with the equities of the particular case. In the evaluation of a convertible bond, for example, a bankruptcy court might treat the actual bond issue as debt, but extract the conversion rights from the bond and treat them as independent options.[72] It is because of its flexibility that recharacterization is a more powerful tool than equitable subordination.

This very flexibility, however, is a double-edged word for creditors. On the one hand, a creditor, through its course of dealings with the borrower, unwittingly risks subjecting its claim to subordination or recharacterization. On the other hand, an opportunity may arise where a creditor may increase its bankruptcy distribution by forcing another creditor into a junior position.[73]

Having explored the treatment of equity and debt through three different lenses, we return to the initial question of why delineations are carved between debt and equity. There is a common thread of distinction that runs through these three disparate areas of economics,

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[72] Richard E. Mendales, *The New Junkyard of Corporate Finance: The Treatment of Junk Bonds in Bankruptcy*, WASH. U. L.Q. (1991).

[73] *See generally* Timothy A. French, *The Rise and Fall of the Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors*, 4 J BANKR. L. & PRAC. 257 (1995); Robert M. Zinman, *Under the Spreading Bankruptcy: Subordination and the Codes*, 2 Am Bankr Inst L Rev 293 (1994); Robert J Graves, *How to Keep Loans to "Insiders" from Being Recharacterized in Bankruptcy*, 3 Bankr. L. Rev. 21 (1992); Steven A. Karg, *Bankruptcy Trap for the Unwary Creditor: Equitable Subordination Resulting from Excess Creditor Control*, 15 SETON HALL LEGIS. J. 434 (1991).

accounting and law. In each case the demarcation of equity versus debt turns on the relationship between the investor and the firm. The rigidity (or, conversely, fluidity) of obligations and rights between the investor and the firm will inform the differentiation between equity and debt. As such, the next issue will be whether the rating agencies in CMBS transactions are asking the right questions in order to distinguish investment vehicles and hence permit accurate market pricing and economic transparency.

IV. Great Expectations

Rating agencies, and hence borrowers and lenders, react differently to various methods of gap financing. In this section we examine the underlying theoretical differentiation between equity and debt as explained by the relationship between the firm and the investor. Equity and debt clearly have legal situational differences (e.g. tax and bankruptcy). The inquiry, then, should be how the theoretical bases for these distinctions correlate with how rating agencies differentiate between gap financing vehicles. Contract theory will be the tool of dissection with the goal of parsing out the relationship between firm and investor and crafting a model of categorization.

There are two avenues of inquiry, joined by contract theory, for analyzing an investor/firm relationship. The first is to look at the right to participate in the governance of the firm. The other is to examine the right to demand repayment of investment. Both avenues, however, will be determined by the nature of the obligation that runs between the investor and the firm.

Firm Governance

The historical distinction in firm governance has been discussed previously by the author.[74] Although equity holders are paid at the discretion of the firm (no right to demand repayment) they are given responsibility for firm governance. On the other hand, debt holders are promised a fixed rate of return but have no say in firm governance.[75]

In terms of firm governance the holders of equity make the decisions while the holders of debt are relegated to the sidelines. Traditional debt holders can take no part in the management of the firm, and the firm owes them no explanation for their actions. The seminal case of RJR Nabisco[76] made the relationship clear:

> [A] bond represents a contractual entitlement to the repayment of a debt and does not represent an equitable interest in the issuing corporation necessary for the imposition of a trust relationship with concomitant fiduciary duties. Before such a fiduciary duty arises, an existing property right or equitable interest supporting such a duty must exist.[77]

In essence this goes back to the classical distinction between debt and equity: the debt holder is insulated from risk of the firm but does not get to share in the reward of the firm.[78] As such the debt holder has no voice in the management of the firm.[79]

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[74] *See*, Poindexter, supra note 4 at 555 and footnotes.
[75] Allen, supra note 25 at 12.
[76] *Metro. Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1524 (S. D. N.Y. 1989) (citing Simons v. Cogan, 549 A.2d 300, 303 (Del. 1988)).
[77] *Id.* at 1524.
[78] As one commentator has noted: "The real question, then, is not how many debt characteristics does the instrument possess, but rather to what extent does the instrument insulate the investor from the risks and rewards of the issuer's business." Hariton, *supra* note 22 at 522.
[79] Of course there is the opportunity to use "exit" threats as a method of influencing firm behavior. This is especially true if structured as a call feature. *See* George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CALIF. L. REV. 1073, 1080 (1995) (arguing that "…debt is a potent and flexible governance instrument and that [lenders] are effective governance players.")

The legal basis for this distinction evolves from contract theory: While the underlying duty of the firm to its equity holders is fiduciary, the duty to its creditors is contractual.[80]

Although there have been attempts at creating some sort of duty toward creditors these challenges were generally unsuccessful.[81] To determine whether an investment is debt or equity, we should ask whether the duty of the firm to the investors is fiduciary or contractual. A fiduciary duty is a caretaker responsibility that gives rise to a cause of action if firm managers undertake activities that cause harm to the investors.[82] It is a duty of care that keeps opportunism in check.[83] In contrast, a cause of action for breach of a contractual duty will only occur if a payment is missed. The greater the right of the investor to participate in the management of the firm, the more equity-like the investment. By extension, the more isolated from management the investor remains, the more debt-like the investment.

This difference can be analyzed along the lines of relational versus discrete contracts. Equity relationships are relational, as they are typically non-standardized contracts

[80] *See*, Normandin, *supra* note 2at 49-50.
[81] *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc. 506 A.2d 173, 182 (Del. Supr. 1986); Simons v. Cogan, 542 A 2d 785, 788 (Del. Ch. 1987), aff'd, 549 A. 2d 300 (Del. 1988). *But see*, Robert Scott, Discussion of *The Changing Nature of Debt and Equity: a Legal Perspective, in* ARE THE DISTINCTIONS BETWEEN DEBT AND EQUITY DISAPPEARING? (Richard W. Kopcke & Eric S. Rosengren, eds., 1989) at 76 (discussing when legal disputes have centered on whether the relational obligations of good faith and best efforts should be applied to debt contracts).
[82] Lawrence E. Mitchell, *Book Review: The Cult of Efficiency: The Economic Structure of Capital Law*, 71 TEX. L. REV. 217, 221-222, 236-238 (1992).
[83] *See*, D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1430 (2002), Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1634-40 (2001)

evidencing an ongoing relationship between the parties,[84] and are based upon a discretionary relationship.[85] Debt relationships, on the other hand. are discrete contracts – more standardized and less idiosyncratic. Debt relationships are rules driven,[86] and represent a transactional relationship.[87] These distinctions allows us to segregate investment vehicles and categorize them not according to their economic cloak, but rather according to their relationship with the firm. Therefore, the analysis of a specific vehicle requires investigation as to the right to participate in firm decisions.

Contractual obligation

Another way of differentiating between equity and debt is the contractual right to demand return on investment. As stated before, an equity holder's return on her investment is contingent on the success of the firm, whereas a debt holder can demand no more (but is entitled to no less) than the contractually agreed upon return. Debt traditionally has been defined as "an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payments regardless of the debtor's income or lack thereof."[88] Courts explain the conceptual difference between lenders and equity holders by contrasting shareholders who place their money at the risk of the business while lenders seek a more reliable return. In other words, a loan is made upon the reasonable assumption that it will be repaid no matter whether the business venture is

[84] *See*, Smith, supra note 83 at 1476; Douglas K. Moll, *Shareholder Oppression and Reasonable Expectations: Of Change, Gifts, and Inheritances in Close Corporation Disputes*, 86 MINN. L. REV. 717, 754 (2002).
[85] Berlin & Mester, *supra* note 65 at 11-13
[86] *Id.* at 10-11.
[87] *See* Scott, *supra* note 81 at 75-76, see also,David Campbell, *Breach and Penalty as Contractual Norm and Contractual Anomie*, 2001 WISC. L. REV. 681, 692 (2001).
[88] Gilbert, 248 F.2d at 402.

successful or not, while capital is put to the risk of the business.[89] The debt contract may be judged according to the standard of good faith and fair dealing but remains relatively static as the conditions of the firm may change.[90]

We return to relational versus discrete contracts. The ongoing relationship of sharing capital appreciation (or risking loss) categorizes an investment as equity-like. The transactional relationship of set payment at defined intervals categorizes an investment as debt-like. In fact it is this feature that rating agencies focus on in reviewing gap financing. The greater the right to demand payment the more frowned upon by the rating agencies.

When does this all matter?

Putting this all in the context of default on the debt in a CMBS transaction crystallizes the importance of the debt/equity distinction. In fact, the legal cases tend to be most concerned about rights of investors in the event of default.[91] Default is the correct point for analysis, because it merges fundamental questions of firm decision making with payment rights of investors holding obligations of inferior priority. In essence, I am advocating a consideration of a default-rule paradigm in event of borrower default.

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[89] Slappey Drive, 561 F.2d at 581; *see also* Midland Distrib. v. United States, 481 F.2d 730, 733 (5th Cir. 1973). The seminal case making this dichotomy, *United States v. Title Guarantee & Trust Co*, put the case most eloquently: "The essential difference between a stockholder and a creditor is that the stockholder's intention is to embark upon the corporate adventure, taking the risks of loss attendant upon it, so that he may enjoy the chances of profit. The creditor, on the other hand, does not intend to take such risks so far as they may be avoided, but merely to lend his capital to others who do intend to take them." United States v. Title Guarantee & Trust Co., 133 F.2d 990, 993 (6th Cir. 1943).
[90] Good faith and fair dealing should not be used to "shoehorn" new rights into the debt contract. *See* Normandin, *supra* note 2 at 54.
[91] *See* Hariton, *supra* note 22 at 508 (citing Scriptomatic, Inc. v. United States, 397 F. Supp. 753, 758, (E.D. Pa. 1975) aff'd 555 F.2d 364 (3d Cir. 1977)).

Default in this context embodies both of the commonly used legal interpretations of default: non-excused contractual breach and utilization of community accepted norms (rules) to order unspecified contractual rights.[92] As will be fully elaborated, the goal here is to recognize both the wealth maximization arguments as well as the information forcing aspects[93] of implementing rules that minimize ambiguity of investor status in the event of borrower breach.

Default also sweeps in all of the intercreditor issues of the transaction. Intercreditor agreements are drafted at the inception of the transaction to contractually order the rights of various investors of the firm. The pressure to recharacterize a particular investment to alter these rights potentially occurs when another class of investors has suffered or is about to suffer a loss. For example, defaults that trigger cash sweeps (hyper-amortization) and/or the exercise of equity kickers negatively impact other investors. At this point the ordering agreed to in the intercreditor agreement will be tested against the debt/equity recharacterization algorithm.

Let's hypothesize a firm with a $65 mortgage lien against its only asset, which has a value of $100. Suppose there is also a $25 third party investment of unspecified categorization and $10 owner equity remaining. Upon default of the $65 debt, the holders of the $25 investment can travel various paths depending on the nature of their

[92] There is certainly a vast body of literature interpreting the default rule paradigm. *See, e.g.*, Charles Goetz & Robert Scott, *Liquidated Damages, Penalties and the Just Compensation Principal*, 77 COLUM. L. REV. 554 (1977). Alan Schwartz, *The Default Rule Paradigm and the Limits of Contract Law*, 3 S. CAL. INTERDISC. L. J. 389 (1993).
[93] These are two common justifications for the default rule paradigm. *See* Robert E. Scott, *Rethinking the Default Rule Project*, 6 VA. J. 84 (2003). For other applications of the default rule paradigm *see*, Schwartz, id.

investment. In formulating a default rule of priority the dequity holders' rights/responsibilities will vary according to 1) their legal rights of participation in governance (equity like rights) and 2) their ability to jeopardize the payment priority of the senior debt (debt like rights).

The rating agencies are most concerned about impairment of the payment priority of the senior debt. But they need to widen and refocus their attention. They should view the nature of the $25 gap financing not only from the perspective of whether the dequity investor has the right to demand payment from the borrower to the detriment of the first lien, but also whether the dequity investor can exercise managerial discretion that would adversely impact the senior debt. By focusing primarily on limiting "debt like" attributes, the possibility arises that unforeseen recharacterization of equity like attributes can likewise impair the position of the senior lien (e.g. managerial rights that will spring into action when the mezzanine lender steps into the shoes of the borrower in the event of default on the mezzanine loan). The move away from hard second liens secured by the real estate asset to more amorphous dequity investment introduces the obfuscation of investor rights and limitations

This is only part of the equation, though. The gap financing is like a pressure cooker. Upon default it can explode into the first lien piece. This is the focus of the rating agencies. There exists another, equally important, economic consequence. The dequity can also blow into borrower equity and impact the rights of other creditors of the borrower. Hence, risk of recharacterization can affect more than just the first lien holder.

Therefore, the debt/equity examination needs to take a further analytical step. The exercise of the rights of dequity holders will potentially impact a wide range of other transaction participants. It is imperative that these other participants be aware of and acquiesce to (through transparent pricing) the rights of the dequity holders. However, as shown above, the courts will exalt substance over form in recharacterizing a particular investment (and hence reordering rights).[94] To satisfy informational equilibrium and economic transparency, the nature of the investment (relational vs. discrete, rights of governance and rights to demand payment) must survive judicial scrutiny and emerge without recharacterization. As shown through examples in tax and bankruptcy, this is not a simple prediction to make.

Market application illustrates this point. When the gap equity was financed through a hard second mortgage, the rights and responsibilities of the parties were relatively well defined and unambiguous. Now that the gap equity is financed through hybrid investment, the ambiguity of recharacterization should be reflected in pricing of the dequity. When purchasing the $25 capital stake, the investor gave up some debt rights (no "hard seconds") in exchange for some equity-like rights in the firm.[95] Equity is a higher risk investment than debt. However, the risk/return makeup in the shift from debt to

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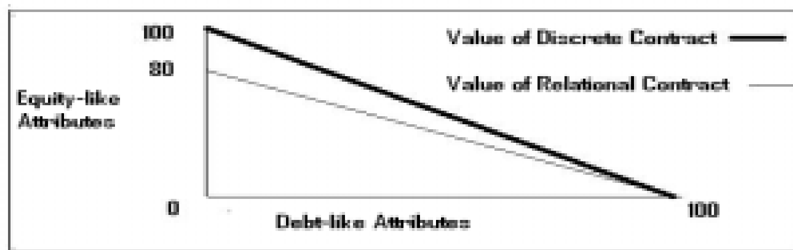
[94] *See e.g.*, Elizabeth Warren & Jay L. Westbrook, *A Litter Peripheral Vision*, AM. BANKR. J., Feb 23, at 26 (2004). Professors Warren and Westbrook sound the alarm about the Fifth Circuit court's willingness to disregard form and rely on substance in transactions in *Reaves Brokerage Co. v. Sunbelt Fruit & Vegetable Co.*, 336 F. 3d 410 (5th Cir. 2003).
[95] For example, in a mezzanine loan, second lien on real property is replaced by a pledge of equity in the borrower. From another angle it matters who owns these equity rights. This is a further ambiguity faced by the first lien holder. As stated above rating agencies take the purchaser of the second lien into consideration..

equity may not be a true representation of the risk/returns of the enterprise.[96] What is not priced in this structure is the volatility and ambiguity produced by the threat of recharacterization along with the concomitant costs of litigation, etc.

This shift can be diagrammed like this:



[96] See Polito, *supra* note 36 at 303 ("Yet, by examining all facts and circumstances to determine how risky is risky enough to be equity, existing law sets no real standard for how much of the risk-and-return of the corporate enterprise a security must bear to be treated as equity.") Another way to look at this problem is how bankruptcy courts value firms in reorganizations. Some commentators, such as Pantaleo and Ridings, have called the bankruptcy courts' focus on P/E multiples misplaced when the firm has significant leverage. Although debt generally is cheaper than equity, it can make an equity investment more risky:

"The increased risk also increases the cost of equity capital and, therefore, decreases a firm's P/E multiple-precisely the opposite of what some courts have concluded. A higher valuation is appropriate was not because debt increases P/E multiples, but because P/E multiples reflect only equity value. Thus, if the comparable firms being valued are capitalized with debt as well as equity, measuring reorganization value by reference only to the P/E multiple of those firms ignores the value in those firms that is reflected in the market value of their debt. Therefore, while debt tends to depress a firm's P/E multiple, its market value contributes to the overall value of a firm. Thus, it needs to be factored into a valuation by using a broader multiple than a P/E multiple if the valuation is to be accurate. Determining value by using only P/E multiples in a case where a target and its comparables have different leverage fails to take this into account."

See Pantaleo & Ridings, *supra* note 55 at 439.

In this chart the thick line represents a one to one trade off between a relational contract (equity) and a discrete contract (debt). The thin line represents the disparate value between the two investments. In essence the difference corresponds to the option value of whether the investment will be recharacterized. The difference is attributable to the ambiguity created by the chance that a more debt like discrete contract will be transformed into a more equity like relational contract by the courts upon default. The value of the option should be reflected in the price of the investment.

To a certain extent, the ambiguity of the US bankruptcy system is reflected in the pricing of the CMBS securities insofar as the ability to impair the first lien is concerned. To illustrate this phenomenon we can compare two legal environments that present more chance for recharacterization (United States) and less chance for recharacterization (Canada). Much like United States bankruptcy law, Canadian bankruptcy law has a reorganization component, and a secured creditor cannot systematically veto a debtor's attempt at reorganization. As compared to U.S. proceedings however, Canadian restructuring proceedings are more business negotiation oriented and less litigation oriented. In fact, the proceedings closely resemble mandatory alternative dispute resolution. "As a result," one study reports, "Canadian insolvency proceedings are materially shorter, less expensive and less litigious than U.S. proceedings".[97]

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[97] Joint Task Force on Business Insolvency Law Reform, *Insolvency Institute of Canada, A Joint Report of the Insolvency Institute of Canada and the Canadian Association of Insolvency and Restructuring Professionals* 4 (2002).

Rating agencies perceive Canadian bankruptcy laws as significantly more supportive of creditors rights that those of the United States. They analyze that Canadian borrowing culture is superior because: (1) Canadian default rates are consistently lower than comparable U.S. default rates; (2) Canadian bankruptcy law is more creditor-friendly than comparable U.S. laws and (3) the collateral associated with a Canadian mortgage can be acted upon quickly. Accordingly, the agencies permitted lower subordination levels on Canadian pools than for comparable pools in the United States.[98]

However for complete economic transparency in the CMBS market, models of debt/equity characterization should be expanded beyond the question of impact upon the payment priority on the first lien. The nature of the dequity investment should be broadened to include both relevant legal indications: governance and right to demand payment. In financing the gap equity, the second lender gave up a portion of the security of a hard second on the property. In exchange, this "lender" received equity that may not be equivalent in value because it does not include the cost of the ambiguity created by the possibility of recharacterization.

This further inquiry and assessment, though, must go beyond the perspective of the rating agencies. Holders of these dequity investments should look more closely at how their legal obligations shift upon default and whether this shift is reflected in the price of investment. A nominally debt like investment that gives holders corporate governance rights in exchange for forsaking the ability to unilaterally demand repayment upon

[98] *See* Leon Dadoun, *The Growing Canadian Market*, CMBS World 17, 18 (Winter 2003).

default would be more attractive to the rating agencies and therefore lower the cost of financing the first mortgage loan. However, there is an additional consideration: whether the purchase price reflects the ambiguity created within this investment that it could or would be recharacterized as equity.

Let's go back to our $25 of gap equity that must be financed. We assume that as a straight debt investment (a "hard second") it would be priced at $25, as it possessed the right to demand repayment (i.e. foreclosure). Now let's strip off elements of debt (e.g. adding a stand still agreement) and add elements of equity (e.g. right to participate and vote in certain management decisions). The move from a discrete contract to a relational contract is not a one for one straight line trade-off. As more equity like attributes are added there is a non-linear progression due to the increasing ambiguity of recharacterization.[99] Therefore, the $25 former debt investment is no longer worth $25 but rather some price less.

Parties can attempt to attenuate this ambiguity through the use of intercreditor agreements. Here we are not only talking about agreements between the senior lien holder and the dequity investor. Rather, there should also be a recognition by the dequity investor that to recoup some of the value lost through ambiguity of threat of

[99] The value of the investment can be interpreted as a function of the probability of repayment. Assume a hypothetical investment of $100. If the probability of repayment is 100% then the price paid should be $100. If the probability of repayment is 0% the price should be zero. The ambiguity of recharacterization produces a risk aversion where if the probability of recharacterization from debt to equity (eliminating right to demand payment) is 50% an investor would not pay $50 but, rather some price less $50 to compensate for the ambiguity.

recharacterization they should strive to maintain priority over other investment classes even though such priority may be lost vis-à-vis the first lien holder.

Additionally, these intercreditor agreements perform another function. In essence they are a form of credit support for the senior debt. The intercreditor agreements give comfort to dequity investors who then agree to invest in something that is less than debt but presumably more than equity. If, through recharacterization, these agreements are not enforced in accordance with their terms the dequity suffers a loss in value. Subordinate real estate investors will (should) begin to demand more at the inception of the transaction possibly affecting the price of the first lien debt.

In constructing the default rule of interpretation of rights upon default we therefore must incorporate both right to demand payment and right to participate in firm governance. The ambiguity risk, i.e. the risk of recharacterization, turns on the courts' interpretation of these two factors. The goal in instituting a default rule of interpretation is to illuminate this possible ambiguity and allow for transparent pricing not only of the senior debt but also of the subordinate dequity. Legal review of intermediate investment vehicles should begin to include not just the ability of the dequity holder to jeopardize payment priority of the first lien, but also whether payment demands and management rights will possibly recharacterize the dequity investment. In economic terms the value of the dequity investment is a probability function where p is the chance of recharacterization.[100]

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[100] The probability of recharacterization will be a function of right to participate in firm governance and right to demand payment. Algebraically, it would be expressed as $V=I*p$(recharacterization).

Conclusion: Delineating the Dichotomy in the Future

As real estate finance employs more and more sophisticated tools the debt/equity distinction will become even more difficult. Characterization as debt or equity has implications in today's real estate market beyond the traditional legal boundaries of tax and bankruptcy. Therefore, mechanisms must be designed to effectuate a more accurate representation of the nature of the investment. A first step would be to include in the analysis the notion that equity like relational contracts are not perfect substitutes for debt like discrete contracts. Then the markets may present a truer reflection of the price of hybrid gap financing.

Furthermore, we need to expand our thinking about the effect of hybrid financing beyond the scope of first lien financing. The effect of recharacterization from debt to equity in the event of default likewise restructures the relationship between the holder of the gap financing and other creditors and investors of the borrower. Real estate firms will have a clearer picture of their investment structure by undertaking a 180 degree examination of firm capitalization utilizing the analysis tools of right to demand repayment and right to participate in corporate governance.

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p(recharacterization)=*f*(right to participate in firm management, right to demand payment). V is value and I is investment price.