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FEATURES

Letter from the Editor

Welcome to the UM Business Law Newsletter!

We are excited to release our First Edition for 2016.

I would like to congratulate Sampada Kapoor for winning our competition for best article and for being named the editor-in-chief for Volume 4. Sampada's article is included in this publication and was previously published by *The Mississippi Business Law Reporter*.

I would also like to give a special thanks to our faculty advisors, Professor Mercer Bullard and Professor John Czarnetzky. Professor Bullard has been vital in producing the *Newsletter* and planning our business law conferences. The Business Law Network put on three conferences in the 2015-2016 school year, which included a fall conference in Oxford, a winter conference in Jackson, and a spring conference in Memphis sponsored and hosted by Regions Private Wealth Management.

The Honorable Randy Pierce, formerly a justice of the Mississippi Supreme Court and currently the director of the Judicial College, was the keynote speaker at the fall conference, and the Honorable Lynn Fitch, Treasurer of the State of Mississippi, was the keynote speaker at the winter conference. We are especially thankful for the support of Regions Private Wealth Management members Andy Carter, Marilyn Rozier, Natalie Mann, and Heather McElwee for presenting at the spring conference and making the event possible.

It is also exciting to recognize Professor John Czarnetzky for being named the Outstanding Law Professor by the law school student body and for winning the 2016 Elsie M. Hood Outstanding Teacher Award. This is a tremendous accomplishment, and it could not have gone to a more deserving professor.

Please check out our website at http://umbusinesslaw.com/.

As always, thank you for reading!

Gerald Waltman III

Lifting the Corporate Veil: *Hobby Lobby* and Its Implications

Sampada Kapoor[*]

"By being required to make a choice between sacrificing our faith or paying millions of dollars in fines, we essentially must choose which poison pill to swallow," David Green, Hobby Lobby CEO and founder, said in a statement. "We simply cannot abandon our religious beliefs to comply with this mandate."[1]

In 2012, Evangelical Christian-owned arts and crafts corporation Hobby Lobby filed a lawsuit on religious grounds due to a government health mandate requiring employers to provide insurance coverage to their employees for contraceptives. The government mandate in question, part of the Affordable Care Act (ACA), included contraceptives such as the morning-after pill and IUDs, which the plaintiffs considered to be forms of abortion. The penalty for noncompliance with the mandate was a $100 per individual per day fine or the replacement of health coverage with higher wages.

Hobby Lobby argued that this mandate violated the Religious Freedom of Restoration Act (RFRA). The RFRA was passed in 1993 in order to ensure that interests in religious freedom were protected. The RFRA provides that:

> [The government may] not substantially burden a person's exercise of religion even if the burden results from a rule of general applicability, . . . [unless] it demonstrates that application of the burden to the person (1) is in furtherance of a compelling governmental interest; and (2) is the least restrictive means of furthering that compelling governmental interest.[2]

In 2014, the U.S. Supreme Court held that the mandate violated the RFRA. In a 5-4 majority, they held in *Burwell v. Hobby Lobby* that closely held for-profit corporations were not required to include contraceptive coverage for women in the insurance it provided its employees.[3] In order to determine whether the mandate violated the RFRA, the Court had to determine two main questions: Firstly, were corporations considered persons? And if they were, did the mandate substantially burden Hobby Lobby's exercise of religion?

Justice Alito, writing for the majority, argued that the extension of personhood to corporations was done in order to protect the rights of shareholders, officers, and employees. Justice Alito stated in his opinion the following concerning personhood:

> A corporation is simply a form of organization used by human beings to achieve desired ends...when rights, whether constitutional or statutory, are extended to corporations, the purpose is to protect the rights of these people…any suggestion that for-profit corporations are incapable of exercising religion because their purpose is simply to make money flies in the face of modern

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[*] Sampada is a rising third-year law student at the University of Mississippi School of Law, and she will serve as editor-in-chief of Volume 4 of the *UM Business Law Newsletter*. She has presented this paper with Professor Mercer Bullard at two conferences sponsored by the University of Mississippi Business Law Network. She received the *Mississippi Business Law Newsletter Award* for this article, and it was published in the Fall 2015 edition of the Mississippi Bar's *Business Law Reporter*.

[1] David Green, *Christian Companies Can't Bow to Sinful Mandate*, USA TODAY, Sept. 12, 2012.

[2] 42 U.S.C. §§2000bb-1 to -4 (2013).

[3] *Burwell v. Hobby Lobby Stores, Inc.*, 134 S.Ct. 2751 (2014).

corporate law.[4]

Having established Hobby Lobby as a "person," the Court then held that the mandate substantially burdened Hobby Lobby's exercise of religion. The Court ruled that the mandate was neither in furtherance of a compelling government interest nor the least restrictive way of guaranteeing access to contraceptives. Since the mandate essentially "failed" both parts of the RFRA, the Court deemed that the mandate could not apply to corporations such as Hobby Lobby.

Legal Precedent

While courts have previously ruled on the expansion of corporate power, there is an absence of legal precedent on the issue of a business entity's religious rights. Justice Ginsberg argued this point in her dissent and challenged the majority's unprecedented view by stating:

> Until this litigation, no decision of this Court recognized a for-profit corporation's qualification for a religious exemption from a generally applicable law, whether under the Free Exercise Clause or RFRA. The absence of such precedent is just what one would expect, for the exercise of religion is characteristic of natural persons, not artificial legal entities.[5]

Despite the absence of legal precedent on the specific issue of religious freedom, the Court found sufficient analogous support in cases that treated natural persons' first amendment rights as being expressed through a corporate entity. A contentious corporate expansion case, *Citizens United v. Federal Election Commission,* concerned the issue of campaign finance. The Court held that the First Amendment prohibited the government from restricting independent political expenditures from corporations. Although the court in *Citizens United* made no reference to the term "corporate personhood," *Hobby Lobby* extended the logic from the former case by essentially asking that if corporations could engage in political speech, could they not also practice religion?

Although at first blush the decision seems narrow, its implications are in fact quite broad. Justice Alito went to great lengths to write a limited decision. In his opinion, he wrote that:

> [t]his decision concerns only the contraceptive mandate and should not be understood to hold that all insurance-coverage mandates, *e.g.*, or vaccinations or blood transfusions, must necessarily fall if they conflict with an employer's religious beliefs. Nor does it provide a shield for employers who might cloak illegal discrimination as a religious practice.[6]

Justice Alito's intentions may have been to create a limited holding, the case still may be applied expansively. The underlying logic in *Hobby Lobby* has the potential of acting as a stepping-stone to even more corporate rights. Beside the implications for women's health care, the *Hobby Lobby* ruling created several deep concerns. One main concern of the ruling is the potential dismantlement of corporate separateness. Another important issue is the potential for the

[4] *Id.* at 2768.
[5] *Id.* at 2794.
[6] *Id.* at 2758.

discrimination of groups such as members of the LGBTQ community by corporations using religious exemption as their justification.

Corporate Separateness, Piercing, and "Reverse Piercing" of the Corporate Veil

By allowing Hobby Lobby to fall under the category of a "person" in the RFRA, the Court recognized a corporation's claim of religious belief for the first time. Critics have argued that the Court's novel extension of corporate rights contradicts the basic principles of corporate law.[7] Specifically, the *Hobby Lobby* holding undermines the doctrine of the corporate separateness (also referred to as the "corporate veil"). The corporate veil refers to a characteristic of corporate liability in which corporations are considered separate entities from the owners and managers.

In the event that corporation owners are no longer considered separate from the actual corporations, the owner or owners are held personally responsible for the liabilities of the corporation.[8] This decision in which the liability is removed is referred to as the piercing of the corporate veil. The corporate veil protects shareholders from personal liability for corporate actions by treating the corporation as a separate entity. The rationale behind the corporate veil is simple: by creating the corporate veil, legislators wanted to encourage entrepreneurial activity by founders, investment by passive investors, and risk-taking by corporate managers.

Courts have previously held that when corporations were simply "alter egos" of their shareholders, they could no longer enjoy the benefits of separateness and the corporate veil would be pierced to the shareholders. By treating the entity's religious views as those of its shareholders, the corporation arguably becomes an alter ego of its shareholders. *Hobby Lobby* allows corporations to become alter egos for their shareholders and triggers veil piercing. Allowing a "tear" in the veil would make the raising of capital more challenging, recruitment of employees more difficult, and entrepreneurial energy less likely to flourish.

Corporate and criminal law professors have also disparaged the decision as being completely contrary to corporate law.[9] They argue that the Supreme Court is going against its own precedent by allowing corporations to have powers that are fundamentally at odds with the concept of corporations.

Furthermore, *Hobby Lobby* and the legislation that springs forth from it could allow for the "reverse piercing" of the corporate veil. [10] While traditional piercing holds an individual liable for the acts of a corporation, reverse piercing imposes liability on a corporation for the obligations of an individual shareholder. The concept of reverse piercing first arose in the landmark case of *Kingston Dry Dock Co. v. Lake Champlain Transportation Co.*[11] Judge Learned Hand ruled in the case that only under rare exceptions would subsidiaries by liable for transactions made in the name of a parent corporation. Following Judge Learned Hand's ruling, the courts remained unfriendly towards the doctrine of reverse piercing for nearly thirty years.

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[7] Amy J. Sepinwall, *Corporate Piety and Impropriety: Hobby Lobby's Extension of RFRA Rights to the For-profit Corporation,* HARV. BUS. L. REV. (2015).

[8] *Kinney Shoe Corp. v. Polan*, 939 F.2d 209 (4th Cir. 1991)

[9] Brief of Corporate and Criminal Law Professors as Amicus Curiae in Support of Petitioners at 8, Kathleen Sebelius, Secretary of Health and Human Services, et al. v. Hobby Lobby Stores, Inc., Nos. 13-354 and 13-356 (10th Cir. January 2014).

[10] See, e.g., Stephen M. Bainbridge, *Using Reverse Veil Piercing to Vindicate the Free Exercise Rights of Incorporated Employers*, 16 GREEN BAG 2D 235 (2013).

[11] *Kingston Dry Dock Co. v. Lake Champlain Transp. Co.*, 31 F.2d 265 (2d Cir. 1929).

Although controversial, the courts permitted reverse piercing in later cases such as in *Shamrock Oil & Gas v. Ethridge,*[12] where a third party creditor filed suit against the defendant corporation's owner in his individual capacity. The court permitted reverse piercing by allowing the plaintiff to seize the *corporation's* asset, an oil-dredging rig, although he was suing the defendant as an individual. Where, as here, the corporation is a "mere dummy" or alter ego of the shareholder, courts may put aside the fiction of corporate separateness.[13]

The doctrine is problematic when the relevant corporation has multiple shareholders, and even when there is only one shareholder it can give creditors of a shareholder an advantage they would not normally have relative to creditors of the corporation. This doctrine would not necessarily be problematic if all shareholders intended to treat the corporation as an alter ego. The issue of having only a few shareholders treating the corporation as an extension of them is the possibility of innocent shareholders who did not take part in the management of the corporation being held responsible for them.

Religious Exemption from the Law

The power granted to corporations by the Supreme Court was decided on the basis of the Religious Freedom and Restoration Act of 1993. Although RFRA did not itself define "person," the holding in *Hobby Lobby* expanded corporate power and for the first time gave for-profit corporations the status of a person with the right to religious freedom. Critics warn that such a designation, cited over time, have a history of becoming broader when cited as a precedent. Justice Ruth Bader Ginsburg argued in her dissenting opinion in this case that a corporation could use the logic of this case and object on religious grounds to paying for blood transfusions, vaccinations or antidepressants. Other scholars say the same logic could justify a corporation's right to privacy as a shield against regulatory scrutiny, or a right to bear arms.[14]

Hobby Lobby may lead to countless other challenges by corporations and businesses seeking to claim that other laws violate their religious beliefs. For example, groups advocating for LGBTQ rights fear that the *Hobby Lobby* decision could lead to companies denying spousal benefits to same-sex couples by using a religious freedom argument. By expanding corporate personhood and giving corporations the power of religious freedom, companies may now able to use the religious exemption to circumvent compliance with laws that prevent discrimination against LGBTQ members.

The Effect of *Hobby Lobby* in Mississippi

The Mississippi Religious Freedom Restoration Act (MRFRA) is a similar version of the RFRA. It that states that "…[t]he government should not substantially burden religious exercise without compelling justification" and that the act was created "to provide that state action or an action by any person based on state action shall not burden a person's right to the exercise of religion."[15] Mississippi's definition of a "person." Title 1, Chapter 3, Section 39 of the Mississippi state code states a "person" as all public and private corporations.[16]

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[12] *Shamrock Oil & Gas Co. v. Ethridge*, 159 F. Supp. 693 (D. Colo. 1958)

[14] Binyamin Appelbaum, *What the Hobby Lobby Ruling Means for America*, THE NEW YORK TIMES MAGAZINE, (July 22, 2014), http://www.nytimes.com/2014/07/27/magazine/what-the-hobby-lobby-ruling-means-for-america.html?_r=1.

[15] Mississippi Religious Freedom Restoration Act, 2014 Miss. ALS 474, 2014 Miss. Gen. Laws 474, 2014 Miss. S.B. 2681

[16] Miss. Code Ann. § 1-3-39

The law's language raises substantial flags in the same way that the RFRA did by allowing persons to argue for religious exemption in the face of certain laws. This language may provide support for corporations to refuse services to members such as the LGBTQ community on religious freedom grounds. Tony Perkins, head of the Family Research Council, pushed for passage of the MRFRA and was present for its signing into law. In a statement praising the Mississippi legislature, Perkins singled out refusing service to same-sex couples as a driving force behind the bill.[17]

The MRFRA, given support by *Hobby Lobby*, could allow corporations in Mississippi to discriminate against the LGBTQ community. According to Sarah Warbelow, the Human Rights Campaign's state legislative director, "Just as we've seen in other states, this bill is bad for business, bad for the state's reputation, and most of all, bad for Mississippians."[18]

Looking to the Future

The decision in *Hobby Lobby* rests on arguments that are contrary to well-established principles of corporate separateness. The expansion of corporate personhood could very likely threaten entrepreneurial activity and alter the most precious characteristic of a corporation—its privilege of limited liability. The privilege protects shareholders from liability for corporate debts, therefore encouraging investment, innovation, and job generation. By piercing this veil and no longer treating corporations as separate, the holding will potentially remove these privileges and result in unintended yet negative circumstances.

Furthermore, by corporatizing religious liberty, *Hobby Lobby* extends the rights and privileges that have long been associated only with churches and religious nonprofits to for-profit businesses. Today, corporations have nearly all the same constitutional rights as individuals. Despite claims that this holding was narrow, the Supreme Court's decision is the broadest in providing corporations the capacity to claim an exemption to a law based on the religious beliefs of their owners. The decision in *Hobby Lobby* encourages state legislatures to enact bills such as Senate Bill 2681, which could allow businesses in Mississippi to exercise the right to religious freedom and potentially discriminate against groups or withhold certain privileges from employees. By following the logic of this case, it is not hard to imagine a future where businesses, emboldened with power, may discriminate against employees on the basis of the owner's religious belief.

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[17] Eric Brown, *Mississippi Gov. Signs 'Religious Liberty' Bill That Allows Anti-Gay Discrimination*, INTERNATIONAL BUSINESS TIMES, (April 4, 2014), http://www.ibtimes.com/mississippi-gov-signs-religious-liberty-bill-allows-anti-gay-discrimination-1567540

[18] Chris Johnson, *Mississippi legislature approves 'turn away the gays' bill*, WASHINGTON BLADE, (April 1, 2014), http://www.washingtonblade.com/2014/04/01/mississippi-legislature-approves-turn-away-gays-bill/

Characterizing Recharacterization:
Anticipating Resolution of the Current Circuit Split

By Emily Robertson*

A circuit split over whether to apply federal or state law in the recharacterization analysis of putative debt claims in a bankruptcy action was recently made all the more divisive by the 2015 Tenth Circuit ruling in *In re Alternate Fuels, Inc.*[1] The decision leaves those in the bankruptcy field and business investors wondering if and how the Supreme Court of the United States will resolve this ongoing split that has existed since a 2011 decision by the Fifth Circuit. [2]

Recharacterization is an action by the court, typically made at the request of unpaid unsecured creditors of the debtor, to classify a disguised debt transaction or loan as a capital contribution by looking beyond the form of the agreement to the substance of the transaction.[3] If a debt is recharacterized as equity, the claim will essentially be relegated to the back of a long line of claimants according to the "priority scheme" set forth in 11 U.S.C. § 726.[4] That section provides that equitable investments are paid only after all unsecured creditors are paid in full. [5] Therefore, if other creditors can move the court to recharacterize the debt, more money will theoretically be available for distribution to their class of claims. This doctrine is sometimes confused with equitable subordination, as both actions can have the same effect of diminishing a claim. However, equitable subordination is distinguishable from recharacterization, in that it is a remedy the courts use to punish unjust conduct by a creditor, whereas recharacterization is a reclassification of a claim based on its true substance. [6]

The concept of recharacterization is not expressly referenced anywhere within the Federal Bankruptcy Code. However, most circuits that have addressed the issue have held that it is an equitable power of the court implicit in the Code that helps to facilitate an efficient bankruptcy plan.[7] While the circuits agree the power is within the court's discretion, an unresolved split over which specific Code provision grants them the authority has led to conflicting applications of law.[8] Though the courts occasionally have comparable outcomes because the tests utilized are frequently very similar, the legal vehicles by which they arrive have distinct policy objectives and procedural ramifications.

Conflicting Standards

The majority approach, which is subscribed to by the Fourth,[9] Sixth,[10] and Tenth[11] Circuits, contends that the power is given under § 105(a) that provides "the court may issue any

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* Emily is a May 2016 graduate of the University of Mississippi School of Law. She has presented this paper, with attorney Robert Gambrell of Gambrell & Associates, PLLC, at a conference sponsored by the University of Mississippi Business Law Network.

[1] *In re* Alternate Fuels, Inc., 789 F.3d 1139 (10th Cir. 2015).

[2] *In re* Lothian Oil Inc., 650 F.3d 539 (5th Cir. 2011).

[3] *In re* AutoStyle Plastics, Inc., 269 F.3d 726, 747 (6th Cir. 2001).

[4] *In re*: Dornier Aviation (N. Am.), Inc., 453 F.3d 225, 231 (4th Cir. 2006).

[5] *Id.*

[6] *In re* Hedged-Invs.Assocs., Inc., 380 F.3d 1292, 1297 (10th Cir. 2004).

[7] *In re* Fitness Holdings Int'l, Inc., 714 F.3d 1141, 1148 (9th Cir. 2013).

[8] *Id.*

[9] *Dornier*, 453 F.3d at 225.

[10] *In re* AutoStyle Plastics, Inc., 269 F.3d 726 (6th Cir. 2001).

[11] *In re* Alternate Fuels, Inc., 789 F.3d 1139 (10th Cir. 2015).

order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."[12] Within this approach, there are two slightly different multi-factor tests, but both are based upon federal tax cases that are particular to the circuit, rather than the applicable state.[13] The Fourth and Sixth Circuits use the same eleven-factor test[14], while the Tenth Circuit looks at thirteen factors. Both are subjective inquiries derived from the characteristics of an "arm's length negotiation". [15] The following factors used in *Alternate Fuels* are not exclusive, and none are dispositive:

(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) participating 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 the 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.[16]

In contrast, the Fifth[17] and Ninth[18] Circuits established the minority view that the power is granted under §502(b)(1), which states that "the court . . . shall allow such claim in such amount, except to the extent that such claim is unenforceable against the debtor and property of the debtor, under any agreement or applicable law for a reason other than because such a claim is contingent."[19] This approach holds that "applicable law" should be interpreted as state law based upon explicit language in the Supreme Court case, *Butner v. United States.*[20] Therefore, if the transaction would not amount to a right to payment under the applicable state law because it would instead be viewed as a capital investment, then it will be recharacterized as such for bankruptcy purposes. [21] In *In re Lothian Oil, Inc.*, the Fifth Circuit applied a Texas standard that is also a multi-factor test originating from federal tax law.[22] While the tests from the two approaches are similar, they are in fact distinct because of the purposeful choice of state precedent by the minority approach, as opposed to a standard test that is applied in all jurisdictions.

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[12] 11 U.S.C.A. § 105(a).
[13] *In re* Hedged-Invs.Assocs., Inc., 380 F.3d 1292, 1298 (10th Cir. 2004).
[14] *Dornier*, 453 F.3d at 233.
[15] *Alternate Fuels*,789 F.3d at 1149.
[16] *Id.*(citing *Hedged-Invs.*, 380 F.3d at 1298).
[17] *In re* Lothian Oil Inc., 650 F.3d 539 (5th Cir. 2011).
[18] *In re* Fitness Holdings Int'l, Inc., 714 F.3d 1141 (9th Cir. 2013).
[19] 11 U.S.C.A. § 502(b)(1).
[20] *Id.* at 1146.
[21] *Id.* at 1148.
[22] *Lothian*, 650 F.3d at 544.

The remaining circuits have either addressed the power uniquely, or have not addressed it at all. The following two circuits have not yet made clear which Code provision grants them authority to recharacterize debt, and thus have different applications that are only adopted in their own circuits. The Third Circuit, in *In re SubMicron Systems Corp.,* announced that it would not utilize a pre-determined multi-factor test, but instead would evaluate the facts on a case-by-case-basis, saying that "no mechanistic scorecard suffices."[23] The Eleventh Circuit looks at only two specific instances that signify a capital investment as opposed to a debt, which are "where the trustee proves initial under-capitalization or where the trustee proves that the loans were made when no other disinterested lender would have extended credit."[24] Finally, the Seventh Circuit did not officially acknowledge recharacterization as an available power in a case regarding the matter tangentially, [25] and the other four circuits have not addressed the issue.[26]

Mutual Rejection of Analyses

In the Tenth Circuit's *Alternate Fuels* case, the putative creditor moved the Court to adopt the minority view based upon the *Butner* case, as well as another Supreme Court decision, *Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Company.*[27] *Travelers* was issued after the circuits adopted the majority approach of using § 105(a) as the basis for the authority, but the case did not directly address the issue of recharacterization. It instead focused on the recovery of attorney's fees in a bankruptcy. The Court held that "claims enforceable under applicable state law will be allowed in bankruptcy unless they are expressly disallowed" because "property interests are created and defined by state law."[28] Furthermore, *Travelers* reversed the Ninth Circuit's ruling in the case, and chastised them for adhering to a rule solely of their own creation that is not found in either the Code or state law.[29] The *Alternate Fuels* appellant urged the Court to apply these principles to debt recharacterization and to analyze the claim under 502(b)(1), however the Court refused to follow the state law approach, and upheld Tenth Circuit precedent.[30] Quoting a Fourth Circuit decision, they ruled that 502(b) strictly deals with disallowance of a claim, rather than recharacterization, and should only be utilized if the creditor has absolutely no rights of recovery from the bankrupt.[31] The Court distinguished the two doctrines, opining, "Unlike disallowance of a claim, recharacterization of a loan as equity does not ultimately relieve a debtor from his obligation to repay the claimant. Although the claimant may not proceed in bankruptcy—since he no longer holds an allowed 'claim'—he may still hold a valid interest in equity to be paid upon the satisfaction of the debtor's other outstanding obligations."[32] Consequently, the Court proceeded to analyze the claim under the standard multi-factor test.

Prior to the Tenth Circuit's rejection of the minority approach in 2015, the Ninth Circuit similarly refused to follow the majority in *Fitness Holdings* in 2013. Just as the Ninth Circuit

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[23] *In re* SubMicron Sys. Corp., 432 F.3d 448, 456 (3d Cir. 2006).
[24] *In re* N & D Props., Inc., 799 F.2d 726, 733 (11th Cir. 1986).
[25] *In re* Airadigm Commc'ns, Inc., 616 F.3d 642, 658 (7th Cir. 2010).
[26] The remaining circuits are the First, Second, Eighth, and District of Columbia.
[27] Reply Brief of the Appellants at 5, *In re* Alternate Fuels, Inc., 789 F.3d 1139 (10th Cir. 2015) (No. 14-3086).
[28] *In re* Alternate Fuels, Inc., 789 F.3d 1139, 1147 (10th Cir. 2015) (quoting Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co., 549 U.S. 451 (2007)).
[29] *Travelers*., 549 U.S. at451.
[30] *Alternate Fuels*, 789 F.3d at 1146.
[31] *Id.* at 1148.
[32] *Id.*

appellant did in his brief in support of the minority approach, the *Fitness Holdings* court referenced both *Travelers*--a reversal of their own holding--and *Butner* as precedent to support the state law application. In agreeing with the Fifth Circuit's holding in *Lothian,* they wrote, "Given the Supreme Court's direction, courts may not rely on § 105(a) and federal common law rules 'of [their] own creation' to determine whether recharacterization is warranted."[33] The Court held that the correct analysis for recharacterization is to determine if the transaction "gives the holder of the obligation 'a right to payment' under state law."[34] Though not mentioned in the *Fitness Holdings* decision, the Fifth Circuit gave another reason for refusal to adopt the majority approach, citing that they prefer a narrow holding of § 105, so as not to exceed their powers. [35]

Anticipating a Resolution

At this point, the Supreme Court is not set to hear any case regarding debt recharacterization, however they did refuse to hear an appeal of the *Lothian* decision.[36] This refusal could arguably be viewed as implicit support for the minority approach. If and when they do grant certiorari, the Supreme Court will have to consider the effects of adopting either approach. Legal scholars in favor of the majority position argue that a uniform test will create more predictability in the courts and protection for investors,[37] while those supporting the minority contend that a state law approach will be the more predictable method and will ensure that property is treated the same in bankruptcy as it is outside of the remedial measure.[38] Though both analyses utilize tests from federal tax law, given the Supreme Court's decision in *Travelers* endorsing a state law approach in bankruptcy claims, it is likely that they will side with the minority. Specifically, the Court opined, "we have 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."'"[39] However, until the Court decides, the circuit split remains in full force.

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[33] *In re* Fitness Holdings Int'l, Inc., 714 F.3d 1141, 1148-49 (9th Cir. 2013) (quoting *Travelers*, 549 U.S. at 451).
[34] *Id.* at 1149.
[35] *In re* Lothian Oil Inc., 650 F.3d 539, 543 (5th Cir. 2011).
[36] Erica Litovitz, *Debt Recharacterization and Its Place in the Bankruptcy Code*, 10 SETON HALL CIRCUIT REV. 307, 327 (2014).
[37] *Id.* at 317.
[38] James M. Wilton &Stephen Moeller-Sally, *Debt Recharacterization Under State Law*, 62 BUS. LAW. 1257, 1280 (2007); Bryan C. Curran, *The "State" of Federal Bankruptcy Law: The Ninth Circuit's Debt Recharacterization Analysis in InRe Fitness Holdings International*, 55 B.C.L. REV. E-SUPPLEMENT 47, 57 (2014).
[39] Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co., 549 U.S. 443, 450-51 (2007) (quoting Butner v. United States, 440 U.S. 48, 49 (U.S. 1979)).

Banks Struggle to Stay on Par Throughout Stress Tests

By Marie Wicks[*]

Even the greatest golfers have their handicaps. The biggest banks do as well. Thirty-one of the largest U.S. bank holding companies (BHCs) emerged in early 2015 from the fifth repetition of the Federal Reserve's capital planning and stress test assessment.[1] The capital-planning element involves the Comprehensive Capital Analysis and Review (CCAR), which requires bank holding companies to submit capital plans to the Federal Reserve Board of Governors.[2] Banks are then subjected to a stress test pursuant to the Dodd-Frank Act.[3] The year 2015 saw the largest number of firms undergoing the stress test,[4] and it marked the first time every bank tested possessed sufficient capital to endure the financial regulator's hypothetical economic downturn.[5] While none of the banking giants *failed* the stress test, however, not every BHC passed with flying colors. The Fed rejected the capital plans of two firms—Deutsche Bank and Santander—and Bank of America's capital plan was conditionally accepted.[6] The remaining twenty-eight firms ultimately received acceptance of their capital plans.[7] Firms like Goldman Sachs and Morgan Stanley resubmitted their capital plans as part of the Fed's second chance option for final approval.[8] While some analysts critique the Fed's stress tests as lacking in transparency,[9] the tests nevertheless shed light on the overall strength of U.S. banks.

The Annual Stress Test

The Dodd Frank Act of 2010 mandated that the Fed conduct annual stress tests to determine whether financial institutions would be able to withstand economic catastrophe, including

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[*] Marie is a May 2016 graduate of the University of Mississippi School of Law. She has presented this paper with Professor Mercer Bullard at three conferences sponsored by the University of Mississippi Business Law Network.

[1] The results of the first round of the stress test were released on March 5, 2015, and the final report was released on March 11, 2015. For a graphic providing an overview of banks' performance in the first round of the test, see Ian Katz & Dakin Campbell, *Fed Says 31 Banks Could Weather an Economic Storm*, BLOOMBERGBUSINESS (Mar. 5, 2015, 3:30 PM), http://wtww.bloomberg.com/news/articles/2015-03-05/fed-stress-tests-show-31-largest-banks-meet-capital-targets.

[2] Amendments to the Capital Plan and Stress Test Rules, 80 Fed. Reg. 43637-01, 43637 (July 23, 2015) (to be codified at 12 C.F.R. pts. 225 & 252).

[3] *Id.*

[4] Last year, thirty-one banks were tested, as Deutschebank was added to the thirty from 2014. *See* Trefis Team, *Fed Stress Test Winners and Losers*, FORBES (Mar. 13, 2015, 8:36 AM), http://www.forbes.com/sites/greatspeculations/2015/03/13/fed-stress-test-winners-and-losers/. In 2016, thirty-three banks will undergo the stress test. Ian Katz & Jesse Hamilton, *Fed to Stress-Test 33 Banks on Weathering Global Recession*, BLOOMBERG (Jan. 28, 2016, 3:00 P.M.), http://www.bloomberg.com/news/articles/2016-01-28/fed-to-stress-test-33-banks-on-severe-global-recession-response.

[5] *Fed Stress Test for Banks: Rationale, Results & Implications*, TREFIS.COM (Mar. 9, 2015), http://www.trefis.com/stock/db/articles/284098/fed-stress-test-for-banks-rationale-results-implications/2015-03-09.

[6] Trefis Team, *supra* note 4. A bank fails the stress test if the Fed rejects its plan to distribute capital to shareholders. Peter Eavis, *Dealbook: What to Know About Bank Stress Tests*, NYTIMES.COM (Mar. 4, 2015), http://www.nytimes.com/interactive/2015/03/04/business/dealbook/05db-stress.html. This rejection may stem from a bank's possessing insufficient capital, for from other qualitative reasons. *Id.*

[7] *Id.*

[8] *See infra* text accompanying notes 21-27.

[9] *See, e.g.*, Jon Hartley, *Fed Should Stop the Stress Test Guessing Game*, AMERICAN BANKER (Mar. 13, 2015), http://www.americanbanker.com/bankthink/fed-should-stop-the-stress-test-guessing-game-1073229-1.html.

increasing unemployment, plunging home prices, and panicking markets.[10] Under the stress test, each bank is subjected to "adverse" and "severely adverse" scenarios. In the 2015 severely adverse situation, unemployment jumped to 10 percent, the Dow Jones Stock Market Index fell by 60 percent in 2015, gross domestic product decreased by 4.5 percent, and the price of oil climbed to $110 per barrel.[11] Banks that were able to survive such conditions and maintain sufficient capital were in good shape.

U.S. Banks' Performance Under the Stress Test

Overall, U.S. banks displayed their strengths under the 2015 stress test. Nevertheless, many bank executives from the nation's largest banks were astonished at the disparity between their capital projections and those of the Federal Reserve.[12] Two American units of European banks and Bank of America were required to take a second look at their capital plans. Bank of America had to resubmit its capital plan in the third quarter after improving upon "weaknesses in certain aspects of Bank of America's loss and revenue modeling practices and in some aspects of the BHC's internal controls."[13] The Fed completely rejected the capital plan of Deutschebank due to deficiencies in "risk-identification, measurement, and aggregation processes; approaches to loss and revenue projection; and internal controls."[14] Santander, an institution out of Spain, also experienced post-stress test rejection for the second consecutive year.[15]

In addition to these results, Goldman Sachs, JPMorgan Chase, and Morgan Stanley emerged with at least one post-stress capital ratio below the minimum requirement and were instructed to reduce overall payouts.[16] J.P. Morgan, for instance, predicted a loss of about $30.3 billion in the severely adverse economic scenario.[17] The Fed's projection for the firm approached $54.8 billion—almost twice as much.[18] Goldman, in turn, predicted it would survive the hypothetical economic calamity with $100 billion more in risk-weighted assets than the Fed's estimate.[19] According to Goldman's calculations, the bank's total risk-based capital ratio—its measure of capital as a percentage of risk-weighted assets—would sink to 13 percent; in the eyes of the Fed, however, the risk-based capital ratio would barely surpass the 8 percent minimum.[20]

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[10] Peter Eavis, *Big Banks Pass Muster in Latest Stress Tests*, N.Y. TIMES, Mar. 6, 2015, at B1, http://www.nytimes.com/2015/03/06/business/dealbook/fed-stress-tests-find-biggest-banks-meet-capital-thresholds.html. Each year, investors and bank executives await the stress test results with anticipation, for a failure to pass capital muster limits a bank's ability to pay shareholder dividends and stock buybacks. *Dealbook: What to Know About Bank Stress Tests*, *supra* note 6.

[11] BLOOMBERGBUSINESS, *supra* note 1.

[12] Ryan Tracy, Emily Glazer & Victoria McGrane, *Fed 'Stress Tests' Still Pose Puzzle to Banks*, WALL ST. J. (Mar. 12, 2015, 8:08 PM), http://www.wsj.com/articles/fed-stress-tests-still-pose-puzzle-to-banks-1426205323.

[13] Trefis Team, *supra* note 4.

[14] *Id.*

[15] *Id.*

[16] BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, COMPREHENSIVE CAPITAL ANALYSIS AND REVIEW 2015: ASSESSMENT FRAMEWORK AND RESULTS 12 (Mar. 2015), https://s3.amazonaws.com/s3.documentcloud.org/documents/1685296/feds-stress-test-of-big-banks-part-two.pdf; *see also Fed's Stress Test of Big Banks: Part Two*, NYTIMES.COM (Mar. 11, 2015), http://www.nytimes.com/interactive/2015/03/11/business/dealbook/document-feds-stress-test-of-big-banks-part-two.html?_r=0.

[17] Tracy, Glazer & McGrane, *supra* note 12.

[18] *Id.*

[19] *Id.*

[20] *Id.* The Fed predicted Goldman's total risk-based capital to drop to 8.1 percent.

U.S. Banks Offered a Second Chance

On the golf course, taking a "mulligan" means attempting a second swing after a wayward shot.[21] This terminology has also entered common usage in the world of stress tests, because the Fed allows banks a second chance: one attempt to resubmit a scaled-back capital plan to improve their scores following the initial stress test results without having to restrict shareholder payouts.[22] In last year's stress test, the Fed approved the revised dividend and stock buyback plans of both Goldman and Morgan Stanley after their initial requests fell short of the minimum capital requirements.[23] For Goldman, this was the second consecutive mulligan and the third year in which Goldman failed to navigate flawlessly the Fed's stress test scenarios.[24]

These struggles, however, do not necessarily denote poor performance on the part of Goldman or Morgan Stanley. Rather, these firms engage in a large proportion of capital-market-businesses, which were sensitive to the conditions of the stress test.[25] Other institutions that engage more closely in traditional banking activities were more likely to see their internal predictions align with the results of the Fed.[26] The diverse portfolios of the financial institutions involved inevitably led to disparities in the results of the stress tests; however, the Fed sees this unpredictability as a sign that the stress tests are doing their job.[27]

The European Central Bank's Asset Quality Review

Regular stress tests do not solely befall U.S. institutions. The Fed's stress test last year occurred months after European Central Bank's asset quality review in October 2014, in which one fifth of the banks tested failed to meet minimum capital requirements.[28] Indeed, the European stress test overall is far more lenient than that of the Federal Reserve, largely due to broader definition in Europe of what amounts to "core capital."[29] Of the 130 banks probed under the ECB stress test, 25 failed. For many analysts, these results fell somewhat short of expectations.[30]

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[21] *5 Things to Watch for in the Fed's Stress Test Results*, WSJ BLOGS (Mar. 11, 2015, 7:55 AM), http://blogs.wsj.com/briefly/2015/03/11/5-things-to-watch-for-in-the-feds-stress-test-results/.

[22] Tracy, Glazer & McGrane, *supra* note 12.

[23] Justin Baer, *Revised 'Stress Test' Plans at Goldman, Morgan Stanley Succeed*, WALL ST. J. (Mar. 11, 2015, 7:22 PM), http://www.wsj.com/articles/revised-stress-test-plans-at-goldman-morgan-stanley-succeed-1426116163.

[24] *Id.*

[25] John Carney, *Goldman, Morgan Stanley Don't Have to Fall into Stress-Test Gap: Results diverge sharply from Fed, but this doesn't indicate a fundamental problem with banks' approach*, WALL ST. J. (Mar. 10, 2015, 4:37 PM), http://www.wsj.com/articles/goldman-morgan-stanley-dont-have-to-fall-into-stress-test-gap-heard-on-the-street-1426019873; *see also* John Carney, *Trading Doldrums Won't Sink Morgan Stanley, Goldman Sachs*, WALL ST. J. (July 14, 2014, 1:33 PM), http://www.wsj.com/articles/ahead-of-the-tape-trading-doldrums-wont-sink-morgan-stanley-goldman-sachs-1405359195.

[26] *Goldman, Morgan Stanley Don't Have to Fall into Stress-Test Gap*, *supra* note 25.

[27] *Id.*

[28] *Stressful Tests: The ECB's Asset Quality Review*, THE ECONOMIST (Oct. 26, 2014), http://www.economist.com/news/business-and-finance/21628422-europes-banks-have-been-probed-some-have-been-found-wanting-who-stressful-tests.

[29] Katy Barnato, *How Many European banks would pass US stress test?*, CNBC (Apr. 2, 2014, 8:07 AM), http://www.cnbc.com/2014/04/02/how-many-european-banks-would-pass-us-stress-tests.html.

[30] *See* Jeff Black, *ECB Fails 25 Banks as Italy Fares Worst in Stress Test*, BLOOMBERG (Oct. 26, 2014, 5:00 AM), http://www.bloomberg.com/news/2014-10-26/ecb-test-shows-25-billion-euro-capital-gap-at-euro-banks.html; *see also* Jack Ewing, *Dealbook: 13 European Banks Fall Short in E.C.B. Stress Test*, N.Y. TIMES (Oct. 26, 2014, 7:00 AM), http://dealbook.nytimes.com/2014/10/26/ecb-stress-test-finds-13-banks-fall-short/?_php=true&_type=blogs&_r=0 ("Estimates of what the capital shortfall would be had varied widely, from tens of billions of euros to hundreds of billions. Many banks had already begun protectively shoring up their capital.").

Further, had the ECB applied tighter capital restrictions identical to ones that will eventually be required upon the completion of Basel III,[31] as many as 34 banks could have failed the stress test.[32] Among the banks that passed the stress test include French, Spanish, British, and German institutions. Where did the banks fare the worst? Italy, in which nine banks failed the test. The world's oldest bank, Monte dei Paschi, saw a €2.1 billion gap, which was the largest capital shortfall of any institution.[33] The Banco Comercial Portugues SA in Portugal emerged with a shortfall of €1.15 billion, although the bank claims to have raised that amount in capital since the test period ended in December 2013.[34]

The European Banking Authority (EBA) observed progress in recapitalization efforts among European banks and decided not to conduct an EU-wide stress test in 2015.[35] Instead, the banking regulator carried out a transparency exercise designed to provide detailed data on banks' loan portfolios and balance sheets.[36] In February 2016, the EBA released the methodology and adverse economic scenarios for this year's EU-wide stress test, the results of which will be published in the third quarter of 2016.[37]

Transparency and Second Chances

Transparency is a key concern in the context of banking regulation. Not only did the European Banking Authority focus on greater transparency of banks' loan portfolios in 2015, but the Federal Reserve's unwillingness to unveil its stress test model each year leaves banks dubious. Like a wayward shot on the golf course, an initial failure to pass the stress test is not fatal and may lead to a second chance for banks to submit capital plans without having to restrict shareholder payouts. However, even as second chances are provided, the Federal Reserve publishes the initial results of the stress test.[38] Thus, banks are under pressure to succeed the first time despite the test's overall opacity. Where banking regulation is concerned, no amount of mulligans can match staying on par.

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[31] Emily Lee, *Basel III And Its New Capital Requirements, As Distinguished From Basel II*, 131 BANKING L.J. 27, 39 (2014).

[32] *See* Jim Brumsden & Ben Moshinsky, *EU Stress Test Shows How Capital Rules Give Room to Hide*, BLOOMBERG (Oct. 26, 2014), http://www.bloomberg.com/news/2014-10-26/eu-stress-test-shows-how-capital-rules-give-room-to-hide.html.

[33] Jill Treanor, *Italian central bank defends institutions after Monte dei Paschi di Siena and eight other banks are told to find billions to plug capital shortfalls*, THE GUARDIAN (Oct. 26, 2014), http://www.theguardian.com/business/2014/oct/26/worlds-oldest-bank-fails-european-stress-tests.

[34] Black, *supra* note 30.

[35] Press Release, European Banking Auth., EBA updates on future EU-wide stress tests (Mar. 3, 2015) http://www.eba.europa.eu/-/eba-updates-on-future-eu-wide-stress-tests ("Moreover, these efforts were preceded by several years of capital raising spurred by the EBA's 2011/12 recapitalisation exercise, which led EU banks to strengthen their capital positions by over EU200bn and to start the 2014 exercise with a CET1 ratio of 11.5%. The largest EU banks CET1 ratio now stands at over 12% against 9.2% in December 2011.").

[36] Chad Bray, *European Banking Regulator Postpones Next Stress Tests to 2016*, N.Y. TIMES, Mar. 4, 2015, at B9, http://www.nytimes.com/2015/03/04/business/dealbook/european-banking-regulator-postpones-next-stress-tests-to-2016.html.

[37] Press Release, European Banking Authority, EBA Launches 2016 EU Wide Stress Test Exercise (Feb. 24, 2016), http://www.eba.europa.eu/-/eba-launches-2016-eu-wide-stress-test-exercise.

[38] Craig Torres, *Fed To Give Failing Stress Test Banks Second Chance*, BLOOMBERGBUSINESS (Nov. 9, 2012, 2:38 PM), http://www.bloomberg.com/news/articles/2012-11-09/fed-to-give-failing-stress-test-banks-second-chance.