Business Restructuring Update

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Sixth Circuit Concurrence Questions Bankruptcy Courts' Debt Recharacterization Power

In *Insight Terminal Solutions, LLC v. Cecelia Financial Management (In re Insight Terminal Solutions, LLC)*, 148 F.4th 869 (6th Cir. 2025), the Sixth Circuit reversed a bankruptcy court's exclusion of deposition testimony in a debt-versus-equity recharacterization dispute. While the majority resolved the appeal on evidentiary grounds, Judge Eric Murphy's concurrence questioned whether bankruptcy courts have any federal authority to recharacterize loans as equity. This concurrence invites the Supreme Court to resolve an entrenched circuit split that could reshape how claims are treated in bankruptcy proceedings nationwide.

Background

Cecelia Financial Management, LLC advanced approximately $5.7 million to Insight Terminal Solutions, LLC under a series of promissory notes. After Insight filed for Chapter 11 in July 2019, a reorganization plan was confirmed under which lender Autumn Wind Lending, LLC became Insight's new owner and equity interests were extinguished.

Reorganized Insight then sought to recharacterize Cecelia's $6 million proof of claim from debt to equity under the Sixth Circuit's 11-factor test from *In re AutoStyle Plastics, Inc.*, 269 F.3d 726 (6th Cir. 2001). Recharacterization would have eliminated Cecelia's claim, as equity holders received nothing under the plan.

Questioning the Foundation of Recharacterization

While the panel resolved the appeal on evidentiary grounds, Judge Murphy wrote separately to raise four principal objections to the doctrine of debt recharacterization.

First, the Bankruptcy Code's text does not expressly authorize recharacterization. Judge Murphy observed that "no specific provision of the Bankruptcy Code" grants this power. Moreover, Congress expressly listed nine situations for disallowing creditor claims under 11 U.S.C. § 502(b), suggesting it did not intend to confer an additional implied power.

Second, statutory history does not support implied recharacterization authority. Unlike equitable subordination (codified at 11 U.S.C. § 510(c)), which requires proof of inequitable conduct, recharacterization demands no such element. Judge Murphy compared the doctrine to third-party releases, calling it a "recent phenomenon."

Third, Judge Murphy challenged reliance on the catch-all provision, 11 U.S.C. § 105(a). Citing *Harrington v. Purdue Pharma L.P.*, 603 U.S. 204 (2024), he noted that § 105(a) permits courts only to carry out powers "expressly conferred elsewhere in the code" and cannot independently justify recharacterization.

Fourth, Judge Murphy argued that *AutoStyle's* factors were improperly borrowed from the tax context. In tax law, federal authority to distinguish stock from indebtedness is expressly recognized under 26 U.S.C. § 385(a). The Bankruptcy Code contains no analogous provision, and the Supreme Court has held that state law controls whether a creditor has a right to payment. Judge Murphy endorsed the Fifth and Ninth Circuits' approach that state law should govern.

Judge Murphy concluded that the "entrenched circuit conflict" means "only the Supreme Court can bring uniformity to this area."

Practical Implications

Judge Murphy's concurrence does not change existing law but serves as a roadmap for future challenges to recharacterization doctrine.

The concurrence adds to a growing body of authority constraining bankruptcy courts' exercise of powers not expressly found in the Bankruptcy Code. To the extent *Harrington* curtailed reliance on § 105(a) for third-party releases, Judge Murphy suggests the same logic applies to recharacterization.

The circuit split also remains unresolved. The Third, Fourth, Sixth, and Tenth Circuits permit federal recharacterization, while the Fifth and Ninth Circuits hold that state law governs, and Judge Murphy's concurrence may encourage litigants to seek certiorari.

In the meantime, lenders and creditors structuring transactions should note that *AutoStyle* factors still govern in the Sixth Circuit. Documenting arm's-length terms, maintaining adequate capitalization, and ensuring repayment expectations are not entirely contingent on business success remain critical defenses against recharacterization.

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