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Claims Chat

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Mandatory Subordination of Affiliate Securities Claims

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The mandatory-subordination provision of § 510(b) of the Bankruptcy Code serves the important purpose of preventing disappointed shareholders from assuming the guise of creditors in order to enhance their recoveries in bankruptcy.[1] By its terms, the statute requires subordination of claims against a debtor arising from such debtor's securities, as well as claims arising from securities of the debtor's affiliates.[2] These claims must be subordinated to "all claims or interests that are senior to or equal the claim or interest represented by such security."[3]

However, if a debtor's capital structure does not contain any class of claims for securities issued by its affiliates (which is often the case), how should such claims be treated? The U.S. Court of Appeals for the Second Circuit recently addressed this question in the *Lehman Brothers* bankruptcy cases and held that claims arising from the securities of a debtor's affiliate should be subordinated in the debtor's bankruptcy case to all claims or interests senior or equal to claims in the case that are the *same type* as the underlying security, rather than the exact security.[4] The decision's equitable approach to applying § 510(b) to the practical realities of bankruptcy cases shows the confidence of appellate courts in the ability of bankruptcy judges to tailor an application of the statute to each case's unique circumstances. The decision also provides a useful reminder for holders of affiliate securities claims that a debtor's bankruptcy case does not represent an opportunity to enhance your bargained-for priority.

Mandatory Subordination

Section 510(b) provides:

> [A] claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock."[5]

John J. Slain and Homer Kripke discussed the genesis of the statute in an article published in 1973.[6] The authors argued for the mandatory subordination of fraud and other securities law claims arising from the issuance of a debtor's securities on the basis that favorable treatment of such claims provides "investors [with] a windfall by giving them an opportunity to reap the benefits of a profitable entity and by allowing them to share with creditors in the event the enterprise was forced to reorganize or liquidate."[7] Congress enacted § 510(b) to prevent this "bootstrapping" by shareholders in a bankruptcy proceeding.[8] In doing so, the statute honors (1) the dissimilar risk-and-return expectations of shareholders and creditors, and (2) the reliance of creditors on the equity cushion provided by shareholder investment — the very

1 *Newton Nat'l Bank v. Newbegin*, 74 F. 135, 140 (8th Cir. 1896) ("When a corporation becomes bankrupt, the temptation to lay aside the garb of a stockholder, on one pretense or another, and assume the role of a creditor, is very strong, and all attempts of that kind should be viewed with suspicion.").
2 11 U.S.C. § 510(b).
3 *Id.*
4 *ANZ Secs. Inc., et al. v. Gibbons (In re Lehman Bros.)*, No. 14-3686, 2015 WL 8593604 (2d Cir. Dec. 14, 2015) ("Second Circuit Decision").
5 11 U.S.C. § 510(b).
6 John J. Slain and Homer Kripke, "The Interface Between Securities Regulation and Bankruptcy: Allocating Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors," 48 *N.Y.U. L. Rev.* 261 (1973).
7 *See Rombro v. Dufrayne (In re Med Diversified Inc.)*, 461 F.3d 251, 256 (2d Cir. 2006) (citing Slain and Kripke) (citation omitted).
8 *Baroda Hill Invs. Ltd. v. Telegrp. Inc. (In re Telegrp. Inc.)*, 281 F.3d 133, 142 (3d Cir. 2002) ("Congress enacted § 510(b) to prevent disappointed shareholders from recovering their investment loss by using fraud and other securities claims to bootstrap their way to parity with general unsecured creditors in a bankruptcy proceeding.").

policy rationales advocated by Slain and Kripke, then later adopted by Congress.[9]

Neither Slain and Kripke nor the legislative history of § 510(b) addressed claims arising from the securities of a debtor's affiliates, but Congress expressly included such claims in the final version of the statute. Presumably, Congress determined that subordination of affiliate securities claims also served the policy objectives behind § 510(b).[10]

From a practical perspective, subordination of affiliate securities claims is not as straightforward as it may seem. Generally, debt and equity issued by a debtor's affiliate do not give rise to claims or interests that might be asserted directly against the debtor's assets.[11] Notable exceptions include instances whereby the debtor has guaranteed payment on the affiliate's security, or the estates of the debtor and its affiliate are substantively consolidated. Thus, a debtor's capital structure often does not have an obviously appropriate place for the subordination of affiliate securities claims. Parties litigating this issue usually dispute whether subordination is applicable only in the narrow circumstances described above, or also when such securities (or claims for ownership thereof) are absent from the debtor's capital structure. Most courts have adopted the latter approach and grant subordination.[12]

The *Lehman Brothers* Decisions

Between 2004-08, Lehman Brothers Holdings Inc. (LBHI) issued several billion dollars' worth of securities that were underwritten by Lehman Brothers Inc. (LBI), a broker-dealer and wholly owned subsidiary of LBHI, as well as several other underwriters (the "junior underwriters"). In September 2008, LBHI sought chapter 11 relief, and LBI was placed into liquidation pursuant to the Securities Investor Protection Act of 1970 (SIPA). Following commencement of these proceedings, investors in LBHI's securities filed securities fraud lawsuits against the junior underwriters, alleging material misstatements and omissions in the offering documents. (LBI was not a defendant because of the automatic stay.) In turn, the junior underwriters filed proofs of claim against LBI in its SIPA proceeding, asserting general unsecured contribution claims for their losses related to defense costs and settlement payments. The trustee in the LBI SIPA proceeding then sought subordination of the junior underwriters' claims pursuant to § 510(b).[13]

The junior underwriters argued that § 510(b) was inapplicable to their claims. Although § 510(b) clearly includes claims arising from securities of a debtor's affiliate, such claims are subordinated "to all claims or interests that are senior to or equal the claim or interest represented by such security." According to the junior underwriters, claims "represented by" LBHI securities means claims that are based on *ownership* of LBHI securities.[14] Thus, their claims could be subordinated in the LBI SIPA proceeding only if there were existing claims in that proceeding based on ownership of the respective LBHI securities. Since the LBI estate did not independently contain securities issued by LBHI, the junior underwriters asserted that there were no claims to which their claims could be subordinated. "In other words, they argued that because the Lehman Holdings-issued securities were not otherwise part of LBI's waterfall, § 510(b) did not apply to the Junior Underwriters' claims."[15]

The bankruptcy court overseeing the SIPA proceeding disagreed. It held that the junior underwriters' interpretation of § 510(b) was hyper-technical, contorted and illogical.[16] Instead, the court held that the "claims ... represented by such security" were, in fact, the junior underwriters' claims for contribution (and not for recovery on account of the LBHI securities themselves), which constituted general unsecured claims against LBI connected in subject matter to the underlying securities.[17] Thus, the bankruptcy court held that the junior underwriters' claims should be subordinated to the claims of general unsecured creditors of LBI. The court added that "[i]f a claim 'represented by such security' were to be restricted to a recovery from the issuer for amounts outstanding under the security, then no claim arising from the purchase or sale of *affiliate* securities would ever fit within the regime for subordination. Such a result would contradict express provisions of the statute, which direct that such claims shall be subordinated."[18]

On appeal, the district court affirmed the bankruptcy court's decision, but on a different ground. The district court clarified that the issue was not whether affiliate securities claims were subject to subordination under § 510(b) — they clearly are by the statute's plain terms — but rather *how* that subordination was to occur.[19] In addition, "the level of subordination can be determined by reference to the type of claim or interest represented by such security — *e.g.*, secured, unsecured, common stock or equity. In cases involving affiliate securities, the type of security dictates the level of subordination whether or not that security represents an actual claim in the debtor's case."[20] The district court added that its interpretation promoted the purposes of § 510(b) by ensuring that creditors receive their distribution ahead of investors, and allocating the risks and costs that are associated with the issuance of securities to underwriters rather than unsecured creditors.[21]

Upon further appeal by the junior underwriters, the Second Circuit adopted the district court's analysis and held that "[c]laims arising from [the] securities of a debtor's affiliate should be subordinated in the debtor's bankruptcy proceeding to all claims or interests senior or equal to the claims in the bankruptcy proceeding that are of the *same type* as the underlying securities."[22] The Second Circuit noted that the junior underwriters' interpretation of § 510(b) would be

9 *In re Med Diversified*, 461 F.3d at 255-56; *In re Telegrp.*, 281 F.3d at 138-41 (discussing legislative history of § 510(b)).

10 Second Circuit Decision at *5-6.

11 *Liquidating Trust Comm. of the Del Biaggio Liquidating Trust v. Freeman (In re Del Biaggio)*, Case No. 12-CV-6447, 2013 WL 6073367, at *7 (N.D. Cal. Nov. 18, 2013) (citing *In re VF Brands Inc.*, 275 B.R. 725, 727 (Bankr. D. Del. 2002)).

12 *See, e.g., Templeton v. O'Cheskey (In re Am. Hous. Found.)*, 785 F.3d 143, 157 (5th Cir. 2015) (rejecting argument that claimant holding affiliate securities claim "should be treated like any other creditor of [the debtor] because [the claimant] never assumed the risks of a ... shareholder' of the debtor [because] this line of reasoning would seem to preclude mandatory subordination of *any* claim arising from the purchase of an affiliate's securities (since the securities of the affiliate are not shares in the debtor) — a result at odds with the plain language of Section 510(b).") (emphasis in original; citation omitted); *VF Brands*, 275 B.R. at 727 (concluding that "[a]pplying section 510(b) requires that the claim of Money's Trust (which is based on damages from the purchase of stock of an affiliate of the [debtors]) must be subordinated to the claims of the general unsecured creditors of the [debtors], which in the absence of that section would be equal in priority to its claim"); *Del Biaggio*, 2013 WL 6073367, at *7 (rejecting argument that affiliate and debtor securities "are not senior or junior to each other because they simply to not compete for the same assets or distributions" and subordinating fraud claim to those of debtor's unsecured creditors).

13 The SIPA trustee also sought subordination of claims asserted by two entities that were not parties to the Second Circuit appeal.

14 *In re Lehman Bros.*, 519 B.R. 434, 450-51 (S.D.N.Y. 2014) ("District Court Decision").

15 Second Circuit Decision at *2.

16 *In re Lehman Bros.*, 503 B.R. 778, 787 (Bankr. S.D.N.Y. 2014) ("Bankruptcy Court Decision"), *aff'd on other grounds*, 519 B.R. 434 (S.D.N.Y. 2015).

17 *Id.* at 787.

18 *Id.* at 785 (emphasis in original).

19 District Court Decision at 449-50.

20 *Id.* at 452.

21 *Id.* at 450, 452.

22 Second Circuit Decision at *3 (emphasis added).

feasible only in two contexts: when the estates of a debtor and its affiliate are substantively consolidated, and when the debtor has guaranteed payment on the affiliate's securities. The court refused to endorse such a narrow reading given the longstanding precedent to interpret § 510(b) broadly.[23] Further, the Second Circuit agreed with the district court that it is "'unlikely that Congress ... relied on [substantive consolidation] to provide meaning to the 'affiliate' language,' given that such consolidation is not provided for explicitly in the Bankruptcy Code," and, in fact, is not regularly granted.[24]

The Second Circuit admitted that "it may become somewhat messy to superimpose the capital structure of the affiliate onto that of the debtor" when subordinating affiliate securities claims.[25] However, the court emphasized that its approach provides flexibility for bankruptcy courts, which are "well-suited to engage in that kind of classification and discrimination."[26] Bankruptcy courts can utilize their equitable powers to group claims for subordination into narrower subcategories, and, "[w]hen granular distinctions of priority among the affiliate's securities are not mirrored in the debtor's estate ... add tiers to the waterfall, or in a different case, ... group multiple levels of priority."[27]

Conclusion

Section 510(b) is by no means the model of clarity, and many courts have found its operative language to be ambiguous.[28] However, the Second Circuit's decision in *In re Lehman Brothers* applies a common-sense approach to the statute and recognizes the particular expertise of bankruptcy courts in determining claim priorities. For example, during the claims-allowance process, bankruptcy courts regularly evaluate the appropriate priorities of asserted claims. Also, when considering plan confirmation, courts must decide whether claims and interests that are classified together under a plan are "substantially similar" as required by § 1122 of the Bankruptcy Code.[29] The Second Circuit's analysis serves as a critical reminder for parties that just because their claim does not fit perfectly within a debtor's existing capital structure, it does not mean that they can avoid mandatory subordination. Parties have to be mindful of § 510(b)'s reach and the strong policies behind it before determining that a securities-related claim should constitute a general unsecured claim. **abi**

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23 *See, e.g., Racusin v. Am. Wagering Inc. (In re Am. Wagering Inc.)*, 493 F.3d 1067, 1072 (9th Cir. 2007) ("As a remedial statute, section 510(b) should be interpreted broadly in order to effectuate the intent of Congress."); *In re Med Diversified*, 461 F.3d at 255 ("The holdings of most prominent decisions of local bankruptcy courts also support the broad interpretation of section 510(b).") (citing cases).

24 Second Circuit Decision at *3-4.

25 *Id.* at *6.

26 *Id.*

27 *Id.* at *6 and n.11.

28 *See, e.g., In re Med Diversified*, 461 F.3d at 255 ("We find that the phrase 'arising from' ... is ambiguous."); *In re Telegrp.*, 281 F.3d at 138 ("We conclude that the phrase 'arising from' is ambiguous."); Bankruptcy Court Decision at 784 ("[I]nterpreting section 510(b) is 'ambiguous or unambiguous when juxtaposed against particular factual situations.'") (quoting *KIT Digital Inc. v. Invigor Grp. Ltd. (In re KIT Digital Inc.)*, 497 B.R. 170, 178 (Bankr. S.D.N.Y. 2013)).

29 11 U.S.C. § 1122.