

## **Categorical Subordination of ESOP Claims Improper**

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Whether a bankruptcy court can subordinate a claim in a bankruptcy case in the absence of creditor misconduct continues to be an unsettled issue despite the U.S. Supreme Court's pronouncement nearly a decade ago invalidating the subordination of tax claims without any showing that the claimants acted unfairly. A ruling recently handed down by the First Circuit Court of Appeals clarifies the distinction between two forms of non-voluntary subordination sanctioned by the Bankruptcy Code — the automatic, or "categorical," subordination of certain shareholder claims, and equitable subordination of creditor claims. In *In re Merrimac Paper Co.*, the Fifth Circuit held that a bankruptcy court erred by categorically subordinating claims based upon promissory notes issued to redeem stock under an employee stock ownership plan without any finding of misconduct on the part of the individual claimants.

### **Subordination in Bankruptcy**

The concept of claim or debt subordination is well recognized under federal bankruptcy law. A bankruptcy court's ability to reorder the relative priority of claims or debts under appropriate circumstances is part and parcel of its broad powers as a court of equity. The statutory vehicle for applying these powers in a bankruptcy case is section 510 of the Bankruptcy Code.

Section 510(a) makes a valid contractual subordination agreement enforceable in a bankruptcy case to the same extent that it would be enforceable outside of bankruptcy. Subordination, however, can also be effectuated in a bankruptcy case under circumstances not involving the voluntary undertakings of two or more parties to a contract.

Section 510(b) addresses mandatory or statutory subordination of shareholder claims (also sometimes referred to as categorical subordination). It automatically subordinates any claim for damages arising from the rescission of a purchase or sale of a debtor-company's securities to the claims of ordinary creditors. Its purpose is to prevent the bootstrapping of equity interests into claims that are on a par with other creditor claims, consistent with the Bankruptcy Code's "absolute priority" rule. According to this rule, unless creditors are paid in full or agree otherwise, shareholders cannot receive any distribution from a bankruptcy estate. Most claims based upon injuries sustained by a shareholder of an insolvent estate will be categorically subordinated under section 510(b).

Misconduct that results in injury to creditors can warrant the "equitable" subordination of a claim under section 510(c). The statute does not specify what kind or degree of misconduct justifies application of the remedy, providing merely that the bankruptcy court may "under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim." It has been left to the courts to develop criteria for determining whether equitable subordination is appropriate.

In 1977, the Fifth Circuit Court of Appeals articulated what has become the most commonly accepted standard for equitably subordinating a claim. Under the *Mobile Steel* test, a claim can be subordinated if the claimant engaged in some type of inequitable conduct that resulted in injury to creditors (or conferred an unfair advantage on the claimant), and if equitable subordination of the claim is consistent with the provisions of the Bankruptcy Code. Courts have since refined the test to account for special circumstances. For example, many make a distinction between insiders (*e.g.*, corporate fiduciaries) and non-insiders in assessing the level of misconduct necessary to warrant subordination. Regardless of the standard applied, two principles are clear under the *Mobile Steel* test: equitable subordination requires some kind of misconduct and a claim or interest will be subordinated only to the extent necessary to redress it.

Although the majority of courts follow the *Mobile Steel* approach, some courts have taken issue with the principle that subordination of non-shareholder claims requires a showing of misconduct that injures other creditors. In many cases, their reasoning derives from decisions and policies that pre-date enactment of the Bankruptcy Code in 1978. They also rely on statements in the legislative history of section 510(c) indicating that pre-Code decisions can assist in determining the priority of claims under the Bankruptcy Code. For example, a long line of cases in the First Circuit stands for the proposition that stock redemption claims should be categorically subordinated even though such claims may not fall within the scope of present-day section 510(b).

In 1996, the U.S. Supreme Court strove to dispel any lingering uncertainty concerning the scope of section 510(c) in a pair of rulings. In *United States v. Noland*, the Court found that section

510(c) does not permit a court to subordinate a noncompensatory tax penalty claim of the IRS that would otherwise have been entitled to administrative expense priority. In part, the ruling was predicated on the idea that section 510(c) codifies the equitable power of the bankruptcy court to consider claims on a case-by-case basis. The subordination of tax penalty claims based on a general policy, rather than the claim's merits, the Court reasoned, represents an inappropriate exercise of section 510(c) in a legislative, rather than equitable, manner. The Supreme Court employed similar reasoning to invalidate subordination of an unsecured tax penalty claim in *United States v. Reorganized CF & I Fabricators of Utah, Inc.*

### **The First Circuit's Ruling in Merrimac Paper**

Ralph Harrison worked at Merrimac Paper Company, Inc. ("Merrimac") from 1963 to 1999. In 1985, Merrimac established an employee stock option plan ("ESOP") qualified under the Employee Retirement Income Security Act ("ERISA"). The ESOP provided that retiring workers would be vested with shares of Merrimac's non-publicly traded stock. At any time within 15 months of retirement, an employee could exercise a put option and force Merrimac to purchase the stock for fair market value, as determined by a third-party appraisal. Merrimac could elect to pay any exercised put option over a period not to exceed five years, in which case it had to pay interest on the deferred principle balance and provide "adequate security" for the deferred payments.

Harrison exercised the put option in 2000. Rather than purchase the stock, Merrimac gave him an interest-bearing promissory note in the amount of \$916,300 to be amortized in three equal annual installments. Merrimac failed to make the second annual payment on the note. Harrison

sued in both state court on a breach of contract and in federal district court on several causes of action arising under ERISA. Merrimac filed for bankruptcy while both actions were pending.

Harrison asserted both a claim under the note (the "Note Claim") and a claim based on the ERISA lawsuit (the "ERISA Claim"). Merrimac sought to subordinate both claims and filed a chapter 11 plan that subordinated all claims related to stock redemption notes. The bankruptcy court ruled that the ERISA Claim could be subordinated under section 510(b), but that the Note Claim fell outside the scope of that provision because it was properly based upon a debt. Even so, the court held that it did have the ability to subordinate categorically all stock redemption claims, including the Note Claim, under section 510(c). Harrison appealed to the First Circuit after the district upheld that determination on appeal.

The Court of Appeals reversed. After examining the language and history of section 510, as well as relevant Supreme Court precedent, the First Circuit concluded that categorical subordination was inappropriate under section 510(c). It held that *Noland* and *CF&I* overrule pre-Code decisions authorizing categorical subordination of stock redemption claims. Subordination under section 510(c), the Court of Appeals observed, requires an analysis of the equities of a particular case rather than the "taxonomic status" of a claim.

The First Circuit proceeded to examine the equities of the Note Claim. Noting that the ESOP was a highly-regulated ERISA qualified plan, the Court explained that ERISA rules require that ESOPs include put options to force employers to repurchase stock owned by retiring employees in cases where the stock is not readily tradable, although employers may elect to pay the

purchase price over time provided it posts adequate security. Based upon these requirements, the First Circuit concluded that retirees in ESOPs are not supposed to be subject to the risks of a typical equity investor once they retire. By exercising his put option, the Court of Appeals reasoned, Harrison legitimately chose to transform his legal relationship with Merrimac from that of equity investor to creditor, as ERISA expressly gave him the right to do. Under the circumstances, including the absence of any allegation of misconduct on Harrison's part, the First Circuit found that it would be inequitable to subordinate his claims under section 510(c).

### **Analysis**

The outcome of *Merrimac* is logical and defensible based upon the circumstances of the case. Unfortunately, the ruling will do little to resolve the ongoing debate concerning whether, in the wake of *CF&I* and *Noland*, equitable subordination requires a finding of inequitable conduct by the claimant. The First Circuit was also careful to leave itself room to find that stock redemption notes issued in non-ERISA cases could be equitably subordinated under section 510(c) of the Bankruptcy Code, even if subordination is not appropriate under section 510(b).

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*Merrimac Paper Company, Inc. v. Harrison (In re Merrimac Paper Co., Inc.)*, 420 F.3d 53 (1<sup>st</sup> Cir. 2005).

*In re Mobile Steel Co.*, 563 F.2d 692 (5th Cir. 1977).

*United States v. Noland*, 517 U.S. 535 (1996).

*United States v. Reorganized CF & I Fabricators of Utah, Inc.*, 518 U.S. 213 (1996).