# Mandatory Subordination Under Section 510(b) Extends to Claims Arising From Purchase or Sale of Affiliate's Securities

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Section 510(b) of the Bankruptcy Code provides a mechanism designed to preserve the creditor/shareholder risk allocation paradigm by categorically subordinating most types of claims asserted against a debtor by equity holders in respect of their equity holdings. However, courts do not always agree on the scope of this provision in undertaking to implement its underlying policy objectives. A New York bankruptcy court recently addressed this issue in *In re Lehman Brothers Inc.*, 2014 BL 21201 (Bankr. S.D.N.Y. Jan. 27, 2014). Concluding that the provision is unambiguous, the court ruled that claims asserted against a debtor arising from securities issued by the debtor's corporate parent are subject to subordination under section 510(b).

## 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 bankruptcy.

Section 510(b) addresses mandatory, or "statutory," subordination of shareholder claims (also sometimes referred to as "categorical" subordination). Section 510(b) automatically subordinates to the claims of ordinary creditors any claim: (i) arising from the rescission of a purchase or sale

of a security of the debtor or an affiliate; (ii) for damages arising from the purchase or sale of such a security; or (iii) for reimbursement or contribution on account of such a claim.

Finally, misconduct that results in injury to creditors can warrant the “equitable” subordination of a claim under section 510(c).

## Subordination of Shareholder Claims Under Section 510(b)

The purpose of section 510(b) 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.

Shareholders have resorted to a wide array of devices and/or legal arguments in an effort to overcome this basic legal premise, including contractual provisions purporting to entitle them to damages upon the issuer’s breach of a stock purchase agreement and alternative theories of recovery, such as unjust enrichment and constructive trust. *See generally Stucki v. Orwig*, 2013 BL 98362 (N.D. Tex. Apr. 12, 2013) (discussing case law).

Many courts have decided cases under section 510(b) by reviewing the traditional allocation of risk between a company’s shareholders and its creditors. Under this policy-based analysis, shareholders are deemed to expect more risk in exchange for the potential to participate in the profits of the company, whereas creditors can expect only repayment of their fixed debts. Accordingly, shareholders, and not creditors, assume the risk of a wrongful or unlawful purchase

or sale of securities (this risk allocation model is sometimes referred to as the "Slain/Kripke theory of risk allocation"). Because of the parties' differing expectations for risk and return, it is perceived as unfair to allow a shareholder to recover from the limited assets of a debtor as a creditor by "converting" its equity stake into a claim through the prosecution of a successful securities lawsuit. The method by which such a conversion is thwarted is mandatory subordination of the shareholder's claim under section 510(b).

In *Lehman Brothers*, the bankruptcy court considered, among other things, whether section 510(b) should be applied to subordinate claims against a debtor for damages arising from the debtor's breach of a contract involving the purchase or sale of a security not of the debtor, but of the debtor's corporate parent.

### ***Lehman Brothers***

Lehman Brothers Inc. ("LBI") was the primary brokerage subsidiary of Lehman Brothers Holdings Inc. ("LBHI"). Claren Road Credit Master Fund, Ltd. ("Claren Road") opened a prime brokerage account with LBI in December 2005.

LBI also served as underwriter with several co-underwriters in connection with various LBHI securities offerings. In December 2005, LBI and certain co-underwriters entered into a master agreement providing, among other things, that each underwriter was obligated to contribute toward losses or liabilities incurred by other signatory underwriters arising from allegations that any relevant offering materials contained misstatements or omissions.

On September 12, 2008, Claren Road and LBI entered into a transaction whereby LBI agreed to purchase from Claren Road approximately €10 million in notes issued by LBHI. Three days later, LBHI filed for bankruptcy, and LBI never performed its obligation under the contract.

On September 19, 2008, four days after LBHI was forced to file the largest chapter 11 case in history, the Securities Investor Protection Corporation sought an order from a New York district court for a protective decree for LBI under the Securities Investor Protection Act of 1970 ("SIPA"), in the largest broker-dealer liquidation ever. The district court issued the protective decree, appointed a trustee to oversee LBI's liquidation, and referred the case to the bankruptcy court.

A SIPA case proceeds in the bankruptcy court very much like a chapter 7 liquidation, with certain exceptions. SIPA expressly provides that to the extent consistent with SIPA's provisions, "a liquidation proceeding shall be conducted in accordance with, and as though it were being conducted under chapters 1, 3, and 5 and subchapters I and II of chapter 7 of title 11." Thus, among other things, the Bankruptcy Code's claims resolution (i.e., allowance and disallowance) provisions—including section 510(b)—generally apply in a SIPA case.

Claren Road timely filed a claim in LBI's SIPA case for damages arising from the breach of the securities contract. After the collapse of LBHI and LBI, numerous investors sued the co-underwriters, alleging that LBHI's offering documents contained material misstatements and omissions. The co-underwriters filed claims against LBI seeking contribution under the master

agreement for millions of dollars in defense costs and settlement payments incurred in connection with the litigation.

LBI's SIPA trustee objected to the claims of both Claren Road and the co-underwriters, arguing that all of the claims should be subordinated in accordance with the plain language of section 510(b).

**The Bankruptcy Court's Ruling**

Noting that "[t]he Court of Appeals for the Second Circuit along with the bankruptcy courts within the Second Circuit have uniformly applied a 'broad interpretation of section 510(b),' " the bankruptcy court ruled that the Claren Road and co-underwriter claims must be subordinated (citing *Rombro v. Dufrayne (In re Med Diversified, Inc.)*, 461 F.3d 251 (2d Cir. 2006), and *KIT Digital, Inc. v. Invigor Group Ltd. (In re KIT Digital, Inc.)*, 497 B.R. 181 (Bankr. S.D.N.Y. 2013)).

The bankruptcy court explained that the language of section 510(b) is plain and, enforced in accordance with its unambiguous meaning, mandates subordination of the claims. The court rejected Claren Road's efforts to characterize its claim as one for breach of contract due to LBI's failure to acquire the LBHI bonds. According to the court, Claren Road's claim was "unmistakably . . . a claim 'for damages arising from the purchase or sale' of the LBHI Bonds."

The bankruptcy court also rejected Claren Road's argument that section 510(b) is ambiguous when applied to a claim arising from the purchase or sale of a security of a debtor's affiliate. Claren Road's claim, the court observed, "fits comfortably within that portion of section 510(b)

which mandates subordination because it is a claim ‘for damages arising from the purchase or sale’ ‘of a security of the debtor or of an affiliate.’ ”

The court acknowledged that Claren Road’s contention that claims “represented by” the LBHI bonds may not be subordinated because the LBHI bonds have no claim against the LBI estate “calls for a closer examination of section 510(b).” Even so, the bankruptcy court characterized as “too narrow” Claren Road’s suggestion that subordination must “relate to the capital structure” that includes the securities—here, the capital structure of LBHI—because it “fails to recognize the common meaning of words used in the statute.”

A more reasonable construction of the language of section 510(b), the court explained, is that the “ ‘claim . . . represented by [the LBHI Bonds]’ is not directed to a recovery from LBI on account of the LBHI Bonds but extends to the breach of contract claim asserted by Claren Road against LBI with respect to these bonds.” According to the court, interpreting the phrase “claim or interest represented by such security” in this fashion is a “common sense interpretation” of section 510(b):

> If 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.

The court found support for its approach in *In re VF Brands, Inc.*, 275 B.R. 725 (Bankr. D. Del. 2002), and *Liquidating Trust Comm. of the Del Biaggio Liquidating Trust v. Freeman (In re Del Biaggio)*, 2013 BL 319638 (N.D. Cal. Nov. 18, 2013). The courts in both of those cases, which involved comparable facts, concluded that claims based upon damages arising from the purchase

of securities of an affiliate of the debtors must be subordinated under section 510(b) to the claims of the general unsecured creditors of the debtors.

Claren Road argued in *Lehman Brothers* that section 510(b)'s legislative history warrants a different result because lawmakers did not intend to subordinate the type of claim asserted by Claren Road. The bankruptcy court rejected this argument. References to legislative history, the court wrote, "are unpersuasive in the current setting where the statute can be understood without reference to background sources."

Finally, for substantially the same reasons articulated in connection with Claren Road's claim, the court ruled that the co-underwriters' contribution and indemnity claims must be subordinated in accordance with the plain meaning of section 510(b). Dismissing the co-underwriters' "strained argument" that "focuses myopically" on what it means for a claim to be "represented by" the securities of an affiliate of the debtor, the bankruptcy court wrote that "a claim made by the Co-Underwriters for reimbursement or contribution is a claim represented by LBHI securities and not necessarily a claim to recover amounts invested in these securities."

## Outlook

*Lehman Brothers* is consistent with the case law trend within the Second Circuit (and elsewhere) of broad interpretation of section 510(b). By subordinating claims arising from the purchase or sale of securities issued by an affiliate of the debtor, the bankruptcy court's ruling undeniably comports with what the court concluded was the plain language of the provision.

Even so, this approach is not universally endorsed in this context, especially if literal application of the statute is inconsistent with its perceived policy objectives—i.e., preserving the risk allocation model between creditors and equity holders. For example, every circuit court that has examined the "arising from" language in section 510(b) has found it to be ambiguous. *See In re SeaQuest Diving, LP*, 579 F.3d 411 (5th Cir. 2009); *In re American Wagering, Inc.*, 493 F.3d 1067 (9th Cir. 2007); *Med Diversified*, 461 F.3d at 258–59; *In re Geneva Steel Co.*, 281 F.3d 1173 (10th Cir. 2002); *In re Telegroup, Inc.*, 281 F.3d 133 (3d Cir. 2002); *In re Betacom of Phoenix, Inc.*, 240 F.3d 823 (9th Cir. 2001). Due to this ambiguity, these courts of appeal, and many other like-minded courts, have deemed it appropriate to examine the provision's legislative history and, having done so, have reached varying conclusions regarding the scope of mandatory subordination under section 510(b). Moreover, on the basis of the legislative history and section 510(b)'s underlying policy considerations, some commentators have posited that claims subject to subordination should be limited to: (i) those seeking to recover the decrease in value of investments in a debtor's securities; and (ii) those whose claimants are seeking to transform residual equity interests into general unsecured claims. *See* N. Theodore Zink, Jr., and Christy Rivera, *Are There Any Limits to Mandatory Subordination Under Section 510(b) of the Bankruptcy Code?*, PRATT'S J. BANKR. L. (March 2007).

The *Lehman Brothers* court found no ambiguity in section 510(b) and accordingly declined to examine either its legislative history or, with one exception discussed below, its policy objectives vis-à-vis the specific factual context involved. As a consequence, the court was not receptive to the argument that a breach-of-contract claim against a broker for failure to execute a trade is simply not the kind of claim that section 510(b) is intended to address.

The court did acknowledge that “there is a level of difficulty added in applying subordination under section 510(b) when the debtor is a broker-dealer, especially one as large and active as LBI,” due to the large number of transactions involving securities of both affiliates and nonaffiliates. It accordingly distinguished between claims arising from the purchase or sale of LBI-affiliated securities, which must be subordinated under section 510(b), and claims arising from the purchase or sale of securities issued by unaffiliated parties, which are not subject to categorical subordination.