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Claimants Fight **Subordination**

The expansion of §510(b) continues.

RECENTLY the U.S. Court of Appeals for the Fifth Circuit affirmed a decision of the U.S. Bankruptcy Court for the Southern District of Texas, which subordinated a claim of $2,742,114 on the ground that the claim "arose from" the rescission of a purchase or sale of a security under §510(b) of the Bankruptcy Code, 11 U.S.C. §510(b).[1] *SeaQuest Diving LP et al. v. S&J Diving Inc. (In re SeaQuest Diving LP)*, 2009 WL 2450680 (5th Cir. Aug. 12, 2009) (*SeaQuest*).

BY LAURENCE MAY

This is the most recent in a series of decisions rendered by the federal courts of appeals over the last several years to grapple with the application of §510(b) to a claim that does not readily fall within the statute's language.

The decision continues the gradual expansion of the statute's embrace. Like the Second, Third, Ninth and Tenth circuits, in applying the statute to a claim that might not seem to be covered by its plain language, the Fifth Circuit judged §510(b) to be ambiguous.

Like its sister circuits, it held subordination in *SeaQuest* to be consistent with Congressional intent and the statute's policies, although it is debatable whether Congress ever intended that a statute enacted largely to address the pre-bankruptcy code practice of granting creditor status to shareholder rescission claims arising under state and federal securities laws should be so widely applied.

As *SeaQuest* shows, courts continue to use §510(b) to subordinate claims when other ways of reaching the same result might also be available.

The specific issue in *SeaQuest* was whether a damage award included in a broader judgment that rescinded several agreements, including a contribution agreement through which the claimant (S&J) acquired a limited partnership interest in the debtor was one arising from the rescission of a purchase or sale of a security.

If the damage claim "arose from" the rescission of the limited partnership contribution agreement, then §510(b) would require that it be subordinated to creditor claims. Although pre-*SeaQuest*, there was a body of case law interpreting damages arising from a purchase of a security, no case had ever considered when a damage claim might arise from rescission of a security transaction. The Fifth Circuit characterized it as one of first impression.[2]

The 'SeaQuest' Story

The debtor, SeaQuest, was a limited partnership whose general partner was a limited liability company. Both the debtor and its general partner were formed in June 2006, and each limited partner was a member of the general partner.

Within two months of formation, the limited partners were at each other's throats. A lawsuit was started, but quickly settled—or at least settled in principle. The contestants, however, could not agree on how the settlement should be consummated and so a second suit was commenced.

A second settlement was soon reached, but once again, the parties failed to close on their agreement. It provided that S&J would withdraw from the debtor and that the contribution agreement under which S&J transferred assets to SeaQuest in exchange for equity would be rescinded and the assets returned. As part of the settlement, SeaQuest agreed to reimburse S&J $2.3 million. The Fifth Circuit repeatedly referred to this amount as a capital contribution made by S&J after SeaQuest's formation.

Lastly, SeaQuest agreed to pay S&J $442,114, which the court described as "an amount that is equivalent of what would have been called a priority return under the partnership agreement had S&J not rescinded its partnership interest." *SeaQuest* at p. 7.

When the second settlement fell apart, S&J pursued its litigation to enforce the agreement. Ultimately, a Texas state court entered judgment rescinding the contribution agreement and awarding S&J the amounts to which it claimed it was entitled under the second settlement agreement.

After SeaQuest filed Chapter 11, an adversary proceeding to subordinate the damages part of the judgment was brought, with the plaintiffs contending that the damage award was subject to §510(b) subordination because it arose from the rescission of S&J's equity interest.

How to Apply §510(b)?

As with earlier court of appeals opinions,[3] the *SeaQuest* court found that application of §510(b) to the facts before it could not be determined from the plain language of the statute, and so concluded that a review of the statute's legislative history and policies was needed.

The court characterized the specific issue before it as whether the damage claim "arose from" "post-issuance rescission" of the agreement by which SeaQuest returned S&J's initial equity contribution in the debtor.

The Fifth Circuit examination of the legislative history and the policy objectives behind §510(b) led it to the 1973 law review article of professors John J. Slain and Homer Kripke, "The Interface Between Securities Regulation and Bankruptcy—Allocating the Risk of Illegal Securities Issuance Between Security Holders and the Issuer's Creditors," 48 N.Y.U.L. Rev. 261 (1973). When Congress enacted §510(b), it generally adopted the Slain and Kripke position that claims of rescinding shareholders arising under the securities laws should be subordinated to general creditor claims in bankruptcy. See, e.g., *In re Geneva Steel*, 281 F.2d 1173, 1177 (10th Cir. 2002).

At the time professors Slain and Kripke wrote their article, rescinding shareholders of a bankrupt entity who demonstrated that their purchase of stock was tainted by the debtor's violation of federal or state securities laws were given allowed damage claims at least on par with those of general unsecured creditors. In certain cases, these claims were even granted a priority over unsecured creditor claims.

Slain and Kripke argued that permitting shareholders to assert these type of damage claims on a par with creditors was at odds with the absolute priority rule, a cornerstone of bankruptcy, and wrongly gave precedence to state and federal securities laws over bankruptcy law. This practice, they contended, gave shareholders who took investment risks an unfair advantage when the issuer became distressed.

Moreover, they noted that rescinding shareholder claims arising out of violations of the securities laws was the one exception to the bankruptcy rule that "stockholders seeking to recover their investments

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cannot be paid before provable creditor claims have been satisfied in full." 48 N.Y.U.L. at 261.

In their article, Slain and Kripke suggest that the issue of priority should be "re-conceptualized as one of risk allocation." In their view, "one interest should be weighted far more heavily than at present: the reliance interest of persons having the normal expectation that equity investment and junior debt will bear the first losses of the enterprise." Id. at 263. They intended that as between purchasers who were misled by a defective or fraudulent stock offering and creditors, creditors should have the first claim to the enterprise's assets.

This followed from the notion that purchasers of stock assume the risk of the issuer's failure in return for the theoretically unlimited upside should the issuer succeed. Creditors, on the other hand, have no such expectations. It was "the stockholder [who] takes the profit and [provides] a cushion of security" for the creditor's claim. Id. at 286.

Although Slain and Kripke were largely concerned with securities fraud claims arising out of the purchase of stock and the proper ordering of those claims in bankruptcy, courts have consistently cited to the article to support the expansion of the statute to claims that Slain and Kripke might very well have concluded should not be subordinated. These decisions have found support for their position in the brief comment by the authors that they were "only incidentally concerned with the precise predicate of a disaffected shareholder's efforts to recapture his investment from the corporation." Id. at 267.

In fact, Slain and Kripke recognized that there are instances when claims of pre-bankruptcy shareholders ought not have their claims viewed as an "effort to recapture" an investment at the expense of creditors.

"In considering allocation of the risk of business insolvency, it is useful to compare the court's treatment of rescinding shareholders with their treatment of former shareholders who have become creditors through a stock redemption-deferred payout plan. [I]n many ways the former shareholder seeking deferred payment as a creditor presents a considerably more appealing case for priority than does the rescinding shareholder." Id. at 287.

Fifth Circuit Decision

While the *SeaQuest* court acknowledged that Slain and Kripke and the legislative history to §510(b) emphasized rescission claims arising out of securities fraud, it accepted the view that the statute did not have to be limited to those type of claims.

While courts have "expanded the scope of § 510(b) beyond the securities fraud context, they have done so in cases where the claimants actually held stock or were promised stock in the debtors at the time of the bankruptcy." *SeaQuest* at p. 12. The court viewed these type of claims, where a shareholder retains (or expects to receive) equity differently from claims of shareholders who had redeemed their interests pre-petition and thus had no equity risk.[4]

This recognition that claims based upon pre-petition redemption of stock have not been subordinated whereas claims of actual or aspirational shareholders have, caused the court some difficulty in explaining why the claim in *SeaQuest*, which arose after rescission, fell under the statute.

The court was of the view that "post-rescission" claims should be viewed in the same way as claims of shareholders that arose after they acquired their shares.

"[W]e find that the rescission category also extends to claims arising from post-issuance conduct." *SeaQuest* at p. 12. It went on to hold that the damage claim must be subordinated under §510(b) because it arose from the rescission.

"All of SeaQuest's financial obligations under that agreement arose from the rescission including its obligation to pay S&J the priority return." Id. at 14.

It is fairly evident that the *SeaQuest* court viewed the claim for damages as, in substance, a request by a partner that its equity contributions to a now insolvent debtor be treated the same as a creditor claim. Such treatment would be at odds with the absolute priority rule.

It is debatable whether Congress ever **intended** that a statute enacted largely to address the **pre-bankruptcy code** practice of granting creditor status to shareholder rescission claims arising under state and federal securities laws should be so **widely applied**.

"S&J recovered the entirety of the asset component of its equity investment through rescission, and now it seeks to share the cash component of its equity investment pari passu with the unsecured creditors. In violation of the absolute priority rule, this investor wants to be treated as a secured creditor with respect to its contributed assets and an unsecured creditor with respect to its contributed cash." *SeaQuest* at p. 14.

No doubt it struck the court as neither fair nor equitable that a return of an equity contribution be given the same treatment, as say, a vendor claim. However, could not this result have been reached without resort to §510(b) and without the need for labeling the claim, based upon "post-rescission issuance?"

There is no indication in the opinion that the court or the parties ever considered whether a claim for a return of equity in an insolvent debtor would be permissible under state law or might constitute a fraudulent conveyance. Clearly, there may have been reasons why these alternate theories were not pursued but they are not apparent from the decision.

Further Expansion Likely

It appears likely that courts will continue a case-by-case expansion of §510(b) and it would not be surprising to soon see a decision arising out of a securitization.

Purchasers of asset-backed securities issued by special purposes trusts are now plaintiffs in class action suits against affiliates of debtors such as Lehman Brothers Holdings Inc. and Washington Mutual Inc. (WaMu). These plaintiffs have, or can be expected to file claims in the bankruptcy proceedings arising out of their purchase of the asset-backed securities. Although these claims would not seem to fall within §510(b), given the approach taken to the statute by the courts, that is far from certain.

The WaMu bankruptcy case provides a good example of the type of issues that would arise in applying §510(b) to claims of purchasers of securities issued by special purpose vehicles. In the WaMu class action, plaintiffs have alleged claims arising out of omissions and misstatements in the issuer's registration statements. While the securities were issued by special purpose vehicles, various affiliates of WaMu along with WaMu played important roles in connection with the issuance.

At first blush, it is difficult to see how the statute could apply to these types of claims. Courts would have to find, for example, that the certificates were issued by an affiliate of the debtor for §510(b) to apply.[5] If this threshold issue were met, troubling issues would still remain, including deciding to whom the claimants should be subordinated.

After all, these securities were not issued by the debtor and they are not part of the debtor's capital structure. Not only are they not claims to the debtor's equity, the securities themselves do not entitle the holders to make claims against the debtor. Yet should it be found that these securities were issued by an affiliate of the debtor and that the claim arose from the purchaser of an affiliated security, a court could revert to a "plain language" approach.

1. In relevant part, §510(b) provides that for purposes of distribution of a debtor's assets under the Bankruptcy Code, a claim "arising from rescission of a purchase or sale of the security of a debtor or of an affiliate of the debtor…shall be subordinated to all claims or interests that are senior to or equal to the claim or interest represented by such security, except that if such security is common stock, such security has the same priority as common stock."

2. The case was certified by the district court for direct appeal to the court of appeals from the bankruptcy court under 28 U.S.C. §158(d)(2).

3. See, e.g., *Rombro v. Dufrayne (In re Med Diversified)*, 461 F.3d 251 (2d Cir. 2006); *In re Geneva Steel Company*, 281 F.3d 1173 (10th Cir. 2002).

4. Compare *Baroda Hill Investments Ltd. v. Telegroup Inc (In re Telegroup)*, 281 F.3d 133 (3d Cir. 2002), and *In re Med Diversified*, supra, with *In re Montgomery Ward Holding Corp.*, 272 B.R. 836 (Bankr. D. Del. 2001) and *In re Mobile Tool Int'l Inc.*, 306 B.R. 778 (Bankr. D. Del. 2004).

5. The Bankruptcy Code defines an affiliate as an entity that directly or indirectly owns, controls or holds with power to vote 20 percent or more of the voting securities of the debtor, or a corporation whose outstanding voting securities are directly or indirectly owned, controlled or held with power to vote by the debtor or a person whose business is operated under a lease or operating agreement by a debtor or persons substantially all of whose property is owned or operated under an operating agreement with the debtor or an entity that operates the business or substantially all of the property of the debtor under a lease or operating agreement.